INSOL INTERNATIONAL

TREATMENT OF SECURED CLAIMS IN INSOLVENCY AND PRE-INSOLVENCY PROCEEDINGS

Treatment of Secured Claims in Insolvency and Pre-Insolvency Proceedings

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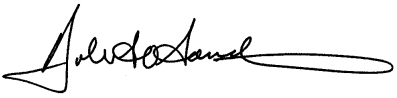
Although *pari passu* distribution amongst creditors is the underlying principle in an insolvency, in practice all creditors do not get treated equally. Indeed, some creditors achieve a full recovery and some classes of creditors are entitled to payment before others. The treatment of secured claims in pre-insolvency and insolvency is a matter that insolvency practitioners are constantly dealing with and the complexities that arise are inevitably different in each case. The security and insolvency laws in countries vary considerably and to find sound practical information quickly is often difficult. It is for this reason that INSOL decided to publish this book on *Treatment of Secured Claims in Insolvency and Pre-Insolvency Proceedings*.

The book is divided into 12 country chapters and is presented in a question and answer format making it very user friendly. Each chapter covers a wide range of key issues that are important to insolvency practitioners including the type of security rights available in each jurisdiction, how security rights are enforced, and grounds upon which security rights can be challenged or avoided if they are deemed to have given preferential treatment prejudicial to the rights of the debtor or third parties. The chapters also deal with priorities over secured creditors and how they can protect their rights. Issues that are particularly relevant to secured creditors in the event of corporate reorganisations are also covered. Where the insolvency and security laws are being reformed, information of those pending reforms have also been included.

This project was led and co-ordinated by Andrew DeNatale of White & Case LLP, New York. Andrew took over this project at short notice and has since given invaluable support to guide this book to publication. Our sincere thanks to Andrew for his assistance which we appreciate very much.

We hope this book will be a useful and valuable addition to your library.



Robert O. Sanderson
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Foreword

Consistent with INSOL's mission statement to "facilitate the exchange of information and ideas", the Technical Research Committee has produced a comparative study of the treatment of secured claims in pre-insolvency and insolvency proceedings across the globe. By using a standard template, the study provides a handy, well-organized reference tool outlining the issues impacting the enforcement of those security rights in such proceedings.

The study bolsters the common wisdom that it is better to be a secured creditor than an unsecured creditor by clearly illustrating the advantages and limitations of secured status in the twelve sample jurisdictions. It is the Committee's hope that the study will enable INSOL members to leverage common wisdom into uncommonly sound advice.

The project would not have been possible without the help and support of others. The initial acknowledgement must go to the Technical Research Committee for developing the concept and format of the project. Thank yous are likewise in order for each of the contributors who submitted excellent material for the jurisdictions covered by the project. Finally, thank you as well to my colleague, Evan Hollander, who assisted in drafting the materials on the United States as well as editing chapters of many of the other jurisdictions.

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Australia

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

The types of available security rights

The most common form of security over land is a real property mortgage, and the rights of mortgagees of land will depend on the terms of the mortgage, the relevant legislation, and the type of land involved. (In Australia, there are three main systems of landholding – general law (common law) land, Torrens title and Crown lease.)

Security interests over goods vary greatly in form and include:

– bills of sale;

– fixed and floating charges under the Corporations Act 2001;

– security interests specific to certain goods such as stock mortgages;

– liens on documents, specific goods and some crops;

– registered security interests over motor vehicles and trailers; and

– retention of title clauses.

In commercial lending and supply situations, the most important of these securities are charges, retention of title clauses and real property mortgages. All three are private contractual arrangements, although charges and mortgages require public registration.

Retention of title clauses

Retention of title is a method by which a person who agrees to sell goods retains title to the goods until some specified event occurs. Usually this event is payment of the price of the goods, but title to goods can be retained until payment of:

– the price of those goods, and other goods previously supplied; or

– all money owed by the buyer to the seller.

Enforcement means that the seller demands return of the goods, and ultimately retakes possession of them from the buyer. Since the seller is, and the buyer is not, the owner of the goods, this demand cannot be resisted either by the buyer, or anyone claiming through the buyer, except a customer of the buyer who previously bought the goods in the ordinary course of the buyer's business. Thus the seller's claim to the goods is superior to that of a company receiver and manager appointed by a secured creditor of the buyer, and is still available to the seller notwithstanding the buyer's liquidation. If a voluntary administrator is appointed for the buyer, this may delay enforcement of a retention of title clause.

Retention of title or charge?

The simplest retention of title clause allows the seller to reclaim the goods while they remain unsold and identifiable in the seller's hands. One of the most difficult issues with such clauses is the extent to which they can be drafted so as to allow the seller to also claim the proceeds of any sale by the buyer, or to claim goods manufactured with, or that incorporate, the seller's goods. If this is attempted, there is a danger that the clause will be interpreted by a court as creating a charge on property of the seller in favour of the buyer, rather than as simply retaining title.

Retention of title and creation of security by way of charge are different concepts. A charge given by a company requires registration under the Corporations Act (see below), whereas a retention of title clause does not. It may be important that the seller does obtain an interest in proceeds of sale, or in other goods incorporating the goods sold, or even in the proceeds of sale of those other goods.

Charges

Charges are a security interest over the property of a company. There are two basic types of charges – fixed and floating. A fixed charge attaches to a specific item or property described in the instrument creating the charge or security document. Its main effect is to prevent the company disposing of that

item of property without the permission of the chargeholder. A floating charge is a security over a collection of variable assets (such as the company's stock, book debts, etc). The company is free to deal with the assets in the normal course of business (eg, by trading its stock). However, the charge documentation will specify a number of "acts of default". When any of these occurs, the charge becomes "fixed" on whatever assets happen to be covered by the charge at that time. The effect is then to prevent the company from disposing of any of those assets.

Charges must be registered on a public register maintained by the Australian Securities and Investments Commission (ASIC). An unregistered charge is void if the company goes into administration or winding up. If the charge is registered late, it loses priority to any charge over the same property that was registered before it.

In practice, a charge confers two main benefits on the chargeholder:

– in the event of default, the chargeholder can appoint a receiver to take possession of the property, sell it and remit the proceeds to the chargeholder (as to receivers, see below);

– in the event of the company being wound up, the charged property is not available for payment of the company's unsecured creditors.

Mortgages

Mortgages are securities over real property. As with charges, they must be recorded on a public register (albeit one maintained by the State in which the property is located, rather than on a single ASIC register).

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

Subject to some exceptions, security rights are generally enforced out of court. The major exception is the enforcement of a charge while a company is in voluntary administration (see below).

The rights of secured creditors and the remedies available to them are dependent upon the nature, extent and terms of the security held, as well as the Corporations Act and the common law.

A secured creditor can elect to:

– appoint a receiver, should a charge be held over property of the company (no court process required);

– if the creditor holds a charge over the whole or substantially the whole of the company's property, appoint a voluntary administrator (no court process required);

– seek to sell (or, in unusual cases, repossess) real property or assets over which a mortgage is held (court process usually required);

– apply to have the company wound up by the court; or

– commence judicial recovery proceedings.

Three practical difficulties commonly affect the enforcement of security through the appointment of a receiver:

– a court challenge by the company to the appointment of the receiver, often turning on whether the contractual pre-conditions for the appointment had been satisfied;

– the appointment of a liquidator to the company, although receivership and winding up can exist side-by-side, there can be disputes relating to either the relative priority for payment of the liquidator's and the receiver's remuneration and expenses or the validity of the security under which the receiver was appointed; and

– the appointment of a voluntary administrator can impose a temporary moratorium on the enforcement of charges (see below).

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

Who can initiate the proceeding?

What are the criteria used for opening the proceeding?

Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.

Does the debtor remain "in possession" of the business?

The main corporate insolvency and pre-insolvency procedures currently available in Australia are:

- Voluntary administration;
- Deed of company arrangement;
- Receivership;
- Winding up; and
- Provisional liquidation.

Voluntary administration

The object of voluntary administration is to provide a short moratorium for companies that are insolvent or nearly insolvent. The affairs of a company in voluntary administration are to be administered in a way that:

– maximises the chances of the company, or its business, continuing in existence; or

– if the company or its business cannot continue in existence, results in a better return to its creditors and shareholders than would result from an immediate winding up.

The administrator is an independent person appointed by the company, who assumes control of the company. It is, therefore, neither a "debtor in possession" nor a "creditor in possession" regime.

Voluntary administration has particular attractions for small and medium-sized companies in financial difficulties. It is designed to be implemented quickly, and to be uncomplicated, inexpensive and flexible. In essence, it provides for a short period of external administration of the company, during which options for its continued survival can be explored.

The voluntary administration of a company may be initiated by its directors if they think that the company is insolvent or likely to become insolvent. An administrator may also be appointed by a creditor with security over the whole, or substantially the whole, of the company's property, or by a liquidator or provisional liquidator (with the leave of the court).

The administrator takes control of the company's business, property and affairs. This imposes an immediate moratorium on the enforcement of claims against the company (except with the leave of the court).

The administrator investigates the business and financial circumstances of the company, and forms an opinion about whether it would be in the interests of the company's creditors for:

– the company to execute a 'Deed of Company Arrangement' (discussed below);

– the administration to end; or

– the company to be wound up.

The administrator must hold a meeting of the company's creditors, usually within four weeks of his appointment (although this can be extended by a court and the meeting itself may adjourn for up to 60 days). At that meeting, the administrator reports to the creditors on his view of the three options, and they vote on which option to adopt.

Deed of company arrangement

A 'Deed of Company Arrangement' is a document which records the terms of a restructuring of a company and which completes the process instituted in the voluntary administration provisions of the Corporations Act.

In essence, a deed of company arrangement is a compromise or arrangement approved by the creditors of a company. Approval requires the majority vote of the creditors in number and by value; if only one of those majorities is obtained, the administrator has a casting vote. Commonly, a deed of company arrangement will contain some or all of the following elements:

– payment of a sum of money by the directors or third parties, with that sum to be distributed between creditors;

– a period of time within which the company is to obtain an investor, sell certain assets or otherwise obtain capital or some other asset for the benefit of the creditors; or

– forgiveness or subordination of debt by a related party or sympathetic creditors.

The precise terms of a proposal contained in a deed are virtually unlimited. Once the deed has been executed it binds the company, its officers and members, the administrator, all unsecured creditors and those secured creditors who voted for it. If the proposal contained in the deed is not put into effect, the creditors can terminate the deed and resolve that the company be wound up.

Alternatively, the deed may be terminated by court order, creditors' resolution or by occurrence of circumstances specified in the deed (eg some act of default or the completion of the restructuring process set out in the deed).

Receivership

A receiver is normally appointed out of court by a secured creditor under the powers contained in a charge or mortgage. The terms of the charge or mortgage, supplemented by the Corporations Act and the general law, regulate the nature and scope of the appointment.

The powers of a receiver are derived from the charge or mortgage and the Corporations Act. They usually include power to:

i. enter into possession and take control of the property charged;

ii. lease or sell the property charged;

iii. initiate legal proceedings;

iv. carry on the business of the company; and

v. make contracts and execute documents on behalf of the company.

A receiver must operate within a framework of duties. These duties, which flow from the general law and the Corporations Act, include:

i. to comply strictly with the terms of the appointment;

ii. to exercise the powers bona fide; and

iii. to act honestly in the exercise of his or her powers and the discharge of the duties of his or her office;

iv. to exercise the degree of care and diligence that a reasonable person in a like position would exercise; and

v. most importantly, in exercising a power of sale, to take all reasonable care to sell the property of the debtor company for not less than its market value or, if it has no market value, the best price reasonably obtainable in the circumstances.

While most securities allow the secured creditor to charge back to the debtor company all costs associated with the enforcement of the security, including the costs of the receiver, such a provision is only as good as the value of the charged assets. Where there is a shortfall, the secured creditor will bear the burden of these costs.

Winding up

Winding up (also called liquidation) is a procedure used to bring a company's existence to an end where it has insufficient assets to satisfy all of its liabilities.

There are two main forms of insolvent winding up:

– winding up by a court-appointed liquidator; and

– winding up by a liquidator appointed by a meeting of the company's creditors.

Most court applications to wind up a company in insolvency are based upon a failure to comply with a statutory demand for payment of a debt more than $2,000. That failure gives rise to a prima facie presumption that the company is insolvent. If the company does not disprove the presumption, it will be wound up by the court. An application to a court to wind up a company in insolvency is most commonly made by a creditor relying on an unsatisfied statutory demand. However, an application can also be brought by the company itself, a secured, contingent or prospective creditor, a shareholder, a director, a liquidator, a provisional liquidator or ASIC.

The filing of an application to wind up a company has several immediate consequences:

i. no action or other civil proceeding can continue or be commenced against the company except by leave of the court;

ii. any disposition of property made by the company or any transfer of shares or alteration in the status of the members of the company made after the commencement of the winding-up is, unless the court otherwise orders, void; and

iii. the company cannot, without the leave of the court, resolve that it be wound up voluntarily although it can apply for the appointment of a provisional liquidator or a stay of the winding up order in order to propose a deed of company arrangement (see above).

The effect of winding up – on the company

Winding up primarily affects the status of a company. It transfers the power of management from the directors and members to the liquidator and creditors in general meeting. Once a resolution has been passed or an order made for the winding up of a company, the company and its creditors can expect the following to occur:

i. the liquidator will collect company property not claimable by secured creditors;

ii. the liquidator seeks to recover property improperly transferred when the company was insolvent;

iii. proceedings against the company in liquidation are stayed;

iv. a process by which claims against the company may be asserted and quantified operates; and

v. an order of priorities for distribution of the company's property operates.

The effect of the winding up – on creditors

The primary effect of a winding up on the unsecured creditors of a company is that they are no longer able to pursue ordinary courses of action to recover their debts. Creditors need to consider how their claim would rank as against other claimants if a company were wound up in insolvency. In a liquidation, the property available for distribution among unsecured creditors of a company includes:

i. the company's own property;

ii. if the company has share capital, any unpaid calls on shares;

iii. rights of actions for damages;

iv. compensation recoverable by the liquidator from directors or a holding company for insolvent trading;

v. voidable transactions that can be clawed back by the liquidator including: unfair preferences; or uncommercial transactions.

The principal function of the liquidator is to collect and realise the company's assets. This requires the liquidator to determine what claims exist against the assets of the company, to apply the assets to meet those claims and distribute the surplus initially among unsecured creditors and then shareholders.

As noted above, property that is subject to a security will not generally fall within the liquidator's powers. However, there is a specific exception in the case of floating charges: where the company's unsecured assets are insufficient to meet the claims of its employees, those claims are to be met out of the proceeds of any floating charges granted by the company, in priority to the rights of the chargeholder.

Provisional liquidation

The aim of provisional liquidation is to ensure that the assets of a company are preserved prior to the making of a winding up order. It differs from other winding up procedures in that it is not concerned with maximising the assets available for distribution among creditors, but is simply an interim procedure aimed at preserving the status quo until that commences. Provisional liquidation is usually sought by a creditor who has applied to have the company wound up and who:

– is concerned that the assets of the company will disappear before the winding up order is made; and/or

– believes that it is necessary to shift control of the company away from the directors in the interim.

Generally, a provisional liquidator has the power to carry on the business of the company and has most of the powers of an official liquidator. However, as the purpose of the provisional liquidation is to preserve rather than distribute the company's assets, the provisional liquidator does not have the power to do "all such things as are necessary for winding up the affairs of the company and distributing its property" and is expected to exercise his/her powers in a way that preserves the assets of the company. This does not mean, however, that the assets of the company can never be sold. For example, assets could be sold if the point of selling the particular assets can be said to preserve the assets of the company overall.

As directors can obtain protection by appointing an administrator, provisional liquidation is becoming rarer for company-initiated regimes.

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

Yes.

While the company is solvent, a charge given in favour of a director of the company is voided if the director attempts to enforce it within six months of its creation without the leave of the court.

Once the company is in winding up, the liquidator can attack a charge on a number of grounds (apart from its being unregistered – see above):

- floating charges created in the six months before the "relation-back" day (i.e., the day on which the formal process of placing the company in external administration began), or between that day and the commencement of winding up, will be void insofar as they are given to secure liabilities that arose before the creation of the charge, unless the company was solvent when the charge was given;
- charges are voidable by a court if they constitute a "voidable transaction";
- "Voidable transactions" are transactions which took place before the company entered winding up and which, in general terms, confer a benefit on the creditor which is unfair, having regard to the position of other creditors or the company itself. There are a range of voidable transactions and a range of time frames before the "relation-back day" (six months to 10 years) within which they can occur.

5. Is enforcement of security rights treated differently in each type of proceeding?

Voluntary administration

A secured creditor with security over the whole or substantially the whole of the company's property will retain its rights of enforcement notwithstanding the administration, provided before or within 10 business days of being notified of the administrator's appointment, it enforces the charge in relation to all property of the company subject to the charge. If the secured creditor does not take that step, then it will not be able, without the written consent of the administrator or the leave of the court, to enforce its security during the period of the administration.

This moratorium against enforcement during the period of administration applies with even more force to secured creditors with security over less than substantially the whole of the company's property, unless the secured creditor took steps to enforce its charge or mortgage prior to the appointment of the administrator. Even then, the administrator may be able to apply to the court and obtain an order restricting the powers of the secured creditor.

Deed of company arrangement

The rights and remedies of secured creditors are not affected by the deed, except to the extent that the secured creditor votes in favour of the deed. The same preservation of rights applies to owners and lessors of property against the company.

Liquidation

Secured creditors are those with proprietary claims over particular assets of a company, eg. a charge or mortgage. Their claims will have priority over those of unsecured creditors and will be satisfied to the extent that the particular asset over which there is a claim is valuable. To the extent there is a shortfall, secured creditors will rank equally for that shortfall with unsecured creditors.

A liquidator's costs, charges and expenses of the winding up are given first priority, generally followed by any wages due to employees, long service leave, annual leave and/or sick leave and then by the claims of unsecured creditors. Where assets are insufficient to meet the claims of unsecured creditors in full, debts are to rank equally and be paid accordingly.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Voluntary administration

Because voluntary administration is a pre-insolvency process, there is no distribution and hence no priorities.

Deed of company arrangement

A deed of company arrangement can adopt any scheme of priorities that the creditors want. Where the object of the deed is to maintain the company or its businesses as a going concern, it will usually provide some priority for employees and trade creditors, ahead of debts owed to the directors and their associates. This is subject to two caveats:

i. the courts can intervene to set aside a deed on the grounds of oppression or prejudice to a creditor or group of creditors;

ii. the Government is currently (December 2006) considering a proposal to mandate a prima facie priority for employee entitlements.

Receivership

As noted above, the proceeds of realisation of a floating charge are subject to a special priority claim for employee entitlements, if those entitlements cannot otherwise be met.

Otherwise, the receiver's duty is to realise the charged assets for the benefit of the chargeholder.

Winding up

Where the company is being wound up, the Corporations Act provides a list of the order in which the proceeds of realisation of the company's assets are to be applied. In general terms, that order is:

– the costs and expenses of the insolvency administration;

– employees' entitlements (*pari passu* up to a fixed amount);

– unsecured creditors (*pari passu*);

– shareholders (*pari passu*, having regard to the amount of money paid up on their shares).

Unless the secured creditor surrenders its security, secured assets remain outside the control of the liquidator and so their proceeds are first applied to the debt held by the secured creditor.

7. How can creditors protect their rights towards the debtor?

In legal terms, the only way that creditors can substantially protect their rights against a debtor company is by taking security.

However, apart from the normal credit controls, creditors can also mitigate their losses by acting quickly to place the company into administration, receivership or liquidation once it is clear that the company is suffering terminal financial problems. This reduces the opportunity for further dissipation of the company's assets, either in the normal course of a failing business or through asset alienation by the company's officers.

Once the company is in winding up, creditors may be asked by the liquidator to provide funding for litigation to recover assets for the company. Such litigation may, if successful, produce a greater pool of funds for distribution for creditors; where a creditor has financially supported such litigation, the court is empowered to (and usually does) grant that creditor a greater shares of the proceeds of the action than it would otherwise be entitled to under the *pari passu* rule.

8. How do creditors protect their rights towards guarantors?

Creditors usually protect their rights against guarantors by taking security over assets of the guarantor.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights?

The Australian system for registration of charges requires that most charges over company property (other than real estate) be entered on a public register maintained by ASIC. Where the same property is subject to multiple charges, the charges take priority in the date order in which they were entered on the register. The Corporations Act requires charges to be registered within 45 days of their creation. However, there is provision for late registration of charges.

If the company goes into voluntary administration or winding up, unregistered charges are rendered void. Charges that were registered after the 45-day time limit is also void, unless:

– a court order was obtained to authorise the late registration; or

– the charge was registered at least 6 months before administration or winding up began.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

This is dealt with under question 5.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

As explained above under question 3, the administrator is allowed to use the secured creditor's collateral during the pendency of the involuntary administration unless the moratorium is lifted by the court. Otherwise, there is no ability to use the secured creditor's collateral without his or her consent. There are no special rules for "cash collateral". Receivers and liquidators can use the company's property as security for fresh borrowings (subject, of course, to any pre-existing security rights). Voluntary administrators may have the power to do so, but this would be unlikely, given the short time frame within which they operate. The power (or otherwise) of an administrator of a deed of company arrangement to grant security would depend upon the terms of the deed (as decided by the company's creditors).

12. What distribution will a secured creditor receive if a company is reorganised?

Unless the secured creditor surrenders its security, its ability to recover its debt is limited to:

– the proceeds of realisation of the security; and

– if those proceeds are less than the debt, the difference – ranked *pari passu* as an unsecured debt.

If the secured creditor surrenders its security, it is treated as an ordinary unsecured creditor and ranks *pari passu* with other unsecured creditors.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

Yes. As noted above, the security attaches to the assets and the security is inalienable from the asset without the consent of the creditor.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

If a secured claim is over secured, the proceeds of realisation of the asset are applied first in payment of the debt and then paid over to the company (or the liquidator, if the company is in winding up).

If a secured claim is under secured, the secured creditor may prove for the balance as an ordinary unsecured creditor.

Canada

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

Personal or movable property

Generally, the interpretation of personal property security rights and their enforcement are matters of provincial law. The primary exception is security under the *Bank Act* (Canada), which is only available to federally regulated banks to secure interests in a debtor's inventory and receivables. In most common law provinces in Canada (Quebec is a civil law jurisdiction), security against personal property is governed by the particular province's *Personal Property Security Act* (the "PPSA"). The PPSA is modeled after Article 9 of the *Uniform Commercial Code* (United States) and governs the taking, perfection, priority and enforcement of personal property security in the particular province.

Under PPSA regimes, security of a general nature is commonly granted under a general security agreement or a debenture, which will usually provide security to the creditor over all of the personal property assets of a debtor. PPSA security may also be asset specific and may be characterized as a conditional sale, a lease or some other type of financing purchase arrangement. A "security interest" in PPSA regimes is any interest given by a debtor in its assets to a creditor that secures payment or performance of the debtor's obligations to the creditor. In order for a security interest to be enforceable under the PPSA, it must have "attached", which generally requires: (i) the execution of a security agreement containing a description of the collateral sufficient to enable it to be identified; (ii) value to be given; and (iii) the debtor to obtain rights in the collateral. For a security interest to have the greatest bundle of rights possible under the PPSA, it must also be "perfected", which generally requires: (i) the security interest to have "attached" as described above; and (ii) the secured party to have either effected a registration under the PPSA or taken possession of the collateral.

As to priorities, generally, the first perfected secured creditor to register its security interest under the PPSA will prevail although there are exceptions to this general rule, including, special priority rules regarding "purchase money security interests" in certain types of collateral.

Real or immovable property

Real property security rights are generally governed by provincial mortgage, title and lending statutes, which regulate both the way in which such security is registered and the way in which it is enforced. Real property security is commonly granted through a mortgage or a debenture registered against title and may also be in the form of assignments of rents or leases. As to priorities, generally, mortgagees take priority according to the order in which their mortgages are registered on title.

Statutory liens and deemed trusts

Liens on personal and real property may also arise statutorily as many federal and provincial statutes contain special provisions that are designed to enhance the collection of certain kinds of claims from a debtor (e.g. Crown claims for tax and employee source deductions). The most common methods to provide these statutory protections are through a statutory lien over the debtor's assets or a statutory deemed trust. Determining the priority of a particular kind of statutory lien or deemed trust requires an analysis of the relevant statute creating the statutory lien or deemed trust and the type of insolvency proceedings affecting the debtor, as certain statutory liens and deemed trusts may lose their priority status in a bankruptcy.

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

Following a default under its security documents, a secured creditor intending to enforce its security over all or substantially all of the assets of an insolvent debtor is required to send the debtor a notice of intention to enforce security in accordance with the *Bankruptcy and Insolvency Act* (Canada) (the "BIA"), and is restrained from enforcing its security for 10 days unless the debtor consents to earlier enforcement. After the expiration of the notice period, there are a number of ways for a secured creditor to enforce its security.

In PPSA jurisdictions, a secured creditor is entitled to exercise self-help remedies and take possession of the collateral. Where appropriate, possession may also be taken by rendering the collateral unusable. A secured creditor who has taken possession generally has the right, upon

complying with certain notice provisions, to either sell the collateral (by private or public sale so long as it is commercially reasonable) to recover the outstanding debt or to foreclose and take the collateral in full satisfaction of the outstanding debt. However, should the debtor or others with an interest in the collateral object to a foreclosure, the secured creditor will be required to sell the collateral. Exercising the foreclosure remedy extinguishes the outstanding debt and prevents a secured creditor from recovering any deficiency through other enforcement remedies while the sale process remedy preserves this right.

Where provided for in its security documents, a secured creditor may have the right to appoint a private receiver or receiver and manager to take possession of and realize upon the assets of a debtor on behalf of the secured creditor. A secured creditor also has the right to seek the appointment of a court-appointed receiver or receiver and manager to assist in the enforcement or realization process. This remedy is usually used where a secured creditor expects to encounter difficulties in exercising its self-help remedies or appointing a private receiver, or where the secured party wishes to obtain the protection of a court appointment. As a result of the court's involvement, this process is generally slower and more costly but does allow the secured creditor to have its enforcement and realization process approved by the court, and minimizes liability issues and the risk of any criticism from other parties.

The primary enforcement remedies available to a secured creditor with respect to real property include: (i) power of sale (contractual or statutory); (ii) foreclosure (court-supervised remedy); and (iii) judicial sale (court-supervised remedy). The various provincial mortgage statutes generally provide for the relevant notice periods that must be observed, and a debtor's rights regarding the curing of defaults and redeeming the mortgaged property. Other enforcement remedies that also may be available to a secured creditor with respect to real property include the following: (i) voluntary release of the debtor's equity of redemption in the mortgaged property by way of a quit claim deed or a transfer; (ii) distress (i.e. seize and sell the assets of the debtor); (iii) injunctive relief; (iv) action for possession of the mortgaged property; (v) attornment of rents; (vi) receivership (private or court-appointed); and (vii) action on the covenant.

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.

(d) Does the debtor remain "in possession" of the business?

Pre-insolvency proceedings

There is no Canadian equivalent to formal pre-insolvency proceedings, although out-of-court restructurings can occur and often take the form of a negotiated agreement between the debtor and its secured creditors under a forbearance agreement. In order for an out-of-court restructuring to be successful, the debtor will also likely have to deal with its unsecured creditors and suppliers as the support of these parties to the restructuring process will also likely be required to enable the debtor to be viable on an ongoing basis.

Bankruptcy / liquidation proceedings

The liquidation of most insolvent debtors in Canada is conducted under the BIA through either voluntary or involuntary bankruptcy proceedings. A debtor may initiate voluntary bankruptcy proceedings under the BIA by filing an assignment for the benefit of its creditors. To qualify, the debtor must be an insolvent person (as that term is defined in the BIA) and, generally, the debtor would retain the services of a licensed trustee in bankruptcy prior to commencing the bankruptcy process to assist in the preparation of a preliminary "Statement of Affairs". This process can be extremely quick given the lack of substantive procedural requirements. Alternatively, one or more creditors may file an application with the court for a bankruptcy order against a debtor. For this type of application to be granted by the court, the creditor must establish that there is a debt of at least $1,000 owing to it and that the debtor has committed an act of bankruptcy under the BIA (e.g. ceasing to meet its liabilities as they generally become due) within the six months preceding the filing of the application. Obtaining a bankruptcy order generally takes longer than an assignment in bankruptcy since court proceedings must be commenced and certain notice periods must also be observed. On a bankruptcy order being made or an assignment being filed with the Official Receiver (the federal government appointee responsible for administering the BIA), the assets of the bankrupt are immediately vested in the trustee in bankruptcy (who is an officer of the court and has a duty to act in the

interests of all creditors). At this point, the debtor no longer has any ability to deal with its assets and the trustee would generally proceed to liquidate the assets of the estate and distribute the proceeds in accordance with the priority scheme in the BIA (which is discussed under question 6 below). The trustee in bankruptcy is also supervised by inspectors who are appointed by the creditors of the estate under the BIA and assist in the trustee's administration of the estate.

Receivership

A receiver may be privately-appointed or appointed by a court order. A private receiver is normally appointed by a secured creditor where its security documents provide for such an appointment upon a default by the debtor. A private receiver is, for certain purposes, the agent of the secured creditor appointing it, and for other purposes (e.g. carrying on the business), the agent of the debtor. The Judicature Acts of the Canadian common law provinces allow the court to appoint a receiver or receiver and manager wherever the court determines it to be "just and convenient" to do so. The courts have traditionally appointed a receiver where a secured creditor with a contractual right to appoint a receiver requests the appointment as part of an interlocutory proceeding within an action commenced by a secured creditor. A court-appointed receiver obtains its power and authority to act from the court appointing it and, unlike a private receiver, a court-appointed receiver is an officer of the court with a duty to act in the interests of all creditors. A court-appointed receivership may be appropriate where: (i) there are highly contentious or complex proceedings; or (ii) the debtor is refusing to co-operate with its secured creditor or grant access to the assets charged by the secured creditor's security.

BIA proposal

Commercial reorganizations under the BIA are conducted by way of a proposal and may only be initiated by a debtor or a person acting on the debtor's behalf and not by a creditor. The BIA requires that a proposal trustee be appointed to assist the debtor and perform various statutory duties under the BIA in connection with the proposal. Unlike in bankruptcy, however, the assets of the debtor do not vest in the proposal trustee and the debtor retains its ability to deal with its assets subject to the supervision of the proposal trustee. The proposal process under the BIA is generally commenced by the debtor filing a notice of intention to file a proposal with the Official Receiver. After filing a notice of intention, the debtor has 30 days to file a proposal with the Official Receiver. This 30-day period may be extended, on application to the court, for up to a maximum of five additional months, provided that such extensions are solely for the purpose of enabling the debtor to file its proposal and are only granted for periods of up to 45 days at a time. After the

proposal has been filed with the Official Receiver, the proposal trustee is required to hold a meeting of creditors to approve the proposal and, thereafter, the proposal must be approved by the court. A proposal may be made to creditors generally or to classes of creditors (both secured and unsecured) who the debtor wishes to compromise in some way, provided that where a proposal is made to secured creditors in a particular class, the proposal must be made to all secured creditors in that class.

CCAA proceedings

Proceedings under the *Companies' Creditors Arrangement Act* (Canada) (the "CCAA") are initiated by the issuance of a court order upon an application by a debtor company or, in rare cases, a creditor. The CCAA only applies to a debtor company or group of affiliated companies that has assets in Canada (or carries on business in Canada) and has total claims against such debtor company or group of affiliated companies exceeding $5 million. Generally, the debtor company must be insolvent or have committed an act of bankruptcy (as that term is defined in the BIA) in order to seek protection under the CCAA. The courts have, however, tended to loosely interpret the term "insolvency" under the CCAA in furtherance of the broad reorganization goals of the CCAA, and are generally satisfied that a debtor company will be "insolvent" for purposes of the CCAA if there is a reasonably foreseeable liquidity crisis or a hypothetical deficiency of assets to liabilities (including contingent and unliquidated liabilities) A debtor company remains in possession of its assets during a CCAA proceeding and the CCAA requires that a monitor be appointed to supervise and assist the debtor company in preparing financial information and preparing a plan of compromise or arrangement. A debtor company typically gives creditors little or no notice of the hearing to commence CCAA proceedings (so as to prevent a race to enforce defaults prior to the initial CCAA order being made) and the initial CCAA application is usually brought in the court of the province of the head office or chief place of business of the debtor company. An initial CCAA order generally includes, among other things: (i) a declaration from the court that the debtor company is a corporation to which the CCAA applies; (ii) an order that the debtor company file a plan of arrangement within a certain time frame and hold meetings of classes of creditors to vote on the plan; (iii) an interim stay of all actions, suits and other proceedings against the debtor company; and (iv) if applicable, an order requesting the assistance of courts in other jurisdictions to enforce the terms of the initial CCAA order.

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which a security right or interest can be challenged?

Under the right set of facts and circumstances, the granting of a security right or interest to a creditor could be challenged as a fraudulent conveyance and/or preference under provincial statutes. The grounds upon which a security right or interest can be challenged under these provincial statutes vary although they all generally require the moving party to prove that the actions of the debtor were undertaken with the intent to defeat or defraud creditors.

In certain circumstances, creditors may also apply to court in respect of certain acts of a debtor company or its directors under the oppression provisions contained in federal and provincial corporate statutes. A court may grant such an application if it is satisfied that the debtor company or its directors have committed any act or conducted any business in a manner that is oppressive or unfairly prejudicial to or unfairly disregards the interest of any security holder, creditor, director or officer. The court may make any order it deems appropriate, including, an order restraining the conduct complained of or an order liquidating or dissolving the debtor company.

A trustee in bankruptcy (and, upon court approval, creditors) may also be able to use certain provisions in the BIA to challenge transactions of a bankrupt that were entered into on the eve of insolvency. In particular, Section 91 of the BIA provides that any settlement of property for nominal consideration that was made within the period beginning one year before the initial bankruptcy event of a debtor and ending on the date the debtor became bankrupt is void as against the trustee in bankruptcy. Such one year period is extended to five years if the trustee in bankruptcy can prove that the debtor was, at the time of the settlement, unable to pay all of its debts without the aid of the property comprised in the settlement or that the interest of the debtor in the property did not pass on the execution thereof. Section 95 of the BIA also makes every conveyance given within three months (or one year in a related party transaction) of bankruptcy by an insolvent person that had the effect of giving any creditor a preference over other creditors void as against the trustee in bankruptcy. The grounds under Section 95 of the BIA require the trustee in bankruptcy to prove that: (i) the bankrupt was insolvent at the time of the transaction; (ii) the transaction had the effect of preferring the creditor in question; and (iii) the debtor intended to prefer the creditor in question. In addition, under Section 100 of the BIA, a trustee in bankruptcy can attack an under-valued transaction if such a transaction: (i) took place during the one-year period preceding the bankruptcy; (ii) was made for inadequate consideration; and (iii) took place between the bankrupt and a person not dealing at arm's length with the bankrupt.

5. Is enforcement of security rights treated differently in each type of proceeding?

Not applicable as there is no formal pre-insolvency proceeding available in Canada.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

As discussed above under question 3, there is no statutory provision for formal pre-insolvency proceedings in Canada although it is common for parties to try and engage in out-of-court restructurings. The rules of priorities in the BIA below provide a useful framework for such out-of-court restructurings.

The BIA is organized in terms of claims instead of creditors and sets out the priority scheme for the payment of all claims against a bankrupt, which takes precedence over any priority scheme set out in provincial legislation. In general, claims in a bankruptcy under the BIA are ranked in priority of payment as follows: (i) claims of owners of property in the possession of the bankrupt (e.g. property held in trust for another person); (ii) "super-priority" claims in favour of the Crown under the BIA (e.g. statutory federal and provincial deemed trusts for employees' withholdings on account of income taxes, employment insurance and employee contributions to the Canada Pension Plan); (iii) claims of secured creditors (who must look to the assets charged by their security for payment of their respective claims); (iv) claims of preferred creditors (which, include, without limitation, (a) the costs of administration of the bankrupt's estate, including the fees and expenses of the trustee in bankruptcy and its solicitors; (b) the levy payable to the Superintendent of Bankruptcy; (c) wages and salaries of employees during the six months immediately preceding the bankruptcy up to a maximum of $2,000 in each case; (d) certain municipal taxes assessed or levied against the bankrupt; (e) certain claims by landlords for arrears of rent and accelerated rent; (f) all indebtedness under any statute respecting workers' compensation, unemployment insurance or withholding taxes; and (g) claims of the Crown not mentioned above in Right of Canada or any province); and (v) all other claims will be considered general unsecured claims and rank *pro rata* and *pari passu*. Preferred claims are paid in full, in order of their ranking, before any payments to lower ranking preferred creditors or general unsecured creditors and any creditor whose rights are restricted by the priority scheme outlined above are entitled to rank as an unsecured creditor for the balance of their claim. If there is any surplus after payment to the unsecured creditors, the balance will be used to pay interest from the date of

the bankruptcy at 5% per annum on all claims proven in the bankruptcy according to their priority. Any remaining amounts would then be available for the shareholders of the debtor company.

The BIA priority scheme outlined above generally applies in a proposal or CCAA plan (subject to certain limitations), although some creditors may agree to different treatment in certain circumstances.

7. How can creditors protect their rights towards the debtor?

Generally, a creditor will need to file a proof of claim in order to receive a distribution in a debtor's insolvency proceeding and vote on a debtor's proposal or CCAA plan.

In order for a claim to be considered in a bankruptcy or a proposal, a creditor must submit a proof of claim to the relevant trustee setting forth the following: (i) the name of the creditor; (ii) the amount owed as supported by invoices or other evidence of the indebtedness; (iii) an indication whether the creditor is claiming security, a preferred claim or other priority; (iv) whether the creditor is related to the bankrupt; and (v) a summary of any payments received by the creditor within three months of the date of the initial bankruptcy event. The BIA sets out the framework for the entire claims process, including the rules for the calling for claims and verifying them.

Unlike the BIA, the CCAA does not contain a statutory claims process. The practice that has evolved under the CCAA generally involves the monitor working with the debtor company to prepare and recommend a complete process (including proof of claim forms, notices and a dispute mechanism) for approval by the court. The court order establishing the claims process will also set a claims bar date so that potential claimants will know that, if they fail to file a proof of claim by that date, they may forever be barred from pursuing the claim against the debtor company.

8. How do creditors protect their rights towards guarantors?

The commencement of insolvency proceedings against a debtor typically does not result in a stay of proceedings against a guarantor. Therefore, a creditor may improve its prospects of collection by enforcing its remedies against a guarantor as soon as possible after the debtor commences insolvency proceedings.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g. perfection)?

In PPSA jurisdictions, an unperfected security interest in collateral is generally subordinate to: (i) a perfected security interest in the same collateral; (ii) the interests of statutory and common law lien holders; (iii) the interest of a person given priority under any other statute; and (iv) the interest of a person who has assumed control of the same collateral through a legal process (e.g. execution or garnishment). PPSA statutes also generally provide that an unperfected security interest will not be effective against a person who represents the creditors of a debtor, which includes a trustee in bankruptcy. Accordingly, a secured creditor should monitor its PPSA file on a regular basis and make any supplementary filings to maintain the perfection of its security interest under the PPSA (e.g. renewal registrations and recording a change of name of the debtor within 30 days after the secured creditor learns of such name change).

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

Prior to the commencement of an insolvency proceeding, a secured party is generally free to foreclose and enforce its security against a debtor. The commencement of insolvency proceedings, however, imposes a stay of proceedings that generally prevents creditors from taking any enforcement actions against a debtor except with leave from the court.

Bankruptcy / liquidation proceedings

Upon the bankruptcy of a debtor, whether voluntarily or involuntary, the BIA imposes a stay of any action, execution or other proceeding by unsecured creditors in respect of the debtor unless the creditor first obtains leave of the court. In the liquidation context, the stay of proceedings does not generally apply to secured creditors, who are free to exercise their rights of self-help or to otherwise realize on their security outside of the BIA. The one exception to this general rule is that, upon the application of the trustee in bankruptcy, the court may, in exceptional cases, stay the rights of a secured creditor for up to six months. For the most part, however, secured creditors may proceed to realize upon their collateral in a bankruptcy and, for this reason, receiverships often are run in parallel to a liquidation under the BIA.

BIA proposal

The stay of proceedings arises automatically under the BIA upon the filing of a proposal or a notice of intention and operates to bind all secured and unsecured creditors. The stay of proceedings operates throughout the period from the date of filing the proposal or notice of intention to the date of court approval and, in respect of those debts compromised by the proposal, beyond. There are, however, certain exceptions to the application of the stay of proceedings with respect to secured creditors. In particular, secured creditors who actually took possession of their secured collateral before the debtor filed the proposal or notice of intention are excluded, as are those who actually gave a notice of intention to enforce their security more than 10 days prior to the debtor filing the proposal or notice of intention. The stay of proceedings also does not apply to secured creditors who are not included within the debtor's proposal or who are in a class of secured creditors who have rejected the proposal. In addition, a secured creditor has a statutory right to apply to the court to lift the stay of proceedings where they can show that their security position is deteriorating or detrimentally affected by the stay imposed under the proposal.

CCAA proceedings

The CCAA permits the court to order a stay of proceedings that will be imposed against, among others, all creditors (secured and unsecured), landlords and persons who are not creditors of the debtor company, to prevent them from exercising contractual rights that would make it difficult, if not impossible, for the debtor company to proceed with its reorganization. Given that the debtor company usually brings the initial application in a CCAA proceeding, the court and the debtor generally have some flexibility to "tailor" the stay of proceedings to the particular circumstances of the case. A stay of proceedings under the initial CCAA order is usually granted for an interim period (e.g. 20-30 days) and, thereafter, can be repeatedly extended at the discretion of the court for such further periods as the court deems appropriate (e.g. 60-90 day intervals). The length of time over which CCAA proceedings continue is dependent on the complexity of the proceedings and there is generally no practical expectation that a restructuring will be completed in the initial stay period. In that regard, the shorter initial stay period is intended to ensure that parties affected by the CCAA proceedings have an opportunity to address the court early in the proceedings. Initial CCAA orders also usually contain a "come-back clause" that enables any interested party to return to court within a specified time period to seek to amend or vary the initial CCAA order or to seek any other relief. This clause is particularly important where the initial CCAA application was made without notice to interested or affected parties.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

In a bankruptcy under the BIA, a debtor has no ability to deal with its assets or operate its business as all of its assets are vested in the trustee in bankruptcy, and a secured creditor is generally permitted to realize on its security outside of the BIA. In a receivership (private or court-appointed), a receiver who is appointed over all of a debtor's assets will generally control all of the debtor's assets and operate its business. Accordingly, assets in which a secured party has an interest may be used or sold during a receivership**,** and any sales proceeds that are realized from such asset sales by a receiver are usually held for the benefit of the relevant secured creditor and stand in the place and stead of the transferred assets. In both a BIA proposal and a CCAA proceeding (and subject to any contrary court order), the debtor generally retains control and possession of its assets and continues to operate its business during the case.

There is currently no specific treatment for cash collateral or debtor-in-possession ("DIP") financing under the BIA or the CCAA. Canadian courts have, however, exercised their inherent jurisdiction and authorized the use of DIP financing in CCAA proceedings. In determining whether to grant DIP financing in a CCAA proceeding, a court will generally consider the following factors: (i) how long will it take to determine whether there is a going concern solution that creates more value than a liquidation; (ii) whether the DIP loan will enhance the prospects for a going concern solution; (iii) the nature and value of the debtor company's assets; and (iv) whether any creditors will be materially prejudiced as a result of the continued operations of the debtor company.

12. What distribution will a secured creditor receive if a company is reorganised?

BIA proposal

To become effective, a proposal must be accepted by the affected creditors and then be approved by the court. Meetings of creditors to vote on the proposal must be held within 21 days of the filing of the proposal with the Official Receiver and all classes of creditors to which the proposal has been made must vote. Secured creditors will generally be classified into separate classes with respect to their secured claims (unless they share the same collateral and their interests are sufficiently similar to give them a "commonality of interest"), and are free to accept any distribution that they deem appropriate under the proposal. However, even if one or more of the classes of secured creditors rejects the proposal, that will not defeat the

proposal since a proposal's acceptance or rejection is based upon the vote of unsecured creditors. Therefore, a proposal will be accepted if it has the support of 50% in number and two-thirds in value of each class of unsecured creditors who vote in favour of the proposal. Any class of secured creditors who have rejected a proposal that has been accepted by the unsecured creditors will not be bound by the proposal or the stay of proceedings and may, therefore, exercise their remedies as they see fit. It is for this reason that, as a practical matter, a proposal often does not attempt to compromise the claims of general security holders, but rather provides that they will be paid on existing arrangements or as the parties may agree. If the requisite majorities of unsecured creditors do not approve the proposal, the debtor is automatically deemed bankrupt. After acceptance of a proposal by the unsecured creditors, the proposal must also be approved by the court (which approval is not automatic and requires the court to be satisfied that the terms of the proposal are reasonable and that it complies with certain formalities in the BIA). Once the proposal is approved by the court, it becomes binding upon the debtor and all affected creditors.

CCAA plan

To become effective, a CCAA plan must be accepted by the affected creditors and then be approved by the court. As with a BIA proposal, secured creditors will generally be classified into separate classes with respect to their secured claims (unless they share the same collateral and their interests are sufficiently similar to give them a "commonality of interest"), and are free to accept any distribution that they deem appropriate under the CCAA plan. The meetings of creditors and shareholders (if necessary) to vote on the CCAA plan will be ordered and convened in such manner as the court directs. The voting requirements under the CCAA require that the CCAA plan be accepted by 50% in number and at least two-thirds in value of the claims of those creditors present and voting in each class. While a CCAA plan can be "crammed-down" on the dissenting minority of an accepting class, there are no provisions under the CCAA that permit a "cram-down" of a particular class of creditors who object to the CCAA plan. However, a CCAA plan may generally seek to accomplish the same goal by creatively carving out certain creditors or types of creditors as unaffected claims. Once approved by the requisite majority of creditors, the CCAA plan must also be sanctioned by the court before it can become effective (which approval requires the court to be satisfied that the plan is fair and reasonable). Once this occurs, the CCAA plan is binding on all members of all accepting classes of creditors affected by the CCAA plan (regardless of how they voted) as if it were a contract between the debtor and those creditors.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

Unless otherwise provided for in the proposal or the CCAA plan, a reorganised debtor company generally retains the unfettered ability to deal with its assets following the successful implementation of a proposal or CCAA plan free and clear of all liens, claims and interests. Furthermore, assuming that a class of secured creditors accepts the treatment of its rights in either a proposal or CCAA plan pursuant to the relevant statutory requirements in the BIA or CCAA, the secured rights of the accepting class of secured creditors (including the rights of the dissenting or minority creditors in the accepting class of secured creditors) over the assets of a reorganised debtor company will be dealt with in accordance with the terms of the applicable proposal or CCAA plan.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

As discussed under question 6 above, the BIA generally divides claims into the following three categories: (i) secured claims; (ii) preferred claims; and (iii) unsecured claims. A secured creditor with a valid secured claim against a debtor has priority over preferred and unsecured claims and generally must look to the assets charged by its security for payment of its claim. A secured creditor also has the option, albeit exercised very rarely, to surrender their security and claim as an unsecured creditor. Moreover, a secured creditor is generally entitled to effect any available common law set-off rights for any pre-filing obligations. Therefore, if a secured creditor has a right of set-off against a debtor, it may deduct the amount of the set-off and prove a claim for the balance.

If a secured claim is over-secured (i.e. the value of the collateral is greater than the amount of the secured claim) and a secured creditor has realized on their collateral, the secured creditor will generally be permitted to prove a claim in the applicable insolvency proceeding for the full amount of the outstanding debt along with post-filing interest and its reasonable fees and expenses (as provided for in its security documents). Conversely, if a secured claim is under-secured (i.e. the value of the collateral is less than the amount of the secured claim) and a secured creditor has realized on their collateral, the secured creditor will generally be permitted to prove a claim in the applicable insolvency proceeding for the amount of the deficiency as an unsecured claim and share rateably in any distribution to unsecured creditors.

England

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

It is relatively straightforward to create security in England. Like other common law jurisdictions, English law draws a distinction between legal and equitable title to property. As a result, there are two main types of security interest which, in practice, are used in most types of financing – a legal mortgage and an equitable charge.

A legal mortgage involves the transfer by the debtor to the creditor of legal title to an existing asset of the debtor as security for the payment or discharge of a monetary liability. An equitable charge involves the creation by the debtor in favour of the creditor of an equitable proprietary interest in a present or future asset of the debtor by way of security for the payment or discharge of a monetary liability. Both types of security interest are, in practice, created by the execution of a document by the debtor. In most cases, the document requires registration at Companies House (which is the central registry of companies incorporated in England).

In the case of an equitable charge, that is all that is required. Since, however, the creation of a legal mortgage requires the transfer to the creditor of legal title (or, in the case of land, a right equivalent to legal title), further formalities may be required, such as registration at an asset registry in the case of land, ships and aircraft. Another important distinction between the two types of security interest is that a legal mortgage can only be created over assets owned by the debtor at the time the mortgage is created but, if an equitable charge is expressed to extend to future assets, they will automatically become the subject of the charge once they become owned by the debtor, without the need for any further documentation or registration.

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* This chapter contains a broad overview of the treatment of secured claims in insolvency proceedings. For further detail and the statutory and case law authorities on which it is based, see R Calnan, Taking Security: Law and Practice (Jordans, 2006), especially chapters 8 (Enforcement) and 9 (The effect of insolvency).

Both types of security interest are effective in the insolvency of the debtor. The advantage of a legal mortgage is in relation to the priority of the security – it generally gives more protection against third parties who claim a competing interest in the asset. The advantage of an equitable charge is that it is very easy to create and can extend to future, as well as existing, assets of the debtor.

An equitable charge can be either fixed or floating. The advantage of a floating charge is that it enables security to be created over assets which are not susceptible to the creation of a fixed charge because they need to be disposed of in the ordinary course of the debtor's business. In practice, a common form of security interest created by corporate debtors is a debenture which creates fixed charges over assets (such as land) which the debtor does not require to dispose of in the ordinary course of its business, and a floating charge over assets (such as stock-in-trade) which it does. Such a debenture can be created very easily over all of the present and future assets of the debtor. All that is required is for the debenture to be executed by the debtor and registered at Companies House.

Mortgages and charges are not the only type of security interest recognised by English law. A pledge can be taken over tangible movable assets, such as goods and documents of title, but it requires the creditor to obtain, and retain, possession of the assets concerned. As a result, pledges are generally only used to secure short-term financings in the context of international trade transactions, where possession of a bill of lading can be obtained by the financing bank. English law also recognises certain types of common law and equitable lien, which arise by operation of law.

Unlike some common law jurisdictions, English law recognises a clear distinction between security interests and outright ownership. An owner of an asset can lease it to another person, or sell it on reservation of title, without its ownership interest being recharacterised as a security interest. Similarly, an outright sale of receivables will not be recharacterised as a security interest. As a result, these types of transaction are not registrable at Companies House. What is important is the legal nature of the transaction, not its economic effect.

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

Enforcement of security in England is also relatively straightforward. The security can generally be enforced by the creditor without the necessity to involve a court; although there are restrictions on enforcement in certain types of insolvency proceeding, which are discussed in the reply to question 10.

Security is sometimes enforced by the creditor taking possession of, and then selling, the secured asset but, in commercial transactions, security is normally enforced by the appointment of a person (usually an insolvency accountant) to enforce the security on behalf of the creditor. The nomenclature in this area can be confusing. If the person concerned is appointed over a particular asset or assets of the company, he is called a receiver. If he is appointed over all, or substantially all, of the debtor's assets, he is known either as an administrative receiver or as an administrator, depending on the type of transaction concerned. An administrator must comply with certain statutory objectives but, in practice, whatever the name of the person concerned, his function is broadly the same. In most cases, he will take possession of the assets which are the subject of the security, continue to trade them if they constitute a business, and then sell them, preferably as a going concern.

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.?

(d) Does the debtor remain "in possession" of the business?

The two main types of corporate insolvency proceedings in England are liquidation and administration. Liquidation is the ultimate, terminal, insolvency proceeding. A liquidator winds up the debtor's affairs, sells its assets and pays the proceeds to creditors. He will not continue the debtor's business. By contrast, the purpose of an administration is to rescue the debtor's business if it is insolvent or close to insolvency. The administrator will

normally continue trading the business of the company for a short period, with a view to selling it as a going concern. In practice, the company itself is rarely saved, but the business often is.

Both types of proceeding can be initiated by the debtor or by a creditor if the company is insolvent (or, in the case of administration, likely to become insolvent) on a cash flow or on a balance sheet basis. The court may be involved in the process, but frequently is not. An important feature of them both is that they result in the debtor's board of directors ceasing to have any real power. Management of the debtor is taken over by the liquidator or administrator, who will be a licensed insolvency practitioner (normally an insolvency accountant).

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

There are various ways in which security can be set aside in insolvency proceedings, either as a result of insolvency legislation or under the general law. In commercial transactions, the four most important are:

(a) transactions at an undervalue;

(b) breach of fiduciary duty;

(c) voidable preferences; and

(d) voidable floating charges.

They are all intended to set aside certain types of transactions entered into by the debtor in the period running up to the commencement of the insolvency proceedings if they are detrimental to its general body of creditors. The first two are concerned with transactions by which the debtor loses value which could otherwise be used to pay creditors. The last two are intended to prevent transactions which prefer some creditors over others.

A transaction at an undervalue can be set aside under insolvency legislation if it took place within two years before the commencement of the insolvency proceedings and the debtor was insolvent at the time or became insolvent as a result of the transaction. There is a defence if it can be shown that the debtor entered into the transaction in good faith and for the purpose of carrying on its business and, when it did so, there were reasonable grounds for believing that the transaction would benefit the company.

This provision does not affect security created by a debtor over its own assets to secure its own liabilities – in such a case, the amount of assets and liabilities of the debtor remain the same. It is, however, capable of applying to guarantees or third party charges entered into by the debtor on behalf of connected parties (such as associated companies). It is nevertheless rare in practice for a liquidator or administrator successfully to attack guarantees and third party charges. This is largely because the directors can normally establish that the debtor does obtain sufficient (indirect) benefit from the giving of the security.

Under the general law, a transaction can also be set aside if it was entered into by the debtor's directors in breach of their fiduciary duty to the debtor and the person dealing with the debtor had actual or constructive notice of that fact. The directors will be in breach of fiduciary duty if they enter into a transaction which they do not believe, on reasonable grounds, to be in its best interests. The time limit is the normal six year limitation period for actions under English law but, otherwise, the requirements in this context are similar to those for an undervalue transaction.

The other two types of claw-back provisions are concerned to prevent the debtor preferring one creditor, or group of creditors, over its other creditors in the period running up to the insolvency proceedings. These provisions apply to the creation of security, as much as to outright transfers.

A transaction with a creditor who is not connected with the debtor and which has the effect of putting that creditor in a better position will be set aside if it was entered into within six months before the commencement of the insolvency and the debtor was insolvent at the time or became insolvent as a result of the transaction, but only if the debtor was influenced in entering into the transaction by a desire to put the creditor in a better position. The rules are stricter for connected parties. In practice, it is almost impossible for an administrator or liquidator successfully to attack fixed security granted in favour of an unconnected third party (such as a bank) because of the difficulty of proving that the debtor desired to put the bank in a better position. The debtor will usually grant the security in order to persuade the bank to continue making facilities available, not because it wishes to confer a benefit on the bank.

Floating charges are, however, more vulnerable. A floating charge created in favour of an unconnected person will be invalid if it was created within one year before commencement of the insolvency proceedings and the debtor was insolvent at the time or became insolvent as a result of the transaction, except to the extent of the value of the consideration for the creation of the

charge at the time of, or after the creation of, the charge. In the case of a floating charge, therefore, the creditor must ensure that the finance is only made available once the security has been granted. The rules are stricter for connected parties.

In practice, these provisions have only a limited effect on security. In a normal financing transaction, where the debtor is solvent at the time of the transaction and is borrowing money from an unconnected creditor who takes security from the debtor before the facility is made available, none of these provisions will affect the creditor's rights. The danger occurs where the creditor has lent on an unsecured (or insufficiently secured) basis and wakes up to the need for security (or additional security) when the debtor is in financial difficulties. In such a case, a floating charge will be vulnerable, although it will still be difficult for the debtor's insolvency officer successfully to attack fixed charges because of the difficulty of establishing that the debtor desired to prefer the creditor.

The most vulnerable types of security are guarantees and third party charges, which can in theory be set aside as transactions at an undervalue or under general equitable principles concerning fiduciary duties of directors. In practice, though, successful attacks on guarantees are rare.

5. Is enforcement of security rights treated differently in each type of proceeding?

Liquidation has never affected the ability of a secured creditor to enforce its security, but there is a moratorium on the enforcement of security in an administration. This is discussed further in the answer to question 10.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

The basic principle is that the secured assets are not regarded as being part of the debtor's property for the purpose of the insolvency proceedings, and accordingly that the secured creditor is entitled to their proceeds. The main limitation on this principle is that insolvency legislation treats floating charges differently from fixed charges. Whilst the net realisations from fixed charge assets are paid to the secured creditor, realisations from floating charge assets are only available to pay the secured creditor once certain other debts have been paid. They are:

- preferential debts;
- a certain percentage of unsecured debts; and
- the expenses of certain insolvency proceedings.

For over a century, preferential debts have ranked ahead of a floating chargee. The categories of preferential debts have fluctuated over the years, but they are now quite limited in scope. The principal types of preferential debt now consist of claims by employees (up to a very small maximum amount) and certain contributions to pension schemes.

Unsecured creditors are also entitled to a certain proportion of floating charge realisations (broadly 20 per cent up to a maximum of £600,000) in priority to the secured creditor.

Although the basic principle of insolvency proceedings is that the expenses of those proceedings are not payable out of assets which are the subject of security, there are statutory inroads into this principle. Most notably, an administrator can dispose of assets which are the subject of a floating charge and can pay his remuneration and expenses out of the floating charge assets in priority to the secured creditor. There are proposals to extend this priority to liquidators.

For all these reasons, it is preferable for a secured creditor to obtain a fixed charge, rather than a floating charge, although it is only practicable to do so in cases where the creditor can obtain sufficient control over the assets concerned.

7. How can creditors protect their rights towards the debtor?

A secured creditor is not subject to time limits in insolvency proceedings although, in practice, it will want to act quickly to enforce the security if it is possible to do so. If the creditor has security over all or substantially all of the debtor's assets, it will appoint an administrator or an administrative receiver (depending on the nature of the transaction), who will then enforce the security. If the secured creditor only has security over part of the debtor's assets, it will normally appoint a receiver, although, if an administrator is subsequently appointed, the receiver may be required to vacate office.

8. How do creditors protect their rights towards guarantors?

Where there are guarantors, the secured creditor will normally give notice to them requiring payment.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g. perfection)?

If the security interest has not been properly created, it will be ineffective. In practice, as has been seen from the answer to question 1, the creation of security is straightforward. The main reason why a security interest is not properly created is failure to register at Companies House. Most mortgages and charges are registrable within 21 days of the creation of the security interest and, if not registered, are void in an insolvency proceeding.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

As was mentioned in the reply to question 5, although liquidation does not affect a secured creditor's power to enforce its security, administration does. The primary purpose of an administration is to save the company or its business, and it is intended to give the debtor company a breathing space within which to enable the administrator to achieve this objective. As a result, no step may be taken to enforce security over the debtor's property except with the consent of the administrator or the permission of the court; and there are similar prohibitions on the ability to repossess goods in the debtor's possession under hire purchase, leasing, conditional sale and reservation of title agreements.

The courts have laid down broad but imprecise requirements as to how the administrator must exercise his powers. In deciding whether or not to allow a secured creditor to enforce its security, the administrator must make his decision speedily. He must also act responsibly and reasonably in deciding whether or not enforcement of the security is likely to prejudice the objectives of the administration.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

As has been seen in the reply to question 6, English insolvency law draws a distinction between fixed and floating charge assets.

A liquidator has no power to deal with fixed charge assets. An administrator does have a theoretical power to sell fixed charge assets without the consent of the secured creditor, but he requires the authority of the court to do so, and must pay the proceeds (or the market value, if higher) to the secured creditor. In practice, this power is rarely used.

An administrator does, however, have much wider powers over floating charge assets. He can use them without obtaining a court order and may pay his remuneration and expenses out of them. There are proposals to give a liquidator a limited power to pay expenses out of floating charge assets. The powers of an administrator or liquidator to use financial collateral (broadly cash and securities) are more circumscribed.

12. What distribution will a secured creditor receive if a company is reorganised?

It is rare for a company which enters into insolvency proceedings to continue being in business. Even when an administrator is appointed, the result will normally be that the company's business is sold, rather than that the company itself is reorganised. Any reorganisation requires the consent of the secured creditor. The secured creditor will therefore receive the distribution it agrees to.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

If there were a reorganisation of the company, the secured creditor's consent would be required, in which event it would be likely to require security over the assets of the reorganised company.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

If the enforcement of the security results in a surplus once the secured creditor has been paid in full (including interest and expenses), this is held on trust for the debtor. If the proceeds of enforcement are insufficient to pay the secured creditor in full, it will be entitled to claim in the insolvency proceedings for the balance as an unsecured creditor.

France

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

Personal or movable property

Several security rights may apply to movable property: right to retain the asset, lien, pledge over tangible and intangible assets *(gage* and *nantissemen*t). In France, a reform was introduced pursuant to an order dated 23 March 2006 which clarifies and regroups most of the existing provisions into a new section of the Civil Code. Security rights related to personal property are governed by three sources: contract, law, (for example, tax lien or employee's lien) and in certain cases, judicial.

Liens

The security granted by law for personal or movable property is a lien. (*privilège*).

A lien allows the secured party to have the debtor's asset sold upon default and the security to be paid out of the proceeds of the sale with preference to the other creditors. Article 2324 of the Civil Code grants the lien according to "the quality of the debt"; it focuses on public interest (tax, French social security) and the necessity to protect a specific creditor (for example, the employee). There is no obligation in the law to publish liens, which makes them less secure.

Article 2330 of the Civil Code distinguishes between general liens (*privilèges généraux*) and specific liens (*privilèges spéciaux*).

General liens cover all assets of a debtor. The secured party has priority regarding the sale of assets, but is not protected in the event of a sale by the debtor. Some general liens can be found in the Civil Code (for example: legal costs, funeral costs, and employee's salary, especially in the event of insolvency proceeding), whereas other general liens can be found in legal texts, such as tax privilege, French social security, and debts that result from insolvency proceeding.

Specific liens are numerous and can apply to one or more assets of a debtor. The main liens are listed in Article 2332 of the Civil Code. They provide the right of first refusal (*droit de préférence*), but contrary to general liens, some of them provide the right to pursue the asset (*droit de suite*) in the hands of a third party in the event of a sale by the debtor. They specifically concern the lessor who has a lien on the goods located in the rented premise. The lessor has a right of first refusal and under certain circumstances, a right to pursue the asset and a right to retain it (*droit de retention*). Another example relates to the seller of the goods in the event of non-payment by the debtor.

In general, a seizure and sale are necessary prior to enforcing the lien.

The subject of competing security rights has previously been dealt with in various case law and been formalized recently with the order dated 23 March 2006. Priority between liens is organized by Article 2331 and 2332 of the Civil Code. If there is competition between general and specific liens, the latter shall have priority. However, there are exceptions to the rule, especially for tax and employee liens.

Pledge

The security rights granted by contract over personal or movable property are the *pledge* over tangible assets (*gage*) and the pledge over intangible assets (*nantissement*).

Since the issuance of the order in 2006, the terminology has been simplified. Before this order was introduced, the pledge was a type of *nantissement* and could equally apply to either tangible or intangible assets. The new classification is as follows: tangible assets can be pledged by way of a *gage*, whereas intangible assets can be pledged by way of *nantissement*. However, many legal texts, other than the Civil Code, have maintained the former terminology and this should be rectified in the future.

The pledge over tangible assets (*gage*) is defined in Article 2333 of the Civil Code. This pledge consists of providing a creditor the right to be paid prior to

the other creditors over movable corporeal assets, present or future. The pledge agreement must indicate the debt, the quantity and the nature of the pledged assets.

Since 2006, it is possible to grant a pledge without loss of possession (*gage sans dépossession*). If an asset is pledged several times, the rank of each pledge is determined by their date of registration. It is also now possible to pledge present and/or future assets. Two formalities must be accomplished to make the pledge without loss of possession enforceable against third parties: the execution of a pledge agreement, and the registration of the pledge agreement in a specific register. Other pledges can be granted over motor vehicles, equipments or stocks.

The pledge over intangible assets (*nantissement)* is defined in Article 2355 of the Civil Code. This pledge consists of the allocation of an incorporeal movable or of a set of incorporeal movables, present or future, as security for an obligation. A pledge of accounts receivable would be included in this definition.

The granting of a pledge over intangible assets may be contractual or judicial. The pledge becomes enforceable against a third party from the date the document is executed and enforceable against the debtor from the date of notification, or from the date of the agreement if the debtor was an original party to it. It is also possible to create a pledge over a future receivable (specifically identified). It should be noted that in practice banks usually have a preference for the so called *Loi Dailly* assignment of receivables by way of security (see below).

Many other pledges over intangible assets exist, such as the pledge over intellectual property rights, partner's rights, goodwill, bank accounts.

Immovable and real property

The main security rights *in rem* are governed by the principle of public registration (*publicité foncière*) in order to be enforceable against a third party.

Mortgage

The main security right used is the mortgage which consists of a right over an immovable property to secure the discharge of an obligation. The secured party has a right of first refusal (*droit de préférence*) and a right to pursue the asset subject to the mortgage (*droit de suite*). The loss of possession is not required.

A mortgage is statutory, judicial, or contractual. A contractual mortgage is entered into by deed with a specific mention of existing and free immovable property, by the debtor or a third party (guarantee), for present or future debts. A statutory mortgage is given by law to certain categories of creditors or debtors, such as spouses, guardians and to specific immovable liens, such as, a seller of an immovable property, or an architect.

The reform of 2006 has introduced the concept of "rechargeable" mortgage which allows the debtor to secure further credit facilities under the same mortgage.

The judicial mortgage is granted to a creditor when a court decision has been pronounced against the debtor based on a judicial request by the creditor.

The second group of security rights related to real estate property is general liens. They cover all the real estate property of the debtor, are granted to cover legal costs and employees have priority with regards to the other security rights *in rem*.

The last security right in this group is the *antichresis* which is a type of mortgage with loss of possession. It requires a written contract to be registered by a notary and published accordingly. The loss of possession is necessary because it provides the creditor with the use of the asset, the right to retain it until full payment has been made and a right of first refusal.

Pledge over business assets (*nantissement de fonds de commerce*)

Business assets can be pledged in accordance with Article L142-1 of the Commercial Code. The pledge generally covers the logo, the commercial name, the leasehold right (if any), the goodwill and the clientele. Intellectual property rights (such as patents or trademarks), the furniture used for commercial purposes, tools and equipments can also be included, subject to certain conditions, provided that they are listed in the pledge agreement.

A pledge over business assets does not cover inventory or stocks. The pledgor does not part with possession of the business and can continue to operate it notwithstanding the pledge created thereon. This security is commonly used by banks.

- Retention of title (*réserve de propriété*): This is now included in the definition of security right by Article 2329 of the Civil Code. This security is commonly used by manufacturers and also by banks in asset finance schemes. It is now governed by Articles 2367 and subs. of the Civil Code and must be agreed in writing.

- Assignment of receivables: Under Article L313.23 of the *Code monétaire et financier* (the so called *Loi Dailly*), a debtor can grant a security right over its commercial receivables. The security is granted as an assignment of title by way of security provided that certain conditions of form and substance are met. In particular the beneficiary of the assignment must be an EU credit institution.

The assignment is only available (i) for securing loans or credit facilities made to the assignor or repayment of sums paid under guarantees issued to its order by credit institutions and (ii) in respect of receivables held against corporate bodies, or individuals if the claims arose in connection with their commercial activity.

The assignment of receivables by way of security is achieved by drawing up and delivering to the assignee an instrument (the so-called "*bordereau*") signed by the assignor identifying the assigned receivables or mentioning items capable of identifying them (such as name of the debtor, place of payment, amount or estimation of the amount of the receivables, maturity date thereof).

The assignment is binding on the debtor and third parties on the date appearing at the bottom of the *bordereau*.

A notice of the assignment can be served on the account debtor at the assignee's discretion upon which notice the account debtor has to pay the proceeds of the assigned receivables exclusively to the assignee.

- A law dated 19 February 2007 has recently introduced the concept of *Fiducie* (trust) in the French legal system, which constitutes a major innovation. However it is still unclear whether it will be possible to use the *Fiducie* for security purposes. Further texts will hopefully clarify the conditions in which the *Fiducie* will, for example, enable creditors to hold the property of assets of their debtors by way of security.

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

The enforcement of security rights depends on whether the security right concerns personal or immovable property. There are no specific practical difficulties other than procedural delays potentially generated by the debtor and its counsels. The enforcement of security rights being a court process, one should always anticipate a fairly long process, however a provisional

seizure or attachment can be obtained by the creditor if the circumstances justify it.

Movable property

The enforcement of the lien depends on its nature. As previously mentioned, some of the liens give a right of first refusal, a right to pursue the asset or a right to retain the asset. Also as previously mentioned a creditor will enforce the lien by a seizure and a sale through a court process.

In order to enforce the pledge, the creditor can request the sale of the asset by public auction (not for pledge over intangible assets such as shares, bank accounts or trademarks) or ask for a court order allocating ownership or become owner of the asset according to a *pacte commissoire* (it is a group of provisions which is inserted in the relevant security document and by which the parties agree, that in the event of the pledgor's failure to perform its obligations before the end of a specific period, the creditor may become the owner of the asset pledged) on the basis of the valuation made by an appraiser (but prohibited for pledges over stock, insolvency proceeding or consumer credit).

Immovable property

With regard to mortgage, the creditor may request the sale of the property by public auction and if the property is not the main residence of the mortgagor, the creditor can ask for a court order allocating ownership or become owner in accordance with a *pacte commissoire* (after an expert has evaluated the property).

3. Describe the types of pre-insolvency and insolvency proceeding in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.

(d) Does the Debtor remain "in possession" of the business?

French pre-insolvency and insolvency law was substantially reformed by the law N° 2005-845 dated 26, July 2005 and its implementing decree N° 2005-1677 dated 29, December 2005. This new set of regulations applies as of 1, January 2006. All pre-insolvency and insolvency proceedings have now been regrouped in Book VI ("*Livre VI*") of the Commercial Code dealing with financial difficulties of companies.

The main objective of the new law is the rescue of businesses in financial difficulties (the "debtor") as early as possible by promoting negotiated settlements with creditors and offering greater procedural flexibility to a company facing financial difficulties. Proceeding can be opened at the request of the company itself or by creditors or even by the public prosecutor depending on the nature of the proceeding.

Article L. 620-1 of the Code de Commerce introduces a new "safeguard" proceeding whose purpose is inspired by the US Chapter 11, with a view to enable the debtor to maintain its activities and work on recovery solutions at an earlier stage.

When a company encounters financial and economic difficulties, a more comprehensive set of preventive and/ or curative measures may thus be used.

The main criteria used for opening the proceeding (Safeguard, Conciliation, Recovery or Liquidation) is whether, and if so on what date, the debtor is unable to meet its liabilities as they become due out of available assets (the "Suspension of Payments" and "Suspension of Payment Date"). This is the so called "*cessation des paiements*" concept. It is crucial to follow as closely as possible the position of the company in this respect. For contractual purposes, it is important to concentrate on the concept of "insolvent" by reference to this concept (e.g. events of defaults in credit agreements).

Preventive proceeding

Several preventive proceedings may apply to French companies that encounter financial difficulties. In particular, the French *Code de Commerce* (i) provides for an alert procedure (*procédure d'alerte*) for the early detection of potential difficulties that could jeopardise the continuity of the business and (ii) encourages a voluntary arrangement in the framework of an out of court arrangement (*mandat ad hoc*) or conciliation proceeding (*procédure de conciliation*) between a company that experiences financial difficulties and its creditors. Finally, the new French insolvency law provides for safeguard proceeding (*procédure de sauvegarde*) available to a company that faces difficulties that it is unable to overcome and which could lead it to becoming

insolvent. These proceeding may only be applied where the company is in good standing (*in bonis*), and shall not be applied to a debtor that is insolvent within the meaning of French insolvency law (unless for conciliation proceeding which may be opened if the debtor faces actual or expected legal, economic or financial difficulties or have been insolvent for less than 45 days).

Insolvency proceeding

Any company that is unable to pay its debts when due with its available assets (i.e. a company which is in *cessation des paiements*) is subject to compulsory insolvency proceeding. The management of the company must file a request for the commencement of these proceeding with the competent court within 45 days from the date on which the company is unable to pay its debts, provided that it has not asked the court to open "voluntary conciliation proceeding" during that 45 day period. A petition for the commencement of insolvency proceeding may also be filed by any unpaid creditor, the public prosecutor or decided by the court on its own motion.

A company subject to compulsory insolvency proceeding will have a choice between:

– Recovery proceeding (*Redressement Judiciaire*), if its business can be reorganised; or

– Liquidation proceeding (*Liquidation Judiciaire*), if its business cannot be successfully reorganised.

Recovery proceeding

The purpose of the recovery proceeding is similar to that of the safeguard proceeding, i.e. to reorganize the debtor with a view to enabling its continued operation, preserving employment and restructuring its liabilities. A recovery proceeding may be opened with respect to the debtor provided (i) it is in the state of *cessation de paiements* and (ii) it has a reasonably good chance to recover. Such proceeding may be initiated by (i) the debtor within 45 days of the suspension of payment date provided it has not sought the opening of conciliation proceeding within this time period, (ii) the court upon its own initiative, (iii) the public prosecutor, or (iv) a creditor.

The judgment opening the insolvency proceeding (the "insolvency judgment") sets the date on which the company actually became unable to meet its debts as they fell due (*date de cessation des paiements*), which may not be more than eighteen months before the date of the insolvency judgment. Certain payments made or commitments entered into during the period

extending from such date until the date of the insolvency judgment (*Période Suspecte*) will automatically be invalidated by the court (See below).

Recovery proceedings generally commence with a two-month "observation period" (*période d'observation*), which takes effect as of the date of the insolvency judgment. The court may extend the observation period if the debtor company's financial position appears to be sufficient to meet its debts. In total, the observation period may last up to 12 months, renewable in exceptional circumstances for another six months. The court may also extend the observation period if it converts safeguard proceeding into recovery proceeding. The court may, however, decide on the immediate liquidation of the insolvent company where there is no prospect of recovery.

The insolvency judgment provides for the appointment of a judicial administrator (*administrateur judiciaire)*. The court determines the extent to which the judicial administrator will be required to assist or manage the affairs of the debtor. The "Judicial Administrator" must investigate the company's difficulties and make proposals for the continuation of its business. Its responsibilities include the completion of an inventory of the insolvent company's assets as well as, depending on the scope of its management powers, the collection of the company's debts, the renewal or suspension of any of the contractual arrangements of the debtor, and any further action necessary to preserve the company's business and assets.

The court will also appoint a "bankruptcy judge" (*Juge Commissaire)* to supervise the proceeding and a "Creditor's Representative" (*Mandataire Judiciaire)* is also appointed by the court. The role of the creditor's representative is essentially to act on behalf and in the interest of the creditors. To this end, he examines the creditor's claims against the debtor and refers them to the bankruptcy judge with a proposal to admit or reject them or to submit them to the competent court.

In the course of the observation period, the court will decide whether there should be (i) a continuation of its business under a continuation plan (*plan de continuation*), (ii) a sale of all or a portion of the business to a third party investor pursuant to a business sale plan (*plan de cession*) and/or (iii) a liquidation of the company (*liquidation judiciaire*).

Liquidation proceeding

The new French insolvency law provides that a company that cannot recover through a recovery plan would have to file for the commencement of "liquidation proceeding" within 45 days of the date it becomes insolvent,

provided that it has not asked the court to open voluntary conciliation proceeding during that time period.

The court may order the commencement of liquidation proceeding either in the "insolvency judgment", in which case the court will appoint a liquidator (*Liquidateur Judiciaire*) to represent the company and sell its assets, or in the course of or at the end of the "observation period", if it has ordered the commencement of recovery proceeding first, in which case the creditors' representative becomes liquidator.

In a liquidation proceeding, the court decides either to order the sale of part or all of the business and assets of the debtor as a going concern together with the necessary employment and commercial contracts pursuant to a "sale plan" (*plan de cession*) or, if it considers that no such plan is likely to take place, orders the realization of the assets either individually or by groups of assets.

The issuance of a liquidation order automatically renders all debts of the insolvent company immediately due and payable, unless a sale of the debtor's business is contemplated during liquidation proceeding. In this case, the court may authorize the continuation of the debtor's business for such period of time as it may determine. During that time period, a stay of proceeding and of payments or debts that arose prior to the insolvency judgment will be imposed.

Management of the debtor

During the safeguard proceeding, the debtor continues to manage itself. The objective behind this principle is to encourage the debtor to initiate a safeguard proceeding before recovery or liquidation proceedings become necessary.

The debtor either continues to manage itself with the assistance of a "judicial administrator", or is managed by a judicial administrator, during the observation period of recovery proceeding, whereas he is totally divested of all rights pertaining to the management of its company where liquidation proceedings are initiated.

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the Debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

The general principle is governed by Article L632-1 of the Commercial Code which lists certain acts which can be nullified if they have "intervened" during the so called suspect period (date between the suspension of payments and the judgment opening the proceeding) (see §3 above).

Security rights granted as security for debts undertaken or incurred during the suspect period can thus be nullified. In practice it is crucial when considering the granting of a security right to make a thorough analysis of the financial standing of the grantor in order to ensure that it is not in a suspect period situation.

5. Is enforcement of security rights treated differently in each type of proceeding?

The treatment of the security rights or interests is different during each step of the proceeding.

During the observation period in the context of safeguard proceeding and recovery proceeding, assets that are the subject of a lender's privilege and mortgage may be sold by the administrator with the consent of the bankruptcy judge. If those assets are subject to security interests which do not confer an actual right of retention, an amount equal to the lesser of the sale price and the secured debt will be deposited in an account. At the end of the observation period, the secured creditors will be paid from this account in accordance with their respective rank. The secured creditors may also be required to accept alternative security.

If the court orders the continuation of the business under a recovery plan, the secured creditors will remain unable to enforce their security, and they will be forced to accept a rescheduling of their secured debts. Such a recovery plan may last up to ten years.

If the court orders the sale of the business at the end of the observation period, and provided that the subject matter of the security does not form part of the business assets sold, a secured creditor benefiting from a pledge would be able to enforce its security by applying to the court for an order transferring the subject matter of the security to the creditor. This procedure

is known as *attribution judiciaire*. It requires a valuation of the subject matter of the security to be made by a court-approved expert. The *attribution judiciaire* will extinguish the debt in an amount equal to the valuation.

The principal advantage of the *attribution judiciaire* procedure is that it enables the secured creditor to obtain title to the subject matter of the security free of the claims of any prior ranking creditors such as the French state (in respect of taxes).

If the subject matter of the security does form part of the business assets sold, the secured creditor will not be able to request the *attribution judiciaire*. The court will, instead, allocate a part of the sale price to the subject matter of the security. The secured creditor will be able to accept this amount in satisfaction of his claim on the relevant asset, although certain preferred creditors (see the preceding paragraph) will have a prior claim to such amount. In other words, the secured creditor in this situation will be in the same situation as the holder of a security interest that does not confer a right of retention.

However, certain security interests may be enforced without having recourse to the courts. This includes, in particular, pledges over assets whose value is not subject to debate (such as pledges over financial instruments listed on a regulated market) or securities involving a transfer of ownership of the underlying assets (such as securities over cash constituted in the form of cash-collateral (*gage-espèces)* whereby the ownership of the cash is transferred to the beneficiary).

In the event that the court orders a liquidation, a secured creditor benefiting from a pledge will be free to seek the *attribution judiciaire* of the subject matter of the security interest.

The secured creditor benefiting from a pledge may also enforce its security without having recourse to the courts if the contract provides that an event of default make the creditor owner of the asset (*clause compromissoire*). It requires a valuation of the subject matter of the security to be made by a court-approved expert. The attribution will extinguish the debt in an amount equal to the valuation.

6. What are the relative priorities in distributions among creditors and shareholders of the Debtor during a pre-insolvency or insolvency proceeding?

The following debts, in the order of priority in which they are listed, are treated as preferred debts and are paid in priority to those owed to unsecured creditors of the company (Article L. 641-13 of the French *Code de commerce*):

- certain salaries and other sums payable to employees;
- certain court costs;
- claims relating to loans or claims when the lender or creditor has accepted a differed payment;
- certain sums advanced in accordance with specific provisions of the *Code du travail*; and
- other claims and debts in accordance with their rank.

It should be noted that priorities in distributions and ranking of claims are governed by intricate rules described in multiple texts and case law. Legal advice should be sought on a case by case basis.

7. How can creditors protect their rights towards the debtor?

As a general advice, it is crucial to follow carefully the developments of the situation of the debtor, in particular when pre-insolvency or insolvency proceedings start to be contemplated, in order, for example, to determine whether the termination of an agreement could be declared prior to the opening of the proceeding, or before the debtor being deemed to be in the suspect period. Once a proceeding is opened it must be followed on a day to day basis when necessary, with the assistance of a legal counsel in particular in order to comply with all delays for declaring claims or filing claims for repossession of assets, or generally to take all appropriate actions.

From the date of the insolvency judgment, the debtor is prevented from making payments regarding the sums that are due and payable prior the insolvency judgment. In the same way, secured creditors are not allowed to enforce their securities during the observation period.

Any claims against the debtor regarding the payment of any sum, or involving the termination of any contract, and actions relating to the enforcement of previously obtained judgments are stayed. Actions relating to claims arising prior to the insolvency judgment that do not involve the payment of a sum of money or the termination of a contract for payment default may be

commenced or continued with the supervision of the judicial administrator and the creditors representative.

Creditors (other than employees) to whom the debtor became indebted prior to the insolvency judgment and creditors whose claim arose after the commencement of the proceeding but is not linked to the activity of the debtor or was not incurred for the purpose of the proceeding are required to send in a statement of their claims to the creditor representative within two months following the publication of the judgment opening the proceeding in the French Official Gazette called BODACC. Payment of the creditors having duly stated their claims will occur at the end of the insolvency proceeding (subject to the amount of available moneys). Debts that arose before the date of the insolvency judgment rank junior to debts arising after the insolvency judgment and after certain preferred creditors (employee for example).

8. How do creditors protect their rights towards guarantors?

From the opening of a safeguard proceeding, recovery or liquidation proceeding, there is a suspension of payments in favor of the debtor. Article L 622-28 al. 2 and L 631-44 of the Commercial Code allows third party guarantors (*cautions*), first demand guarantors (*garants autonomes*), and joint obligation debtors (*coobligés*) when they are individual entities, to benefit from this suspension during the observation period. These guarantors cannot be sued by the creditor until a plan is adopted. At the end of this period, the court may grant payment postponements (*différé de paiement*) to the guarantor, with a two year limit.

However, during this stay of actions against the guarantor, article L 622-28 al 3 of the Commercial Code allows creditors to take conservatory measures, to protect their future claim against the guarantors.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g., perfection)?

In the statement of their claim, secured creditors have to specify the quality of their security and what steps the creditor has taken to perfect its security rights. The failure to comply with this rule leads to the loss of the preferential rank.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

As from the opening of the proceeding, secured creditors of the debtor are not entitled to enforce their security interests during the observation period and no further security may be granted over the debtor's assets without the prior consent of the bankruptcy judge. The granting of a mortgage or a charge as security for a prior debt during the p*eriode suspecte* will automatically be invalidated by the court.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

As mentioned in the answer to question 5 above, certain security interests as cash collateral may be enforced without having recourse to the courts.

12. What distribution will a secured creditor receive if a company is reorganised?

Article L. 643-2 of the French *Code de commerce* provides that creditors holding a mortgage or lender privilege are entitled, once they have fulfilled the legal obligation to declare their claims to the creditor's representative and even where such claims have not yet been acknowledged by the *juge-commissaire*, to enforce their rights if the liquidator or the *commissaire à l'exécution du plan* has not initiated the sale of the charged assets within the three-month period following the date of the judgment which instituted or declared the liquidation or the sale of the business.

If the liquidator does sell the property during such three-month period, the sale price will be distributed to the creditors. In such event, the creditor holding a first ranking mortgage shall only be paid after payment of the employees' privileged receivables, the legal fees and claims of creditors defined under Article L. 641-13 of the French *Code de commerce*.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

If the court orders the sale of the secured asset as part of the business in the context of a business sale plan and in the event that the security had been granted in order to secure a loan which was granted to finance the acquisition of such asset, the ultimate purchaser of the asset is bound by the terms of the outstanding loan agreements extended for the purpose of such acquisition and therefore by the security rights previously granted.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

Not applicable as the concept of "over secured claim" or "under secured claim" do not exist under French law.

Germany

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

Personal or movable property

Security interests in respect of movable or personal property are principally granted through a security transfer of title (*Sicherungsübereignung*), a pledge (*Pfandrecht*), a security assignment (*Sicherungsabtretung*) or a retention of title (*Eigentumsvorbehalt*). In contrast to common law jurisdictions there is no concept of a floating charge under German law, which means that each category of assets of a German company has to be separately identified and to be made the subject matter of appropriate security arrangements. Security rights are mostly regulated by statutory law, the German Civil Code (*Bürgerliches Gesetzbuch – BGB*), which applies to every private legal instrument including commercial transactions, as long as there are no other applicable specific rules.

A security transfer of title is usually used in relation to movable assets like inventory. Such security interest requires a full transfer of title. It is created by agreement between the parties and the grantor retains possession of the relevant asset. The agreement is not required to be in a particular form and registration of the security transfer of title is neither required nor possible. A pledge is an accessory (*akzessorisch*) collateral, which means that there is a direct legal link between the collateral and the secured claim, i.e. if the secured claim ceases to exist, the collateral will cease to exist and the collateral cannot be transferred without the secured claim. It is created by agreement between the parties. A pledge is created by pledging a chattel or claim as security for a debt. It is a right *in rem* to satisfy a claim. It requires that the debtor deliver up possession of the chattel. Registration of a pledge is neither required nor possible. Claims or rights

may either be pledged or transferred for security purposes by way of an assignment. In case of a pledge the third party debtor in principle must be notified of the pledge in order for the pledge to be effective. An assignment (f.ex. of receivables, IP rights or insurances) is, again, effected by agreement between the parties. There are no particular requirements as to the form of such agreement and registration is, again, neither required nor possible. The debtor does not need to be notified of the assignment. A retention of title means that the seller of personal property may retain title until the purchase price has been paid (condition precedent).

Real or immovable property

Security over real or immovable property is available either in the form of a land charge (*Grundschuld*) or a mortgage (*Hypothek*). A land charge is a non-accessory security right, i.e. a land charge is in principle independent from the existence of the secured claims. The link between the land charge and the secured claim is created under a separate security agreement. In contrast to the land charges, a mortgage is an accessory right, depending on an underlying personal debt. Both are created by a private agreement between the parties, a notarised declaration of the chargor (*Eintragungsbewilligung*) and registration with the land register. Therefore, fees for notarisation will be incurred. The registration of the land charge (as opposed to the separate security agreement) in the land register incurs an additional fee. In both cases, the amount of the fees payable depends on the amount secured by the security interest.

In practice, due to their more flexible non-accessory nature land charges are considered the preferable real estate security interest and are used almost in all cases.

Granting security

In general, a security interest is created by contract, but there are a few exceptions. The most important statutory liens are the contractor lien (*Unternehmerpfandrecht*) and landlord's lien (*Vermieterpfandrecht*).

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

Since the assets of the debtor are effectively confiscated with the commencement of insolvency proceedings and the power to manage and administer the assets of the debtor passes to the administrator, the procedure discussed below is related to enforcement outside of insolvency proceedings.

In order to enforce security rights under German law, the creditor normally must obtain a court judgment. Court proceedings would have to be initiated and the debtor would be ordered by the court to make the payments in question. The court judgment could then be used to enforce the security. In order to avoid lengthy proceedings, the mortgage or land charge documentation usually includes a submission of the debtor to immediate enforcement (*Unterwerfung unter die sofortige Zwangsvollstreckung*) against the property in relation to outstanding claims. Such submission to immediate enforcement requires a notarial deed which, for the purpose of enforcement of the mortgage or land charge, replaces a court judgment so that on the basis of the notarial deed enforcement can be initiated without having to obtain a court judgement.

Before a judgment can be executed with state assistance (bailiffs) three essential prerequisites must be fulfilled. First, the creditor must actually hold a court certified copy of the complete (written) final judgment (*Titel*); secondly, the judgment must contain an execution clause (*Klausel*); and thirdly, the judgment with the execution clause must be served upon the debtor (*Zustellung*).

For enforcement against immovable property the creditor can choose between three alternative steps: a mortgage to be entered in the land register (*Grundbuch*) on application of the creditor by way of execution (*Zwangshypothek*); a sale by court order (*Zwangsversteigerung*); or sequestration with an administrator appointed by the court in order to receive the rents and profits thereof (*Zwangsverwaltung*).

The proceeds from a judicial sale will firstly be used to cover the costs of the proceedings. The proceeds will then be distributed to all mortgagees/chargees according to their ranking, i.e. outstanding claims of the first ranking mortgagee/chargee will be discharged first.

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.

(d) Does the debtor remain "in possession" of the business?

There is no German equivalent to formal pre-insolvency proceedings, but pre-insolvency work-outs, like moratoriums, voluntary liquidations and business restructurings are quite popular as they aim at finding an out-of-court settlement. Another tool is the German insolvency plan, a procedure that bears a strong resemblance to the reorganisation procedure of the Chapter 11 US Bankruptcy Code. The insolvency plan may provide for changes in the legal relationships of the debtor and creditors. However, the insolvency plan is part of a formal insolvency proceeding.

Who can initiate the insolvency proceeding?

The commencement of insolvency proceedings requires a petition to the competent insolvency court by either the debtor or one of its creditors. If a company is insolvent, the management of the company must apply for the commencement of insolvency proceedings without culpable delay and no later than three weeks after the occurrence of a ground for insolvency. The three-week period may only be used for restructuring or negotiations with an investor if it is reasonable and likely that such measure will be successful. The obligation to file for insolvency arises irrespective of the executives' knowledge of insolvency. As a result, the executives are under an ongoing obligation to monitor the standing of the company to exclude the risk of personal civil and criminal liability.

Criteria used for opening the proceeding

Under the German Insolvency Act (InsO), insolvency proceedings require a reason for being opened. Such reasons can be:

- the debtor's liabilities are greater than its assets ('over-indebtedness'or *Überschuldung*) or

- the debtor is unable to meet its debts as they fall due ('inability to pay debts' or *Zahlungsunfähigkeit*).

An event of 'impending inability to pay debts' (*Drohende Zahlungsunfähigkeit*) does not give rise to the obligation to file for insolvency proceedings but entitles the debtor (not creditors) to do so.

The insolvency court will refuse a request to open insolvency proceedings if the debtor's assets are insufficient to cover the costs of the proceedings. Otherwise, it will open the insolvency proceedings.

The main actors in insolvency proceedings

Apart from the debtor, main parties involved in the insolvency proceedings are the insolvency court (*Insolvenzgericht*), the administrator (*Insolvenzverwalter*) and the creditors' representation, i.e. the creditors' meeting (*Gläubigerversammlung*) and the creditors' committee (*Gläubigerausschuss*).

Insolvency court

The main functions of the insolvency court are to create the procedural framework for the realisation of the debtor's assets, to appoint and to supervise the administrator. The realisation of the debtor's assets is part of the administrator's job. The insolvency court has exclusive power to terminate insolvency proceedings. It is also able to order or approve special proceedings, e.g. insolvency plan, self-administration (debtor in possession) and discharge of residual debt.

Administrator

The administrator is a professional person (i.e. always a natural person), usually a lawyer, who derives his or her powers through the appointment by the court. In legal terms, the administrator is not a representative of the creditors or of the debtor. He is independent. Upon the opening of the insolvency proceedings the debtor's right to manage and transfer the assets involved in the insolvency proceedings is transferred to the administrator. He/she can choose to liquidate the company; continue the business and restructure the debt through an insolvency plan; or sell the business as a going concern. The administrator is personally liable for damages occurring because of a disregard of his/her legal duty of care. The parties to whom the administrator owes a duty of care are the debtor and the creditors as well as third parties who claim ownership of goods possessed by the estate due to retention of title.

Creditors' representation

The creditors' meeting in its capacity as a supervisory and controlling body is an institution peculiar to insolvency proceedings. The creditors' meeting is convened by the insolvency court. All secured and unsecured creditors, the administrator and the members of the creditors' committee are entitled to attend the creditors' meeting. The creditors' meeting votes upon resolutions concerning particular matters of importance if there is no creditors' committee and decides whether to cease or continue the debtor's business.

Unlike the creditors' meeting, the creditors' committee is optional. In larger insolvencies, however, a creditors' committee is regularly appointed. Its function, both in liquidation and administration proceedings, is to assist and supervise the administrator's 'management'. In liquidation proceedings, the creditors' committee is vested with substantial decision-making powers. The prior approval of the committee is required for transactions to be undertaken by the administrator, which are of particular importance.

Does the debtor remain "in possession" of the business?

The position of the debtor is not as strong as it is under U.S. law. Prior to the court's order for the commencement of insolvency proceedings there are no automatic restrictions on the debtor's power of disposal. However, after filing for insolvency, the insolvency court has the power to make all provisional arrangements, which it considers necessary to protect the estate against changes to the detriment of the creditors. In particular, the court may impose restrictions on the debtor's power to manage and administer assets. The court regularly appoints a preliminary insolvency administrator (*vorläufiger Insolvenzverwalter*). With the opening of insolvency proceedings, the assets of the debtor are effectively confiscated. Although the debtor retains title to property, the power to manage and administer the assets of the debtor passes to the administrator.

Only in cases of self-administration (*Eigenverwaltung*), the debtor continues to run and manage the business by himself, however, under the supervision of a creditors' trustee (*Sachwalter*). The German Insolvency Act (*Insolvenzordnung*) of 1999 has introduced this new form of self-administration into corporate insolvency. The purpose of self-administration does not deviate substantially from the purpose of regular German insolvency proceedings. The management in self-administration may liquidate the company, turnaround and continue the business, or sell the business as a going concern. The self-administration procedure is a useful option where maintaining the specialist skills of the current or established management is likely to benefit the debtor's creditors. Self-administration is also useful in international insolvency proceedings of group companies.

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

Certain transactions can be challenged by an administrator during insolvency proceedings in order to increase the assets (voidable transactions). The transactions particularly at risk are gifts and certain transactions undertaken during or shortly before the financial crisis of the debtor. A basic requirement of all challenges under the German Insolvency Act is that the transaction has a disadvantageous effect on the creditors as a body in that it impairs their chances of recovery. Typically, this is the case where the transaction has diminished the assets or increased the liabilities of the future estate. In detail, however, the particular grounds of challenge are rather subtle and shall be explained only in general terms here.

In particular, the following transactions may be challenged by the administrator:

- transactions undertaken by the debtor during the previous ten years prior to filing for insolvency or after such filing with the intention of disadvantaging its creditors where the other party was aware of the debtor's intention at the time of the transaction;
- transactions undertaken by the debtor for no consideration within four years prior to the application for insolvency proceedings;
- transactions which in consideration of a shareholder's claim for repayment of his loan replacing equity or in consideration of an equivalent claim granted security or satisfaction, if such transaction was made during the previous ten years in case of security or during the previous year in case of satisfactions, in each case prior to filing for insolvency proceedings or subsequent to such filing;
- transactions made in the period of three months prior to the filing for insolvency and the period between filing for and opening of insolvency proceedings can be set aside even more easily. The law distinguishes between satisfaction of claims or security the creditor is entitled to (fair consideration), and satisfaction of claims or security, the creditor is not entitled to (unfair consideration).

However, a transaction in principle can not be set aside if the debtor receives adequate consideration immediately.

If a creditor receives security, collateral or payment in breach of these rules, he has to waive all rights under a security, repay all moneys or retransfer all

assets received if the transaction is challenged by the administrator. If the security includes rights in movable goods or rights, the creditor would also be liable for all further damage to the relevant asset.

5. Is enforcement of security rights treated differently in each type of proceeding?

Generally speaking, the German Insolvency Act imposes an automatic stay on the enforcement of rights as soon as the insolvency proceeding commences but does not place any restrictions on enforcement at the pre-insolvency stage.

However, there are several exceptions to the principle of automatic stay. For details see the answer to question 10.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Before the opening of insolvency proceedings there are no priorities in distributions among creditors, except for those contractually agreed, e.g. in an inter creditor agreement. After the opening of insolvency proceedings there is a strict ranking. The German Insolvency Act recognises four types of creditors: secured creditors, estate creditors (the creditors of the estate whose claims arise after the commencement of insolvency proceedings, mainly through dealings with the administrator), insolvency creditors (the creditors of the debtor, who, at the commencement of the insolvency proceedings, have a claim against the debtor), and subordinated creditors.

Secured creditors who have security rights in assets which belong to the bankruptcy estate and which are in the possession of the insolvency administrator, are not entitled to realise the assets. Instead, the administrator will realise the collateral and pay the proceeds to the secured creditors.

The estate creditors' (*Massegläubiger*) claims must also be satisfied before the proceeds of the liquidation can be distributed among the insolvency creditors. Claims against the debtor which arise after the commencement of the insolvency proceedings upon agreement with or action by the administrator are not treated as insolvency claims. This would apply to a new loan which is provided to the administrator. The estate creditors play a separate role because they have not extended credit to the debtor voluntarily

and, thus, have not assumed the risk of the debtor's insolvency. Moreover, they have enhanced the estate by delivering goods or rendering services, so that it would not be justified to treat them on an equal level with the insolvency creditors.

In principal all other insolvency creditors are treated equally and their claims rank *pari passu.* This means that all claims listed in the list of creditors' claims are satisfied proportionally, except claims of subordinated insolvency creditors. The latter rank junior to the other claims of insolvency creditors. Claims of subordinated creditors are, for example, interest accruing from the claims of insolvency creditors since the opening of the insolvency proceedings, shareholders' claims for repayment of loans replacing equity, etc.

Shareholders are paid only after all creditors have been paid in full.

7. How can creditors protect their rights towards the debtor?

Generally, in order for a claim of a creditor to be considered, the creditor has to apply for registration of its claim in a list of creditors' claims (*Insolvenztabelle*) within a certain time limit. This list is set up by the insolvency administrator. However, in general they do not suffer any severe disadvantages if they catch up on that issue belatedly. In case the insolvency administrator has sold assets that originally secured the creditor's rights, for example, the creditor may claim the proceeds out of the sale. Nevertheless, it is strongly advisable to indicate the securities at an early stage since it puts the creditor in the position to exert influence on the liquidation of the securing assets.

As reported above, once proceedings have been commenced, the assets of the debtor are effectively confiscated by the administrator, so the creditor is stayed from taking action against its collateral. Possible enforcement actions of creditors are discussed in more detail in the answer to question 10 below.

8. How do creditors protect their rights towards guarantors?

First, one has to differentiate between an on demand guarantee (*Garantie*) and a surety (*Bürgschaft*). An on demand guarantee under German law is a personal security that is non-accessory. An on demand guarantee is a contractual relationship which is not explicitly governed by statutory law but is developed and shaped by legal practice, in particular by court judgments. A surety under German law is a personal security which is accessory. A surety is a contractual relationship which is governed by particular rules of the

German Civil Code. English terms used to describe these concepts vary. A German law *Garantie* is often translated as 'guarantee' and sometimes as 'indemnity', and a German law *Bürgschaft* is sometimes called 'surety' and sometimes 'guarantee'.

The commencement of insolvency proceedings does not result in a stay of either a surety or an on demand guarantee. Therefore the creditor could take action against the obligor/guarantor to satisfy his claims.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g., perfection)?

In case the acquisition (including registration where required) of a security right of a creditor has not been completed prior to the opening of the insolvency proceedings the creditor remains unsecured. German law provides for the general principle that after the opening of insolvency proceedings rights in objects – be it a land charge, a pledge or even the title itself – forming part of the estate generally cannot be acquired with legal effect any more. In case of security assignments of future claims, for example, claims of the estate generated after the opening of proceedings do not secure the creditor's interest.

With respect to real property, the Insolvency Act provides for the exception of acquisition in good faith under certain circumstances. However, even after the acquisition in good faith there remains the risk that the acquisition will be challenged by the insolvency administrator.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

With respect to secured creditors it depends on the type of security whether the creditor is entitled to take enforcement actions. Creditors who are secured by retention of title, for example, are still entitled to enforce their right if the insolvency administrator has chosen not to continue the underlying purchase agreement. Creditors secured by land charges may also enforce their rights irrespective of the pending insolvency proceeding. However, in practice these creditors might face arguments while trying to enforce their security since their measures might overlap with enforcement actions of the insolvency administrator. Creditors secured by fiduciary transfer of assets/receivables or

pledges are in general not entitled to take enforcement actions themselves; it is rather the insolvency administrator who enforces their rights. Generally, he sells the secured assets, charges a liquidation fee of approximately 9 % of the proceeds for that action and pays out the remaining proceeds to the creditors.

At the pre-insolvency stage claims may generally still be enforced. However, between the filing for insolvency and the opening of the insolvency proceedings (such period usually lasts up to three months in Germany) the insolvency court (respectively the competent court for enforcements with respect to the estate's real property) is entitled to prohibit or suspend enforcement measures by creditors except with respect to immovable assets.

In general, creditors do not have the possibility to challenge a stay of enforcement, neither at the pre-insolvency stage nor after the commencement of the proceedings.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

After the opening of insolvency proceedings the right to manage and transfer the debtor's assets passes to the insolvency administrator. Thus, he is in general, entitled to use and dispose of the debtor's movable and immovable assets. However, with respect to assets that effectively do not belong to the estate due to a right of segregation of the creditor holding title in the property, the administrator is obliged to release these assets. Movable assets subject to security rights which are in the possession of the insolvency administrator may be used by the administrator for the period until their realization. However, the secured creditor is entitled to a compensation for the loss in value of the asset in which he has security rights.

Under German law there is no specific treatment for "cash collateral".

In practice, the continuation of the debtor's business often depends on the willingness of creditors to inject fresh capital. In case an insolvency administrator incurs such loans the creditor's claim will be satisfied ahead of other insolvency creditors. Nevertheless, usually creditors insist on security rights for these loans. The administrator may grant such right if there are still sufficient "free" assets in the estate to secure the loans. In any case, the administrator may secure the loans by the goods and receivables generated during the continuation of the business.

12. What distribution will a secured creditor receive if a company is reorganised?

Part of the insolvency reform in Germany was the introduction of a procedure that bears a strong resemblance to the reorganization procedure of the Chapter 11 US Bankruptcy Code. The core element of this procedure is the insolvency plan which is part of the German Insolvency Act and which provides for reorganization.

If a company is reorganised by an insolvency plan, a secured creditor will generally receive a distribution according to the provisions of the insolvency plan. If the insolvency plan does not contain any provisions regarding the secured creditors, the plan does not affect their rights.

The plan may be proposed by the debtor or by the administrator. In addition the creditors' meeting is entitled to request that the administrator proposes a plan. The insolvency plan may provide for changes in the legal relationships of the debtor and creditors. Three types of creditors are to be dealt with: secured creditors, unsecured creditors and subordinated creditors. A group of creditors must be formed for each of these categories of creditors. Subgroups may be formed where certain creditors have homogeneous economic interests. Employees should and creditors with small claims may form separate groups. To conclude the plan, the insolvency court determines a date for discussion of and a decision about the plan. A majority of creditors in each class and a majority of the value of the claims in each class must approve the insolvency plan. Even if the necessary majorities have not been achieved, a voting group shall be deemed to have consented if the requirements of so-called prohibition of obstruction are fulfilled. According to the prohibition of obstruction the rejection of the plan by a voting group is irrelevant provided that: (a) the creditors forming such group presumably suffer no loss under the insolvency plan compared to their situation without such plan; (b) these creditors participate adequately in the economic value the parties will receive under the plan; and (c) the majority of the voting groups have given their consent to the plan with the necessary majorities. The prohibition of obstruction resembles the "cram down-rule" in Chapter 11 of the US Bankruptcy Code. Finally the plan has to be approved by the insolvency court.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

The confirmation of the plan by the competent court will effect the arrangements provided for in the plan. The general legal concept with respect to insolvency plans provides for discharge of claims of the unsecured creditors to the extent they do not receive the quota according to the plan. In contrast to that rights of secured creditors remain unaffected if not provided for otherwise in the insolvency plan.

However, as the parties are free to arrange the plan according to their own interest the plan may deviate from this general rule. The plan may make determinations with respect to the distribution of the debtor's assets between the secured and unsecured creditors. It may provide for a waiving of the secured rights as well. As soon as the order confirming the insolvency plan becomes legally binding it becomes binding upon all the parties involved. If the plan is to create, modify, transfer or waive rights in objects or if shares in a company with limited liability are to be transferred, the declarations of intent on the part of the parties involved which are included in the plan are deemed to have been given in the form required by law at the same time. The same applies to the undertakings included in the plan on which the creation, modification, transfer or waiving of rights in objects or transfer of shares is based. In contrast to that the plan does not affect the rights entitling the creditors of the insolvency proceedings against the debtor's co-obligors and guarantors. Moreover the rights of such creditors to objects not forming part of the assets involved in the insolvency proceedings or deriving from a priority notice covering such objects remain unaffected by the plan.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

There are two types of over-collateralization, the initially over secured (*anfänglich übersichert*) and the subsequently over secured creditor (*nachträglich übersichert*).

According to the case law of the German Federal Supreme Court (BGH) security, and the agreements granting such security, can be void if an initial over-collateralisation is constituted which is so excessive that it must be considered as being against *bonos mores* (*gegen die guten Sitten*). Although no specific case law exists, a decision by the German Federal Supreme Court (BGH) indicates that the loan-to-security ratio would be well beyond the threshold applied to subsequently excessive collateralisation, if the realisable

value of the security is more than 150 per cent of the amount of the secured obligations. In addition, the over-collateralisation, in order to be regarded as initially excessive, must be based on a creditor's reprobate attitude (*verwerfliche Gesinnung*), which is assumed if a creditor, out of self-interest, displays an ethically unbearable recklessness against a borrower.

If the realizable value of the security at any date after being granted permanently exceeds the amount of the secured obligations by more than 10 per cent, the subsequently excessively secured creditor is, according to the case law of the German Federal Supreme Court, regularly obliged to release security back to the debtor insofar as the estimated market value of security, which depends on the risks of realization of the security and on the market situation, exceeds the secured amount by more than such 10 per cent.

A fully secured creditor is entitled to receive payment of the full principal, including pre and post interest and expenses in case the security purpose agreement includes such costs. If this is not the case, claims regarding post interest and expenses are subordinated.

If secured claims are under secured the creditor bears the risk of not recovering all of his claims in case of enforcement. In any case, the secured creditors retain an unsecured claim as an insolvency creditor for the short fall.

India

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

In India, lending is generally secured by obtaining one or more of the following forms of security:

Mortgage: The most common type of security in commercial financing is "mortgage by deposit of title-deeds" commonly known as "equitable mortgage" where the borrower creates a charge over its immovable property by deposit of title deeds with the lender with intent to create a security interest thereon. In some cases, "English mortgage" i.e. mortgage by way of transfer of immovable property with right of retransfer on repayment and "simple mortgage" i.e. mortgage without delivery of possession by executing a deed and registration thereof, is also created but this form of mortgage is not very prevalent as the stamp duty payable is very high. At times, the immovable property of a guarantor or a third party is also accepted as collateral security. The mortgage of immovable property and charges are governed by section 58 to 104 of The Transfer of Property Act, 1882. Creation of "negative lien" over a property is also used; however, this is not very popular due to the difficulty of enforcement.

Hypothecation: Hypothecation over the movable assets including accounts receivable is another common form of security taken by lenders. This creates a floating charge as the assets remain in the possession of the borrower and on default the charge gets crystallized. The hypothecation of movable assets is provided for under the Indian Contract Act, 1872.

Personal guarantee: After mortgage and hypothecation, obtainment of personal guarantee of the promoters and/or directors of the companies is the most prevalent form of security in commercial financing. Chapter VIII (section 124 to 147) of the Indian Contract Act, 1872 governs contracts of guarantee.

Other securities: Pledge of movables, specific machinery, shares listed on stock exchange etc. is another common form of security. Chapter IX (section 172 to 181) of the Indian Contract Act, 1872 governs the contract of pledge. Recently, the providing of escrow cover by providing unconditional instructions to the bank to pay the amount demanded by the creditor has also become a prevalent form of security.

The rights created by a debtor by way of mortgage/hypothecation/pledge are perfected by way of registration. The document evidencing creation of a charge must be registered within 30 days from the date of its execution under the Indian Registration Act, 1908 with the office of the concerned Registrar of Assurances situated in every district of India.

Further, in the case of a corporate entity, the particulars of the charge together with the document evidencing creation of the charge must be recorded with the respective Registrar of Companies of the State under section 134 and 135 of the 1956 Act within 30 days from the date of its execution. In case of delay, a further period of 30 days is available for doing so on payment of an additional fee as provided under section 125 of the 1956 Act.

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

Banks and financial institutions generally enforce their secured as well as unsecured claims by initiating proceedings under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (DRT Act) by filing an application for recovery before the Debt Recovery Tribunal(s) (DRT) constituted under the DRT Act in various states in India. However, for claims below Rupees Ten Lakhs (One Million Rupees), banks and financial institutions are required to go to the civil court, which could either be the District Court or the High Court depending upon the pecuniary and territorial jurisdiction.

In 2002, the Parliament also enacted the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARESI) which enables banks and financial institutions to enforce their security by way of taking possession of the collateral or management thereof and subsequent sale/lease without the intervention of the court. The provisions of SARESI *inter alia* do not apply in cases where the amount due is less than twenty per cent of the total principal and interest outstanding. Any person (including borrower) aggrieved by any of the measures taken by the secured creditor under SARESI can appeal to the DRT having jurisdiction of the matter within forty-five days from the date on which such measures had been taken. The order by the DRT under section 17 can be challenged by way of a further appeal to the Appellate Tribunal.

Secured creditors, other than banks and financial institutions seeking recovery of an amount greater than Rupees One Million can initiate an ordinary suit for recovery or a suit for foreclosure of mortgage under section 67 of the Transfer of Property Act, 1882 before the civil court. In such case, the provisions of Code of Civil Procedure, 1908 (CPC) apply.

State Financial Institutions established under the provisions of the State Financial Corporations Act, 1951 have been granted the rights to take over the management or possession or both of the industrial concern as well as a right to transfer by way of lease or sell and realise the property pledged, mortgaged, hypothecated or assigned to them under Section 29 of the said Act without intervention of the court in case of default in payment by the borrower.

Proceedings to enforce rights under mortgages and hypothecations under the DRT Act are somewhat expeditious compared to the procedure available under common law. Although the DRT Act provides that a recovery application and appeal shall be disposed of within six months, in practice it takes three to four years, if not more to conclude the recovery proceedings alone, including determination of debt and execution of a Recovery Certificate by DRT by auction etc. The proceedings may be further delayed by an appeal against the interim or final order or a stay under the provisions of SICA, discussed below. Proceedings before the civil courts including execution take five-six years if not more.

With respect to enforcement rights relating to pledged goods, the enforcement of such rights is expeditious since it does not require the intervention of the court.

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.

(d) Does the debtor remain "in possession" of the business?

At the pre-insolvency stage, the reorganization or rehabilitation of a company is carried out under the provisions of the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) and the regulations thereunder. Section 391 of

the Companies Act, 1956 (1956 Act) discussed below also permits the company court to compromise or make arrangements with creditors and members of a company.

Once the provisions of the Companies (Second Amendment) Act, 2002 (2002 Second Amendment) become operative and SICA is repealed, the jurisdiction in respect of reorganization of companies will vest with the National Company Law Tribunal (NCLT) as described below.

SICA requires that when an industrial company has become a sick industrial company, the Board of Directors of the company shall, within sixty days from the date of finalization of the duly audited accounts of the company for the financial year as at the end of which a company has become a sick industrial company, make a reference to the Board for Industrial and Financial Reconstruction (BIFR), comprised of a chairman and members selected and appointed by the Central Government, for determination of the measures for the company's revival and rehabilitation. However, if the Board of Directors has sufficient reasons even before finalization of accounts to form an opinion that the company has become a sick industrial company, it shall, within sixty days after it has formed such an opinion, make a reference to the BIFR. The Central or State Government, Reserve Bank of India or a public or state financial institution or a scheduled bank may, if it has sufficient reasons to believe that any industrial company has become a sick industrial company under SICA, can also make a reference in respect of such a company to the BIFR.

For the purposes of SICA, a sick industrial company means an industrial company (being a company registered for not less than five years and employing fifty or more workmen), which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth. Net worth is the sum total of the paid up capital and free reserves. For the purposes of net worth, "free reserves" means all reserves created out of the profits and share premium account but does not include reserves credited out of re-valuation of assets, write-offs of depreciation provisions and amalgamation/merger of the company with any other company under 1956 Act.

Section 46AA of the 2002 Second Amendment changes the definition of sick industrial company as an industrial company which has at the end of any financial year accumulated losses equal to fifty percent or more of its average net worth during four years immediately preceding such financial year or failed to pay its debts within any three consecutive quarters on demand for its repayment by a creditor or creditors of such company.

On receipt of a reference, the BIFR may hold an enquiry to determine if the company is a sick industrial company and may appoint any Operating Agency (OA) which is any public financial institution or state level institution or scheduled

bank or any other person as ordered by BIFR, to enquire into and make a report with respect to such matters as may be specified. If the BIFR comes to the conclusion that the company is not a sick industrial company, it shall reject the reference. If on making an inquiry, the BIFR is satisfied that a company has become sick, it shall decide whether it is practicable for the company to make its net worth exceed the accumulated losses within a reasonable time on its own and shall give such company, such directions as it may deem fit to make its net worth exceed the accumulated losses. If the BIFR decides that it is not practicable for a sick industrial company to make its net worth exceed the accumulated losses within a reasonable time and it is necessary in the public interest to adopt remedial measures, it may direct any OA to prepare a scheme providing for such measures in relation to such company as it considers necessary consistent with the parameters laid down under SICA. The assets of the company remain in its possession, however, the BIFR can pass orders restraining the company, its promoters, directors, managers, agents, representatives of the company from disposing of or dealing with the same.

In case a viable scheme for revival is proposed, the scheme is circulated to every creditor (including secured creditors) whose claim is affected by the proposal for its consent within a period of sixty days from the date of such circulation. If no objection is received within the said period it is deemed that consent has been given and the BIFR can sanction the scheme and on and from the date of such sanction, the scheme shall be binding on all concerned including secured creditors.

If however, the BIFR is of the opinion that it is not possible for the company to turn its net worth positive within a reasonable time, and that it would be just and equitable that the company be wound up, it formulates its opinion accordingly and forwards the same to the High Court concerned for taking further steps under the 1956 Act.

Now with the enactment of the SARESI, no reference under SICA by a company can be filed where the secured creditors have taken any measure under SARESI against the assets of the company. Further, a pending reference before BIFR shall abate if seventy five percent of secured creditors initiate action under SARESI.

There is an Appellate Authority for Industrial and Financial Reconstruction (AAIFR). The AAIFR hears appeals from the parties aggrieved by the orders of BIFR. The proceedings before BIFR and its Appellate Authority are quasi judicial in nature.

In some states, State Relief Undertakings (Special Provisions) Acts have been enacted granting power to the State Government to declare by way of a gazette notification any undertaking functioning within the State as a relief

undertaking to enable the State Government to conduct, or to provide loan, guarantee or financial assistance for the conduct of such industrial undertaking as a measure of preventing unemployment.

There is no statute governing the non-judicial rehabilitation, workout or restructuring of companies. However, such workouts are quite prevalent in financing. There is a Corporate Debt Restructuring Committee representing all the banks and financial institutions. From time to time, the Committee issues guidelines for restructuring. The Reserve Bank of India also issues guidelines and instructions for banks for restructuring of dues.

The 1956 Act as amended from time to time generally governs corporate insolvency and *inter alia* contains the provisions for winding up of companies. It is a composite law dealing *inter alia* with the incorporation of companies, their management, regulation and winding up. It was last amended in December 2002 by way of the 2002 Second Amendment, however the said amendments have not been fully notified and thus not operative.

Under the 1956 Act, the jurisdiction to wind up the companies is vested with the High Court of the State within whose jurisdiction the registered office of the company is located in terms of Section 10. However, after making the order of winding up, the High Court is empowered to refer the proceedings to the District Court within whose jurisdiction the registered office of the company is located. The Companies (Court) Rules, 1959 provide *inter alia* for the procedure to be followed in the winding up proceedings.

Currently the winding up of a company can be carried out only by way of judicial proceedings brought before the High Court within whose jurisdiction the registered office of the company (whose liquidation is being sought) is situated under the provisions of the 1956 Act and the Rules framed there under. Once the relevant provisions of 2002 Second Amendment become operative, which is expected to be this year, the jurisdiction of winding up of companies will vest with the NCLT, a special tribunal to be set up by the Government of India under the 2002 Second Amendment. NCLT will have the same powers as held by the High Court at present.

An application to the court for the winding up of a company, can be made by way of a petition presented (a) by the company; or (b) by any creditor or creditors including contingent or prospective; or (c) by any contributor or contributors; or (d) by the Registrar of Companies; or (e) in a case falling under Section 243 of the 1956 Act, by any person authorized by the Central Government in that behalf.

However, generally, the winding up proceedings are triggered by creditors and/or on the recommendations made by BIFR under SICA.

The winding up of a company under the 1956 Act can be by an order of court or voluntary. The court may wind up a company if (a) the company has by special resolution resolved that it be wound-up; or (b) the company does not commence its business within a year from its incorporation, or suspends its business for a whole year; or (c) it is unable to pay its debts[1]; or (d) a default is made in delivering the statutory report to the Registrar or in holding the statutory meeting; or (e) the number of members is reduced in the case of a public company below seven and in the case of a private company below two; or (f) the court is of the opinion that it is just and equitable that the company should be wound up.

The additional grounds for winding up of a company added by way of the 2002 Second Amendment are (a) if the company has acted against the interest of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality; or (b) if the company has defaulted in filing with the Registrar its Balance Sheets and Profit & Loss Account or annual returns for five consecutive financial years; or (c) if the NCLT comes to the conclusion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time while meeting all its financial obligations and that it is not possible to revive the company in future and that it is just and equitable that the company should be wound up.

On hearing a petition, the court may dismiss it or adjourn it conditionally/unconditionally or make any order of winding up or pass any interim order or make any other order as it may deem fit, including appointment of a Provisional Liquidator (PL).

An Official Liquidator (OL) appointed by the Central Government is attached to each High Court and is a full-time officer. Where a winding up order has been made or where a PL has been appointed, the liquidator takes into his custody or under his control all the property, effects and actionable claims to which the company is or appears to be entitled. All the property and effects of the company are deemed to be in the custody of the court as from the date of the order for the winding up of the company.

Under the 2002 Second Amendment, apart from the Central Government appointed officials, even professional firms of accountants, lawyers, cost accountants, company secretaries or a combination thereof can be appointed as OL.

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[1] A company shall be deemed to be unable to pay its debts – if a creditor to whom the company is indebted in a sum exceeding five hundred rupees, has served on the company a demand by registered post at its registered office requiring it to pay the sum so due and the company has for three weeks thereafter neglected to pay the sum; or if execution or other process issued on a decree or order of any court in favor of a creditor of the company is returned unsatisfied; or if it is proved to the satisfaction of the court that the company is unable to pay its debt. (By way of 2002 Second Amendment, the amount has been raised from rupees five hundred to rupees one lakh.)

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

In winding up proceedings under the 1956 Act, any transaction with a creditor (including the grant of a security right) entered into by a company in preference of other creditors within six months prior to the date of commencement of winding up is generally deemed a fraudulent preference and is accordingly invalid in accordance with section 531 of 1956 Act. But if a company makes payment to a creditor who is pressurizing the company with a threat of a suit and attachment of property, then such a payment cannot be called 'fraudulent' provided the debt was due and payable. A transfer or assignment by a company of all its properties to a trust/trustee for the benefit of all its creditors is also void as per section 532 of 1956 Act.

Under Section 531A of the 1956 Act, a transfer of property whether movable or immovable (including the grant of a security right) or any delivery of goods by the company within a period of one year prior to the presentation of a winding up petition is void as against the liquidator, unless the transfer/ delivery was made in the usual course of company business; and the transfer was in favor of a purchaser or encumbrance in good faith and for real and valuable consideration.

Where a company is being wound up, a floating charge on the undertaking or property of the company created within the twelve months immediately preceding the commencement of the winding up, is invalid unless it is proven that the company was solvent immediately after the creation of the charge, except to the extent of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for, the charge, together with interest on that amount at the rate notified by the Central Government in this behalf in accordance with section 534 of 1956 Act.

Where a company is being wound up or subject to the supervision of the court: (a) any attachment, distress or execution put in force, without leave of the court, against the estate or effects of the company, after the commencement of the winding up; or (b) any sale held, without leave of the court, of any of the properties or effects of the company after such commencement shall be void. This however, does not apply to any proceedings for the recovery of any tax or impost or any dues payable to the government.

5. Is enforcement of security rights treated differently in each type of proceeding?

The DRT Act does not make any distinction between a secured and unsecured debt for the purpose of invoking its jurisdiction by the banks and financial institutions and therefore there is no special treatment available for enforcement of security rights. The secured creditors, other than banks and financial institutions have to approach the civil court for enforcement of security by way of an ordinary suit for recovery or by filing a mortgage suit. As detailed in answer to question 2, the proceedings under SARESI can be initiated without court intervention, however later the invocation could be challenged before the DRT. No different treatment is given for enforcement in any of the proceedings.

In case of a winding up, secured creditors, if they are public financial institutions or banks as defined under the DRT Act, are not required to seek leave of the Company Court in case they wish to pursue their rights under the DRT Act as held by Supreme Court of India in *Allahabad Bank vs.Canara Bank* 2000 (4) SCC 406.

However, in case of the debtor company being before BIFR/AAIFR under SICA, then security rights cannot be enforced against the company under the DRT Act or before any other court due to operation of section 22.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Under the 1956 Act, section 529, 529A and 530 deal with the distribution of assets on the winding up of a company. In the winding up of a company (a) workmen's dues including wages; and (b) debts due to secured creditors to the extent such debts rank under clause (c) of the proviso to sub-section (1) of section 529 of the 1956 Act *pari passu* with such dues, are paid in priority to all other debts and if the assets are insufficient to meet them, in which case they abate in equal proportions. Subject to the preferential payments (secured creditors and workmen dues), all revenues, taxes and rates due from the company to the Central or a State Government or to a local authority at the relevant date as defined in the 1956 Act and having become due and payable within the twelve months next before that date are paid on priority over general unsecured creditors. Under the provisions of SICA, BIFR is not empowered to distribute the assets and it can only order sale of assets and forward the proceeds to the concerned High Court for distribution in accordance with the provisions of 1956 Act.

7. How can creditors protect their rights towards the debtor?

On initiation of legal proceedings against the debtor before the DRT or before the civil courts, the creditor can seek injunctions/restraint or attachment orders in respect of assets charged and sometimes, on uncharged assets also if a good cause is shown. The creditor can also seek appointment of a receiver or remove any person from possession or custody of the property if a good cause is shown.

In case of a winding up order against the debtor company, the secured creditor can pursue its remedy outside the winding up by court, however, it can participate and make a claim before the OL in case the assets charged to them are sold by the OL under the order of the Company Court in terms of the 1956 Act. In SICA proceedings all the secured creditors are necessary parties.

8. How do creditors protect their rights towards guarantors?

No specific or special procedure is available for protection of right qua guarantors. Generally along with the debtor, the guarantors are also sued for realization of the liability on joint and several basis before the DRT/courts and in case of knowledge of personal asset of the guarantor, the creditor can seek restraint/attachment of such asset by showing sufficient cause.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g., perfection)?

Under section 141 of the 1956 Act, the Central Government has the power to extend the time for registration of a charge or any modification thereon if a satisfactory cause is shown for omission or it deems it just and equitable to grant that relief in favour of any creditor. However, this is only available prior to a winding up order being entered against the debtor company. Pursuant to sub-section (2) of section 125 of 1956 Act, non-registration of the charge is void against the liquidator and creditors, but doesn't prejudice the contract or obligation for repayment of money secured by the charge. It also doesn't affect its status under the SICA proceedings. Therefore the claim and the right to realize the same by initiating legal proceedings before the DRT/court are not affected.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

Pursuant to section 22 of the SICA, without the consent of the BIFR or as

the case maybe, the Appellate Authority no proceedings for the winding up of the industrial company or for execution, distress or the like against any of the properties of the industrial company or against its guarantor or for the appointment of a receiver shall be commenced or continued where an inquiry is pending or any scheme is under preparation or consideration or a sanctioned scheme is under implementation or where an appeal is pending. This provision providing for automatic moratorium in respect of companies approaching for reorganization under the SICA has been taken away under 2002 Second Amendment.

In terms of SARESI, if an asset reconstruction company has acquired the assets of the company under SARESI or if seventy five percent of secured creditors initiate action under SARESI, no reference can be made to BIFR and a pending reference before BIFR shall abate and thus the protection under section 22 of SICA become unavailable.

Similarly, when a winding up order has been made or the OL has been appointed as PL, no suit or legal proceeding can be commenced, or if pending at the date of the winding up order, can proceed with against the company except by leave of the court and subject to such terms as the court may impose. The banks and financial institutions are not required to seek leave in case they wish to pursue their rights under the DRT Act as held by the Supreme Court of India in *Allahabad Bank vs. Canara Bank*.

The stay under SICA can be challenged on appeal before the Appellate Authority under the SICA or by way of a writ petition under Article 226 and 227 of the Constitution of India before the concerned High Court. The stay order passed by the company judge under the 1956 Act can be appealed before the division bench of the High Court.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

Under the DRT Act, pending adjudication of the debt there is no power available to the DRT to order use or sale of security. However, where both the debtor and the creditor consent the DRT can permit such arrangement by use of its inherent power under the DRT Act. There is no specific treatment for "cash collateral" except injunction and attachment of the same by the DRT. However, normally creation of new security rights is not allowed.

In the case of a proceeding under the SICA, the sale or lease of collateral can be allowed by the BIFR/AAIFR under a scheme of reorganization of a sick industrial company. While the assets of a company can be dealt with in any manner to facilitate a scheme for revival, they cannot be disposed of for recovery of a debt as the BIFR has no power to distribute the proceeds.

The power available to BIFR is limited to disposal of the assets, after it has recommended winding up, but it has to forward the proceeds to the High Court for distribution in accordance with section 529, 529A and 530 of the 1956 Act. In terms of a scheme for revival, new rights on security can be granted if agreed to by all secured creditors.

12. What distribution will a secured creditor receive if a company is reorganised?

The BIFR/AAIFR has limited jurisdiction over the secured creditors and does not have the jurisdiction to force the secured creditors to accept a particular scheme. It further cannot force the secured creditors to grant financial assistance, relief, or concessions with respect to their debts. While the assets of a company can be dealt with in any manner to facilitate a scheme for revival if agreed to by the secured creditors, they cannot be disposed of for recovery of a debt as the BIFR has no power to distribute the proceeds. The power available to BIFR is limited to disposal of the assets, after it has recommended winding up, but it has to forward the proceeds to the High Court for distribution in accordance with section 529, 529A and 530 of the 1956 Act.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

Unless the claim of a secured creditor gets satisfied under a scheme of revival, the rights over the assets within the reorganised company remains unaffected.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

In accordance with section 555 of the 1956 Act, any money representing unpaid dividends and undistributed assets in the hands or control of the liquidator, on dissolution of a company are required to be paid into the Companies Liquidation Account. The preferential payments and debts mentioned in section 529 to 530 of the 1956 Act rank equally with other debts and are to be paid in full including principal, interest and other charges, unless the assets are insufficient to meet them, in which case they abate in equal proportions.

Italy

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

Personal or movable property

The most common types of security rights for movable property are pledge and lien.

With a *pledge*, the debtor typically transfers the possession of the pledged assets to the creditor or to a jointly appointed custodian as security for a debt. The ownership usually remains with the debtor but, failing the fulfillment of the secured obligation, the pledged assets may be sold in compliance with applicable law. However, if an irregular pledge (*pegno irregolare*) is executed, the ownership is transferred to the creditor as a guarantee and it is re-transferred once the debt is paid.

Stocks of companies (listed or unlisted), rights, patents, trademarks and credit instruments, such as promissory notes or written evidence of debt, can also be offered as a pledge.

A *lien* is a charge over the debtor's movable assets granted to a creditor depending on the source of his/her right. Liens can be either general (*privilegio generale*), taken over all the debtor's movable assets, or special (*privilegio speciale*), taken over only certain of the debtor's assets. The lien allows the creditor to satisfy his/her right with parts priority vis-à-vis the other creditors, in respect of priorities set out under the answers to question 6 below.

A special type of lien is provided for by Article 46 of the Banking Law; it can be granted by the debtor only, not by a third party, to secure a loan that has a maturity of at least 18 months. This form of lien can apply to any of the following assets, if they are financed by a secured loan:

- Existing and future equipment, licenses and instrumental goods produced by the debtor;
- Raw materials, inventory, goods in course of production, finished goods, fruits, animals and livestock;
- Goods purchased through the loan; and
- Proceeds, present or future, of the sale of the items indicated in the points above.

Such a special lien does not require the transfer of the possession of the relevant assets but only a written evidence of its filing.

Real or immovable property

According to Italian Law, security rights over immovable property are mainly granted through a *mortgage* (*ipoteca*). A mortgage is a security right over the immovable property and grants the mortgagee the right to expropriate the property subject to the mortgage and to satisfy the mortgagor's obligations to it by application of the proceeds of the sale of the mortgaged property. A mortgage can be created by law (*ipoteca legale*), by a judicial decision (*ipoteca giudiziale*) or by a private initiative through notarial deed (*ipoteca volontaria*).

A mortgage can also be created over specific types of movable assets, such as aircrafts, ships and motor vehicles (registered movables).

Mortgages are perfected through the registration of the documents as above specified in the real estate property register of the place where the property is located, or in the relevant register for registered movables.

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

Generally speaking, the security rights are enforced through the intervention of the court.

In fact, pursuant to the Italian legal system a covenant, whereby secured assets become the creditor's property in case of the debtor's default, is null and void (Article 2744 of the Civil Code – *patto commissorio*). The creditor is not even entitled to use the secured assets without it first being authorized by the debtor.

In case of default, the secured assets must be sold through a public auction in order to enhance the competition among possible purchasers and maximize the sale proceeds.

Therefore, in order to proceed with the sale of secured assets upon default, the creditor must first formally demand payment of the amount due in accordance with Article 2797 of the Civil Code.

The debtor may challenge such demand of payment in court. In any case, the execution must take place by way of a public auction. The creditor may seek a judicial order in accordance with Article 2798 of the Civil Code, by which secured assets are assigned to him/ her for an amount up to the sum due for principal, plus interest. This is the only way that a secured creditor can obtain ownership of the secured assets without bidding in a public sale.

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.

(d) Does the debtor remain "in possession" of the business?

After the recent reform of the Italian Insolvency Law, adopted by the Law of 14 May 2005, no. 80 and Legislative Decree of 9 January 2006, no. 5 the different types of pre-insolvency and insolvency proceedings are as follows:

- Composition agreement *(concordato preventivo)*
- Debt restructuring agreements *(accordi di ristrutturazione dei debiti)*
- Extraordinary Administration *(amministrazione straordinaria)*
- Bankruptcy *(fallimento)*

The following discussion will cover in respect of each of these insolvency proceedings, the issues relating to who can initiate the proceedings, the criteria used for opening the proceedings and the main actors in these proceedings.

Composition agreement (concordato preventivo)

A company in financial difficulty can enter into an agreement with its creditors, with a view to restructuring the business and avoiding the bankruptcy of the company. The court supervises the composition agreement, which is available to companies carrying on commercial activities, except for public bodies.

The debtor must file the request for a composition agreement in the judicial district in which it maintains its place of business and must disclose the details of the proposed agreement with the creditors.

In order to open proceedings the debtor must be registered with the Companies Registry (*Registro delle Imprese*) at least two years before the request, not have been declared bankrupt or granted a composition agreement in the previous five years, and not have been condemned for fraudulent bankruptcy or charged with crimes against property.

The debtor must file, together with the request, a report of an expert stating the feasibility of his/her proposal.

The competent court verifies that the necessary criteria for opening the proceeding have been met and appoints the bodies necessary to the proceeding, in particular the *Commissario Giudiziale,* the officer who controls the activities of the directors of the company and calls the creditors meetings. In addition, an important role is performed by the creditors' committee and the expert who must confirm the feasibility of the plan.

The procedure can be divided into four steps. They are: (i) preliminary, (ii) creditors' approval, (iii) confirmation of composition agreement, and (iv) execution of the composition. The possible conclusion of each step, in case of negative outcome, leads to the adjudication of bankruptcy.

The application for the admission to the procedure of composition is filed by the legal representative of the company, once he/she has obtained the approval of the shareholders. The application, by way of a petition signed by the debtor, is filed with the competent court where the main offices are located, even though different from the registered office.

The request for a composition agreement is subject to the approval of the majority of the amount of debts admitted to vote. In practice, the petition for approval of a composition agreement must be supported by an updated report about the financial and economic situation of the company; a detailed list of the assets and a list of the creditors, showing their claims and their preferential rights, if any; the list of the creditors having real or personal

security rights on assets belonging to the debtor; and the value of the assets and the indication of the creditors of the unlimitedly liable shareholders, if any.

The role of the court is, therefore, confined to verifying the presence of the requirements and approving and enforcing the agreement. If the majority of the amount of the credits votes in favor of the proposal, the court approves the agreement by decree, which is compulsory for all the creditors preceding the opening of the procedure; the payments are met in the order provided for by the law: court costs, receiver's fees, procedural expenses, preferential creditors, and unsecured creditors.

If the company successfully implements the agreement with the creditors, it continues to operate; otherwise, it is declared bankrupt. The secured creditors acquire the right to vote on the composition agreement if they renounce their security and ranking.

It is important to note that the debtor runs the business under the supervision of the *commissario giudiziale*.

Debt restructuring agreements (accordi di ristrutturazione dei debiti)

According to Italian Bankruptcy Law, the debtor can also file a request for a debt restructuring agreement, which has already been approved by the creditors.

The agreement must be entered into by the debtor and the creditors representing at least sixty per cent of all debts, regardless of the nature of the credit (secured or unsecured). Furthermore, a report drafted by an expert concerning the feasibility of the agreement has to be submitted to the Bankruptcy Court. Such a report is essential and the approval of the debt restructuring agreement by the court is mainly based on its contents. In particular, the report must demonstrate the ability of the agreement to ensure full payment of the so-called "external creditors" (i.e. the creditors not signatory of the agreement).

A debt restructuring agreement must be published in the Companies Register at the Chamber of Commerce and is effective as of the date of its publication. The creditors and any other interested parties are entitled to challenge the debt restructuring agreements within thirty days from the date of the publication.

The court shall then decide the merits of any challenging petitions and, assuming such challenges are rejected, approve the agreement.

Should the debtor be declared bankrupt after the approval, the law provides that any act, payment or guarantee performed in order to implement and execute the debt restructuring agreement approved by the court cannot be subject to claw-back action (*azione revocatoria*).

The debt restructuring agreement is a flexible legal instrument and the main players are the debtor and the creditors while also the advisers and the legal counsel take a relevant role. In most cases, a single agreement will be entered into by the debtor and its creditors. However, the performance of more than one agreement with creditors may also be allowed. Furthermore, the agreement may provide for a particular role for some creditors. In particular, major creditors could exercise a surveillance power over the debtor's business, as well as management or control rights.

Such an agreement contains different terms and conditions of payment of the relevant claims and provisions concerning the re-funding of the business, in order to allow the continuation of the business activities by the debtor and their restructuring.

Extraordinary administration (amministrazione straordinaria)

As a result of recent financial difficulties involving important Italian companies, the Law of February 18, 2004, no. 39 has been enacted in order to improve the pre-existing procedure concerning the extraordinary administration for large insolvent companies, provided by Legislative Decree of July 8, 1999, no. 270.

An insolvent company may institute an extraordinary administration by filing a request with the Minister for Economic Development and, at the same time, filing a petition with the Bankruptcy Court in order to ascertain its insolvency status. According to the provisions of the new law, insolvent companies may apply to the Minister for an immediate admission to the Extraordinary Administration if they have, either individually, or as a group established for at least one year, that there are (a) not less than five hundred employees in the preceding year; and (b) debts, including those arising from the guarantees issued, for an aggregate amount of not less than three hundred million euros.

Once admitted to the Extraordinary Administration, the insolvent company is managed by the Extraordinary Administrator (*Commissario Straordinario*) who continues to carry on the company's ordinary business activity pending the duration of the Extraordinary Administration.

The outstanding debts vis-à-vis the insolvent company are frozen at the date of declaration of insolvency and they will be paid at the end of the proceeding, while the creditors are not entitled to start or to continue any execution proceedings upon the debtor's assets.

A Surveillance Committee of five members, with supervision and control duties, is also appointed by the Minister as a consultative body. Two members of the Surveillance Committee are chosen among unsecured creditors and three among experts in the company's business activity or in insolvency law.

Within one hundred and eighty days from his/her appointment, the Extraordinary Administrator is required to file the Restructuring Plan with the Minister for Economic Development, as well as to file a report with the Bankruptcy Court containing the description of the causes of the company's insolvency, together with an estimate of the relevant assets and a list of the creditors, indicating the respective amounts and priority rights.

The Restructuring Plan is subject to the approval of the Minister. If the Minister refuses the implementation of the proposed plan, the Extraordinary Administrator may ask the Minister to approve a Sale Plan, otherwise, the Extraordinary Administration is converted into an ordinary bankruptcy proceeding.

The Restructuring Plan can provide for satisfaction of the creditors' claims, both secured and unsecured, through a composition with creditors, which is part of the plan. The composition must detail any relevant clause and condition for the satisfaction of the creditors, as well as any possible guarantee for its performance.

The composition shall be approved if it is passed by the creditors representing the majority of the claims admitted to vote; the creditors who do not deliver their vote to the court are deemed to vote in favour of the composition. If the majority is reached, the court shall approve the composition.

The debtor does not remain in possession of the business under this proceeding. The Extraordinary Administrator is appointed by the Minister; he/she takes possession of the company's assets and is entrusted with the management of the business.

Bankruptcy (fallimento)

When a company is in a status of permanent financial crisis and it is unable to pay its debts when they become due, it is declared bankrupt.

The proceeding is initiated by a judgment of the competent court rendered upon a petition filed by creditors, by the debtor it self or by the Public Prosecutor. It must be shown that the company is unable to pay its debts. Commencement of bankruptcy proceedings results in an immediate suspension of the payments of all debtor's debts and liabilities.

The court, once it receives the petition for bankruptcy, must declare the debtor bankrupt and appoint a trustee in bankruptcy. The court can declare bankruptcy proceedings to be concluded on its own initiative, or at the request of the trustee in bankruptcy or the debtor, if all creditors have been paid or all assets have been liquidated or there is not an useful purpose, due to insufficient assets being available for the creditors.

The debtor is deprived of all the rights to manage or dispose of his/her assets, including any assets acquired after the date of the insolvency proceedings.

The Reform of the Italian Insolvency Law has introduced new provisions designed to facilitate the continuation of the business. According to Article 104 of the new Bankruptcy Law, the court may authorize, together with the declaration of bankruptcy, the debtor to provisionally continue to run the business (*esercizio provvisorio)* when its interruption may cause serious damage to the company; the same article even provides the option to lease the company to a third party *(affitto d'azienda).*

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

According to Article 67 of the Bankruptcy Law, the following transactions are voidable by the trustee in bankruptcy, provided that the trustee in bankruptcy can prove that the other contracting party was aware of the debtor's insolvency.

- Transactions at an undervalue;
- Payment of receivables due and payable, which have been satisfied by any means other than cash and other usual instruments of payment, if made within one year before the declaration of bankruptcy by the court;
- Pledges and mortgages granted in the year before the bankruptcy to secure pre-existing debts not yet due and payable;
- Pledges and mortgages granted in the six months before bankruptcy to secure debts due and payable.

Transactions if entered into in the six months before the declaration of bankruptcy, may also be voided, if the trustee in bankruptcy proves that the other party was aware of, or could have been aware of, the debtor's insolvency. Further payments of debts due and payable and grants of security interests to secure contemporaneous loans are also voidable. These provisions are intended to render suspect pre-bankruptcy transactions ineffective vis-à-vis the creditors. The Trustee in bankruptcy's actions is "*in personam*", although they

may affect third parties' interests, by granting a right to trace the debtor's assets, wherever they are located.

There are two requirements to be satisfied for the avoidance of transactions. The first is objective, consisting in the actual loss of the debtor's assets which are to be recovered by the bankrupt's estate and the second is subjective, i.e. the knowledge of the insolvency by the non-debtor party. The trustee in bankruptcy bears the burden of proving a non-debtor's knowledge of insolvency.

5. Is enforcement of security rights treated differently in each type of proceeding?

According to Italian Law, the provisions concerning the enforcement of security rights are the same for each insolvency proceeding. In the legislator's view, in case of default, the secured assets must be sold by public auction in order to enhance the competition among possible purchasers and ensure that the maximum price is paid, for the benefit of the debtor and of the other creditors.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Pursuant to Article 54, Bankruptcy Act, secured credits (mortgage, pledge, lien) entitle the repayment of principal, interest (pre and post-filing in bankruptcy) and costs. If the secured creditors are not satisfied in full, their residual claims may share as unsecured creditors for the difference. The order of priority is established by Article 2777 of the Italian Civil Code.

Order of priority in respect of movables

i) Expenses incurred by the bankruptcy procedure take priority over any other claim, including those secured by mortgage or pledge. Such expenses include for example payments necessary to continue the bankrupt's business (suppliers, staff, etc.); trustee in bankruptcy and lawyers' fees. All such items are commonly defined as "pre-preferential claims" (*crediti in prededuzione*);

ii) Wages and salaries as well as employees' allowances (Article 2751 bis, 1, Civil Code); damages for lack of payment of social security contributions by the bankrupt company;

iii) Professional fees for the last two years, commercial agents' commission and indemnities relative to the year prior to declaration of bankruptcy (Article 2571 bis, 2,3, Civil Code);

iv) Claims having the rank of priority according to special laws;

v) Claims secured by pledge, including by irregular pledge where necessary formalities have been complied with;

vi) Claims secured by special privilege;

vii) Claims for social security contributions and compulsory insurance;

viii) Claims for taxes due on income of immovable property;

ix) claims for income taxes and indirect taxes.

Order of priority in respect of immovables

i) Expenses incurred by the bankruptcy procedure;

ii) Claims having the rank of priority according to special laws;

iii) Claims for taxes on real property;

iv) Claims for indirect taxes;

vi) Claims secured by special privilege on immovables;

vii) Claims secured by mortgage.

7. How can creditors protect their rights towards the debtor?

In all the proceedings foreseen by Italian Bankruptcy Law, the realization of secured claims is granted to their holders in the same way: the creditors who believe their claims to be of a secured nature, must advise the trustee in bankruptcy. For this purpose, the creditors must, however, seek a judicial authorization. After having heard the trustee in bankruptcy and the creditors' committee, the Bankruptcy Court can establish if, when and how the secured assets can be sold. Therefore, even the secured creditor to enforce his/her right must file a claim and such rule is applicable to each type of insolvency proceeding.

The sale of secured assets takes place within the proceeding and under the control of the judge and in the case of bankruptcy, the trustee in bankruptcy. The proceeds of the sale are assigned to secured creditors up to the amount of their claim for principal and interest: the difference, if any, must be returned to the bankruptcy estate.

8. How do creditors protect their rights towards guarantors?

The protection of the creditor granted by the Italian legal system towards the guarantor corresponds to that granted towards the debtor. Therefore, the answers stated under question no. 7 is also applicable to the present question.

In fact, except for specific legal claims, the creditor can start a proceeding against the debtor or the guarantor with the aim to improve the chances of collection.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g., perfection)?

If the secured creditor fails to comply with the formalities set forth by the law, the security interest would not be enforceable against third parties. This means that the secured creditor would not be given any priority vis-à-vis other creditors.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

In the event of the insolvency of an Italian collateral provider, in accordance with general principles of law and the provisions of Article 53 of the Italian Bankruptcy Law, the creditor must file a petition with the court, asking the authorization to sell the secured assets according to the forced sale procedure as described under question no. 2.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

Under a regular pledge of collateral, the debtor remains the owner of the assets transferred to the secured party although he/she no longer has their possession, as a result of the transfer to the secured party. Therefore, the debtor may not use the property during the pendency of the insolvency or bankruptcy proceedings and he/she cannot transfer the pledged asset.

The secured party has an obligation to protect the assets granted to him/her under the pledge, is responsible for any deterioration or loss of the assets, cannot use them without the debtor's prior consent and cannot re-pledge them or let third parties use them.

An irregular pledge overcomes the above difficulties. This type of pledge may apply when cash is given as collateral and enables the pledgee to dispose of them. In this case, the ownership of the assets passes to the secured party which has an obligation to return equivalent assets to the debtor when he/she receives payment. However, any payment and the value of the collateral can be netted so that the secured party has only a duty to return the difference.

With regard to the lien, it is not technically a security and does not convey a right *in rem* to its holder but merely qualifies the type of claim.

Under a mortgage, the debtor can grant other guarantees to different creditors. The order of priority among various mortgages issued by the same debtor to different creditors on the same property depends on the date of registration of the document whereby the charge is established, according to the rule "first in time, first in priority".

Regarding special provisions about cash collateral, according to Article 4 of Legislative Decree no. 170 of May 21, 2004, a pledge, as well as an assignment of claims or of financial assets is defined as a "security financial collateral agreement". According to the new rules, when the pledge is granted to a bank, the pledgee is entitled to directly satisfy its claim on the financial assets given as security and its sole obligation is to immediately inform the debtor or, in case of insolvency, the liquidator thereof in writing and returning to the liquidator the proceeds of sale of the financial assets in excess of its claim.

12. What distribution will a secured creditor receive if a company is reorganised?

According to Italian Bankruptcy Law, the reorganization of a company is executed through the composition agreement, the debt restructuring agreement and, in case of companies having the requested requirements, the extraordinary administration.

With regard to a composition agreement, even if it is not expressly stated, the debtor is required to pay its secured creditors in full because they will not vote for the composition proposal, while in the debt restructuring agreement, the secured creditors may approve the debtor's proposal but, in any case, they have a priority right in the distribution.

In case of extraordinary administration, the secured creditors are paid after the expenses and the debts arising from the activities of the debtor during the proceedings (*crediti prededucibili*).

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

Yes, since they are rights *in rem*, i.e. securities on the real property.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

If a secured claim is over secured, the creditor will receive an amount up to the principal amount of the debt, plus interest (pre and post-petition) and costs, while the difference must be returned to the bankruptcy estate.

If a claim is under secured, the creditor will not receive the whole amount of his debt and the negative difference will become an unsecured claim.

The Netherlands

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

Pledges and mortgages

Dutch law distinguishes between registered (*registergoederen*) and non-registered assets (goederen), which include both tangible assets and intangible assets such as rights. Security *in rem* over registered assets is taken in the form of a mortgage (*hypotheek*). Security *in rem* over non-registered assets is created by means of a pledge (*pandrecht*). Pledges and mortgages do not lead to a transfer of ownership. While the ownership remains with the debtor, the pledge and mortgage are a mere charge over the secured asset or collateral, which can be enforced in an event of default.

The most common categories of registered assets are real property, aircraft and ships that have been registered in the public land register, ships register and aircraft register respectively; and lease-hold (*"erfpacht"*) or usufruct (*"vruchtgebruik"*), building and planting rights (*"recht van opstal"*) and apartment rights (*"appartementsrechten"*). A mortgage over these registered assets is created by a notarial deed followed by the registration of the mortgage in the relevant public register. The mortgagor retains full legal title to and possession of the collateral.

Security over non-registered assets is made in the form of a pledge. Generally, a pledge is created in the same manner that a transfer of ownership of the collateral would be perfected.

Dutch law distinguishes between a possessory pledge and a non-possessory pledge in relation to tangible movable assets (*roerende zaken*) and between a notified pledge and a non-notified pledge[1] in relation to rights. A non-possessory pledge and a non-notified pledge are made by either a notarial

[1] A non-notified pledge is a pledge on rights against third party debtors of the pledgor which has not been disclosed to such debtors.

deed or a private deed between the parties and the subsequent registration of the deed in a register maintained by the Tax Inspectorate. Certain non-registered rights, such as shares and patent rights, cannot be made subject to a non-possessory / non-notified pledge.

The most common categories of assets over which a pledge can be created are:

- Tangible assets: these can be made subject to a possessory pledge by handing possession to the pledgee or a third party nominated by it (for instance a warehouse keeper). They can also be made subject to a non-possessory pledge in the manner described above.
- Existing and future book debts, receivables / rents and other rights against an identified or identifiable debtor (collectively: "receivables") can be pledged by means of a notified pledge, i.e. a private deed and the subsequent notification thereof to the receivables debtor provided that the receivables are described in the deed in such manner that they are identifiable. A non-notified pledge of receivables can only validly be created over existing receivables and future receivables that originate directly from a legal relationship that exists at the time of the pledge. When creating a non-notified pledge the parties therefore commonly agree that the pledgor shall periodically (sometimes even daily) sign supplemental pledge deeds in order to make sure that any rights that will come into existence after the initial pledge will be pledged.
- Rights and claims against unknown third parties can be charged with a pledge provided that the third party debtor is notified of the pledge as soon as his identity has become known.
- Registered shares in the capital of a Dutch company must be pledged under a notarial deed and the subsequent filing of the deed.
- Intellectual property rights can be pledged. A pledge over registered intellectual property rights will become enforceable only if it is registered in the relevant intellectual property rights register.

Security is created as a security for the obligations of a debtor. It can be created in relation to a specific debt or obligation or in relation to any existing or future indebtedness of the debtor *vis à vis* the secured creditor. It is possible that a party will grant a mortgage or pledge on his assets as a security for the indebtedness of a third party.

Other forms of security

By operation of law, vendors also may invoke a right to reclaim the supplied goods (*recht van re-clame*), which they can do during a brief period (ranging from a few days to several weeks depending on the nature of the vendor's business) after the vendor has supplied the goods to the debtor. The invocation

of the right to reclaim goods can only be made if the goods are unpaid and are still in the same condition as when the goods were supplied. The effect of this invocation is that the title to the supplied goods returns to the vendor irrespective of a subsequent attachment or bankruptcy of the debtor. The right to reclaim may be contracted out.

Vendors of tangible goods may retain the title to the goods sold and supplied (*eigendomsvoorbehoud*). This right should be stipulated in the contract of sale. This is typically done in the general conditions of the supplier.

A creditor who has the lawful possession of goods that are owned by the debtor may exercise a right to hold on to the goods until he gets paid (*retentierecht*) by operation of law. By virtue of this right, the creditor may refuse to give up possession of these goods if the debtor does not fully pay his obligations arising out of the contract pursuant to which the creditor holds possession of the debtor's goods.

The European Collateral Directive[2] has been implemented in the Netherlands. In cases involving certain types of parties, title to cash and listed securities can be transferred by means of security. In that event, the lender is under an obligation to redeliver a similar amount or equivalent shares (as the case may be) after lapse of the security period.

Outside the scope of application of the European Collateral Directive (as enacted in Dutch law) a security transfer of title is void.

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

Security rights are generally enforced after an event of default has occurred and after it has been established that the debtor has failed to remedy the default. The pledgee or mortgagee is not required to seek court intervention in order to confirm the indebtedness before commencing foreclosure over the collateral, except in the case of foreclosure over aircraft registered under the Geneva Convention.

Generally security rights are enforced by means of a public sale of the collateral in the manner as prescribed by the Dutch Code of Civil Procedure and the Civil Code. In respect of certain assets, the creditor and the debtor may agree on a different method of sale, or they may ask the court to allow a different method of sale.

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[2] The aim of the Collateral Directive (2002/47/EC) is to create a uniform EU legal framework to limit credit risk in financial transactions through the provision of securities and cash as collateral. Collateral is the property (such as securities) provided by a borrower to a lender to minimise the risk of financial loss to the lender in the event of the borrower failing to meet its financial obligations to the lender. The Directive reduces the formal collateral requirements and harmonises and clarifies the collateral process.

Mortgage

A mortgage is enforced by a public sale which is conducted by a notary. The mortgagee may ask the court to approve a private sale following a procedure during which interested parties may submit their bids to the notary. The notary will present a report to the court of all the bids that he has received. The court has discretionary powers to approve a private sale or not.

A mortgage on aircraft registered under the Geneva Convention and ships must always be enforced by a public sale which will be conducted by a notary or by the court (as the case may be).

Enforcement of pledges

If a pledge of tangible goods is a non-possessory pledge, the pledgee may (if required) ask the court for an order that the pledgee may take possession of the pledged goods for the purpose of enforcement. The court may order that the pledgee may enter the pledgor's premises to take physical possession of the goods.

Pledged tangible goods and rights (other than receivables) will as a rule be sold through a public auction under the rules of the Dutch Code of Civil Procedure. After an event of default has occurred and the debtor is in breach of his obligations (*in verzuim*), the debtor and the creditor may agree on a private sale as a means of enforcement.

Moreover both the debtor and the secured creditor have the right to ask the court to allow a different method of enforcement. This right can be contracted out in the pledge agreement. The creditor may also ask the court to transfer the title in the secured asset to the secured creditor against a credit in the amount of the debt.

A pledge of receivables is usually enforced by the collection of the receivable through a notice by the pledgee to the third party debtor. However, it can also be enforced by selling the pledged receivables. As a result of such notification, which does not require court intervention, the pledgee is entitled to claim payment of the pledged receivables. The debtor's right of set-off will generally not be affected if his counterclaim arose prior to the notification, or if his counterclaim originates from a contractual relationship with the pledgor that existed prior to the notice of the pledge.

A pledge on cash is enforced by the pledgee taking the monies to satisfy his claim.

Concurrence of secured creditors

Where there are more than one pledge or mortgage or an attachment by an unsecured creditor, the foreclosing creditor must share the proceeds with the other creditors in accordance with the ranking of the other secured creditors' or attachors' claims. If the creditors and the debtor cannot agree on the distribution of the proceeds, any creditor may ask the court to decide.

Cash collateral, securities collateral

Collateral within the meaning of the European Union Collateral Directive is enforced by the secured creditor's retaining the collateral and doing whatever the secured creditor sees fit (including public or private sales or retention of goods in satisfaction of debt) in satisfaction of a corresponding amount of the outstanding indebtedness. The obligation to redeliver assets of a similar kind is cancelled upon enforcement. No leave from the court is required.

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, receiver, trustee, receiver, controller, representative of creditors, state representatives etc.

(d) Does the debtor remain "in possession" of the business

The Dutch Bankruptcy Act distinguishes between two different proceedings for companies: temporary suspension of payment (*surseance van betaling*) and bankruptcy (*faillissement*). Both are insolvency proceedings within the meaning of the European Insolvency Regulation. It also provides for a debt forgiveness program for individuals (*schuldsaneringsregeling natuurlijke personen*). The latter is not described further in this article. The objective of temporary suspension of payment proceeding is to allow the debtor to reorganize its business or restructure its debt to avoid bankruptcy.

Suspension of payment is designed to give a company an opportunity for recovery and reorganization. It is a temporary suspension of payment obligations towards unsecured and non-preferred creditors only. Generally, suspension does not affect the rights of secured and/or preferred creditors (mortgagees, pledgees, the Tax Collector's Office, employees etc.). Although suspension of payment is

designed as a means for recovery and reorganization it has become more and more common for a company (or its (secured) creditors) to elect for bankruptcy to save an insolvent business. The reason for this is that in bankruptcy there are very few restrictions on the dismissal of employees of the company. In the case of a suspension, the business can only be sold by the company under the application of the EU directive regarding the retention of employees' rights. This directive ensures that with the sale of a business, all employees' rights and obligations are transferred to the purchaser of the business by operation of law. This directive does not apply in case of a bankruptcy. A suspension may be converted into a bankruptcy when it is evident that the suspension will not be successful. Bankruptcy cannot be converted into a suspension of payment.

The Dutch Government has instructed a legislative committee to propose a (draft) new insolvency Act. The new insolvency law is aimed at facilitating reorganizations in a formal proceeding.

Who can initiate the proceeding?

Suspension of payment proceedings can be opened at the request of the debtor only. All companies and other legal entities can apply for suspension of payments. Natural persons conducting a business can also apply for suspension of payments. On application, the court immediately grants a provisional suspension of payment. This remains in force until a creditors' meeting takes place (usually within three months). At the creditors' meeting, only the unsecured and subordinated creditors can vote in respect of the application for a suspension of payment up to a maximum of 18 months. The debtor can apply for an extension.

Bankruptcy may be requested by the debtor itself, any creditor who remains unpaid and, where the public interest so requires, the Public Prosecutor's Office. Special provisions apply for financial institutions and insurance companies. The effects of the bankruptcy are the same irrespective of the petitioner.

Criteria used for opening of the proceeding

When petitioning for suspension of payment proceedings, the debtor must demonstrate to the satisfaction of the court that it cannot continue to pay its debts as they fall due. The debtor must also demonstrate that it will eventually be able to resume the payment of its debts or that a scheme of arrangement will be offered to its creditors. The petition may require a prior resolution by the shareholders and the supervisory board, depending on the articles of the company. The Bankruptcy Act provides that temporary suspension of payment is granted by the court immediately upon the application by the debtor if the court on the basis of the petition itself is satisfied that the criteria will be met.

The test for bankruptcy is a cash flow test. The petitioner must prove to the satisfaction of the court that the debtor is unable to meet its payment obligations. This is usually the case if more than one creditor remains unpaid. A petition by the debtor requires a prior resolution by the shareholders and, if applicable, by the board of supervisory directors (*raad van commissarissen*) whereby the shareholders will also appoint a representative to file the petition for bankruptcy. The court will decide on the basis of a summary review of documents and arguments whether the debtor has indeed ceased to pay. The court should always apply this bankruptcy test, unless it concerns a request for a secondary (or non-main) proceeding (as provided in the European Insolvency Regulation), in which case the court will assume that the debtor is insolvent. Bankruptcy is considered to be an attachment on all assets and liabilities of the company. It takes effect from 0.00 hours of the date of the bankruptcy order, except in the case of certain financial transactions, where it has effect as of the hour of the bankruptcy order. The procedure serves as a preparation for compulsory liquidation of the assets by the receiver.

The main actors

In the Netherlands there are no special bankruptcy courts. The District Courts of the place where the debtor has its registered seat will have the jurisdiction to open either suspension of payment proceeding or a bankruptcy. If the petition concerns a foreign debtor or a debtor without a known registered office in the Netherlands, a Dutch District Court will have jurisdiction if the debtor has a branch office in its district.

As of the commencement of a suspension of payments, the powers of the debtor in relation to its assets, debts and liabilities are shared with the administrator. The powers and, as the case may be, duties of the debtor's directors and shareholders' remain otherwise unaffected. The administrator is appointed by the court. The administrator's duty is to manage the assets together with the debtor. In doing so the interests of the creditors should be protected. The administrator usually is a member of the local bar, although the law does not explicitly require this. An auditor or any other professional may be appointed as administrator as well. In certain cases the court may appoint two or more administrators. The court may also appoint (and in practice usually does so) a supervisory judge, who will give advice to the administrator if asked. In cases with a large number of claims, the court has the discretion to order certain measures, such as the appointment of a committee of representation (*commissie van verte-genwoordiging*) of at least 9 members. This committee represents the most important categories of creditors during the voting procedure at the creditors' meetings.

If the court opens a bankruptcy, it will appoint a receiver (*curator*), who usually is a member of the local bar. The court will also appoint a bankruptcy judge (*rechter-commissaris*), who supervises the proceedings. The receiver is charged with the administration and liquidation of the bankruptcy estate. The receiver has full power to represent the bankrupt debtor provided that such representation involves the assets and liabilities of the bankrupt company. The receiver has the exclusive power to dispose of the debtor's assets. The directors of a bankrupt company remain in place and may represent the company in any other matter (such as representing the company in matters against the receiver or in case the company would offer a composition). Also the shareholders' powers remain unaffected; however they cannot make shareholders' resolutions to the detriment of the company's creditors.

In a bankruptcy, the court may, immediately or at a later stage, appoint a creditors' committee of one to three known creditors. The creditors' committee advises the receiver. It may demand inspection of the books, records and other data carriers relating to the bankruptcy at any time. The receiver must provide the creditors' committee with all required information. The creditors' committee has the right to call a creditors' meeting. The receiver must seek the advice of the creditors' committee before instituting or pursuing any legal proceedings or defending any proceedings. However, the receiver has the sole right to dispute claims. The receiver must also obtain the advice of the creditors' committee in relation to his policy regarding the liquidation of the company's assets and the time and amounts of any distribution. If the receiver does not agree with the advice in relation to a certain matter, he must notify the creditors' committee immediately. The creditors' committee may then request the supervisory judge to grant a decision. The receiver must then suspend any action in the relevant matter for three days.

Does the debtor remain "in possession" of the business?

As stated above in suspension of payment proceedings, certain powers of the debtor are shared with the administrator. In bankruptcy the debtor's rights to legally dispose of and administer its property, rights and interests are transferred to the receiver.

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

The Bankruptcy Act contains provisions that entitle the receiver to void certain transactions (including the granting of a security right) between the

debtor and third parties that have prejudiced other creditors. If such avoidance takes place before the Dutch court, this right may be limited if the transaction is governed by foreign law. Where only Dutch law applies, the receiver may void any transaction performed or entered into by the debtor prior to the bankruptcy, provided the receiver can prove that:

- the debtor did not have a prior obligation under a contract, judgment or the law to enter into or perform the transaction;
- the transaction is detrimental to the creditors' collective interests, which will be the case if the receiver proves that one or more creditors will receive less from the estate than would have been the case had the transaction not been made; and
- at the time of transaction both the debtor and the other party knew or should have known that the interests of the creditors would be adversely affected.

The burden of proof as far as the said knowledge is concerned is reversed and shifted to the other party (i.e. that party must prove that it did not know and could not reasonably have known that the transaction was detrimental to the debtor's creditors) if the receiver in addition to the first two requirements above (i.e. no existing prior obligation and the detrimental effect) proves that the:

- transaction took place within one year before the date of the bankruptcy judgment (or if preceded by a suspension of payments, the date thereof); and
- value of the consideration paid by the debtor materially exceeds that of the performance by the other party; or
- transaction consists of a payment of or creation of (additional) security for, a debt that was not due and payable; or
- transaction was made with a party that is related to the debtor.

If the voidance action is successful, the transaction is void only as far as the estate is concerned. The receiver may reclaim any transferred assets and the receiver may otherwise seek damages to make restitution to the estate, as it should have been without the voided transaction. Any consideration or amount paid for any reclaimed assets should in principle be returned to the other party by the receiver. If a detrimental transaction did not include any consideration in favor of the debtor, the receiver is only required to prove that the debtor was aware of the detrimental effect thereof to the creditors' interests. Gifts and other gratuitous transactions made within one year before the bankruptcy are presumed to have been made with such knowledge, if the receiver proves that indeed they were detrimental to the other creditors.

The receiver may also void pre-bankruptcy payments (which include any other performance) of payment obligations of a debtor to a creditor in the

event that such creditor knew, at the time of such payment on the due date, that a petition for the debtor's bankruptcy had been filed with the court or, alternatively that such payment resulted from conspiracy (*samenspanning*) between the debtor and the creditor intentionally aimed at paying the latter to the detriment of the debtor's other creditors.

5. Is enforcement of security rights treated differently in each type of proceeding?

Generally, the rights of secured creditors are neither affected by a suspension of payment proceeding nor by a bankruptcy. During a moratorium however (which can last up to four months) the secured creditor cannot exercise its rights. It should also be noted that in bankruptcy the receiver may require that the secured creditor enforce his security right within a reasonable period.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Generally, all claims rank equally but claims secured by a mortgage or pledge take priority in the proceeds of the collateral. In addition, certain claims may take priority over the claims of secured creditors including:

- costs of enforcing judgments or deeds of indebtedness;
- costs of the debtor's bankruptcy (if secured creditors fail to sell the collateral separately from the bankruptcy process);
- tax claims, including VAT and wage tax take priority in the proceeds of certain movable property, to the extent that those claims cannot be paid out of the proceeds of the unsecured assets, unless the pledgor takes possession of the pledged movable assets before the bankruptcy and before the tax authorities make an attachment.

Preferred claims that do not take priority over security rights include among others; tax and social security premium claims, and wages and certain pension claims with respect to the proceeds of all the debtor's assets.

The ordinary creditors only receive payment if all preferred creditors have been paid in full including principal, interest and costs.

It is generally assumed that shareholders' equity claims are subordinated to all other unsecured claims. Shareholders' loans may be characterized as subordinated on the basis of an explicit or implied term of the contract.

7. How can creditors protect their rights towards the debtor?

Secured creditors

In suspension of payment proceedings, a secured creditor may submit its claim with the administrator. It is advisable that the administrator be contacted immediately and be advised of the existence of the secured claims and security interests.

In bankruptcy, a mortgagee or a pledgee must submit its claim in writing to the receiver prior to the verification meeting (as described below) and specify the nature and amount of its claim. Such secured creditors must also submit a statement in writing in respect of its security interests, accompanied by documentary evidence, i.e. copies of the deeds.

A mortgage or a pledge creates both a right to the proceeds of the assets in the estate and the right of the secured creditor to ignore the bankruptcy or suspension of payment proceeding and foreclose on the asset itself. Mortgages and pledges are generally not affected by bankruptcy or suspension of payment proceedings. The mortgagee or pledgee may in the event of default (or if in the security document a bankruptcy is defined as an event of default) enforce its rights against the assets as if there were no insolvency proceedings, subject to the restrictions of a moratorium, if any.

Mortgagees and pledgees are entitled to foreclose on the collateral without the co-operation of the administrator or receiver. Subject to court approval, the secured party may also enforce its security rights via a private sale. Any proceeds in excess of the mortgagee's or pledgee's claim should be transferred to the debtor (or, as the case may be, the receiver). In bankruptcy, the receiver must vis à vis the secured creditor exercise the rights of other creditors, which is particularly relevant if the claims of other creditors have a higher ranking. In that case, the receiver collects from the proceeds the amount corresponding to the higher ranking that can be recovered from the collateral. The monies so collected form part of the bankruptcy estate. The creditor whose rights have been so exercised by the receiver shall only receive the proceeds when the receiver makes a distribution and after a deduction of a contribution to the costs of the bankruptcy. The bankruptcy receiver is at all times entitled to free an asset of a security right by paying the mortgagee or the pledgee the amount owed to it (*inlossing*). If the mortgagee or pledgee does not or cannot (if there is no default) timely foreclose the secured assets, a receiver in bankruptcy may demand that the secured creditor do so within a reasonable period of time. If the secured creditor does not do so, the receiver may sell or collect the collateral. In that case, the secured creditor's claim will still be preferred in respect of the proceeds of sale subject to a deduction of a proportional share of the costs of the bankruptcy proceedings.

The debtor (or the officeholder) and the pledgee may agree to a different method to liquidate the pledged assets, in the event of default.

Foreign law security rights may be recognized by virtue of the European Insolvency Regulation or Dutch domestic law, depending on the nature of the right.

Ordinary creditors

Outside bankruptcy, ordinary creditors can only recover claims by making an attachment on the debtor's assets before they are sold. In order to receive a distribution in a bankruptcy, the ordinary creditor should file his claim with the receiver. Claims should be submitted in writing to the receiver prior to the verification meeting (*verificatievergadering*) and should set out the nature and the amount of the claim. The claim should be accompanied by documentary evidence. The receiver must confirm receipt to the creditor. All creditors are entitled, although not required, to attend the "verification meeting". The verification meeting is a formal meeting of creditors. Its purpose is both to discuss, admit or dispute claims and to classify them as preferred or ordinary or subordinated; and to discuss and vote on any composition that is being offered to the ordinary creditors.

A verification meeting will be planned only if it is likely that unsecured creditors will receive a distribution. The supervisory judge will set a date for the verification meeting and a date prior to which creditors must have filed their claims with the receiver and he will instruct the receiver to make the proper publications and to give notice to all known creditors. Not less than 7 days prior to the verification meeting, the receiver must file with the court lists of provisionally admitted, conditionally admitted and disputed claims. The receiver should try to resolve any disputed claim. The court admits all claims that are not disputed. The admission of a claim recorded in the minutes of the meeting is final. The receiver may also withdraw any earlier objection. A negative decision by the court on the admissibility and value of the claim does not prejudice any other of the creditor's rights. If a claim is disputed and the supervisory judge is unable to resolve the dispute, the supervisory judge refers the matter to the court for verification proceedings. A creditor whose claim is disputed should ensure that its representative attends the creditors' meeting. Claims that are submitted late are admissible only if submitted not later than two days prior to the creditors' meeting and if neither the receiver nor any creditor objects to the late submission. Claims submitted thereafter will not be admitted, unless a creditor who resides outside the Netherlands submits the claim. These creditors have the right to submit their claim until the creditor's meeting itself, in case they were unable to submit their claim at an earlier stage. Even thereafter it will be possible to submit claims, and further verification meetings can be held in specific circumstances. If a claim

has not been submitted before, a creditor can still do so if the receiver submits a distribution list.

In suspension of payments proceedings, the filing of claims is only made for the purpose of voting at the creditors' meetings. The rejection or admission of claims in those instances shall not prejudice any other of the creditors' rights.

8. How do creditors protect their rights towards guarantors?

A suspension of payment proceeding or a bankruptcy typically does not prevent a creditor from starting an action against a guarantor. In addition thereto, the creditor who has started an action against a guarantor may also, simultaneously claim against the insolvency estate of the jointly and severally liable co-debtor of the guarantor for the total amount due to him at the time of the declaration of the suspension or bankruptcy until his claim has been settled in full.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g., perfection)?

As of the commencement of the debtor's suspension or bankruptcy, it is no longer possible to perfect security without the officeholder's consent. A right *in rem*, which is only perfected upon registration or date stamping by a register, cannot be perfected anymore and will therefore be deemed non-existent.

This situation should be distinguished from a validly perfected non-notified pledge over receivables. The secured creditor remains in a position to notify the pledge to third party debtors and, accordingly, to claim payment of the pledged receivables.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

Pledge, mortgage

Generally, the secured creditor may foreclose over the collateral and claim payment of pledged receivables, whether an insolvency proceeding is pending or not. In a suspension of payment and in a bankruptcy, the officeholder or a creditor may ask the court to order a moratorium. A moratorium can be ordered for a period of up to two months. It can be

extended once for another period of up to two months. The law does not explicitly stipulate whether a moratorium during suspension of payments reduces the duration of a subsequent moratorium during a subsequent bankruptcy. During a moratorium, foreclosure may only take place with leave from the court or over assets excluded from the moratorium.

Cash or securities collateral

The secured creditor may foreclose on cash or securities collateral, whether an insolvency proceeding is pending or not. This right cannot be barred by a moratorium or a deadline set by the officeholder.

Retention of title, seller's lien

A supplier may reclaim the goods that he supplied and to which he has retained or timely reclaimed the title, subject to a moratorium.

Retention of goods

The right of retention of goods is a statutory remedy available to certain creditors who may suspend their obligation to hand over goods owned by the debtor. The creditor who has bona fide possession of these goods (retentor) may exercise the right of retention against the debtor, whether bankrupt or not, and in most cases against third parties who have a right to the goods such as secured creditors.

The right of retention of goods gives a preferred right to the proceeds of the goods in the event of the debtor's insolvency. The receiver may demand delivery of the goods and sell them subject to the preferred right of the retentor. He may also pay the retentor and recover the goods. The retentor may demand that the receiver exercise his rights within a reasonable period of time, failing which the retentor may sell the goods without having to share in the costs of the bankruptcy.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

An administrator or receiver cannot sell secured assets without consent of the secured creditor. The debtor does have a right to use secured assets which it has in its own possession. If enforcement of a security right is temporarily stayed as a result of a moratorium, it is arguable that the debtor or the bankruptcy estate must compensate the secured creditor for the continued use during the moratorium.

Cash collateral in the meaning of the European Collateral Directive posted by the debtor typically is not in its possession and, accordingly, cannot be used by the debtor pending insolvency proceedings.

During insolvency proceedings, the debtor can only grant new security rights with the consent of the administrator or receiver.

12. What distribution will a secured creditor receive if a company is reorganised?

If a Dutch debtor seeks reorganization, it will typically seek opening of suspension of payment proceedings. However, these proceedings generally do not affect pledgees, mortgagees, and other preferred creditors. These creditors may therefore foreclose as they see fit (subject to a moratorium). Secured creditors will only receive a distribution at the end of the reorganization to the extent that their claims were not satisfied by the recoveries from the collateral. Other preferred creditors should be paid in full during suspension of payment proceedings. It should be noted that the Tax Collector's Office in certain cases may agree to debt forgiveness in the context of a composition that the debtor has proposed to its ordinary creditors.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

To the extent that a security right or a preference is not waived or the secured or preferred claims have not been paid, the security right will remain over the reorganised company's assets and the secured and preferred creditors' claims can be recovered from those assets.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

If the value of the collateral exceeds the claim of the secured creditor the following happens. After paying the costs of execution from the proceeds the pledgee deducts from the net proceeds the amount owed to him, including principal, interest and costs, and for which he has a right of pledge. The balance shall be paid to the pledgor / debtor.

If a secured claim is under secured, the remaining claim after foreclosure shall be treated as an unsecured claim.

Russia

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

Movable or personal property

Russian law provides for the following types of security: fine, pledge, retention, suretyship, bank guarantee, and deposit. The list of security interests available for parties is not exhaustive and other types of security interests may be selected at the option of the parties to a contract[1]. Unlike in other countries, which do not treat some of these measures as a type of security, all these security interests are grouped under Russian law, and included in Chapter 23 of the RF Civil Code, entitled "Security of Performance of Obligations".

All the above listed security measures are used to secure due performance of the underlying obligation. Choosing the most suitable security measure depends on the nature of such primary underlying obligation. For example, to secure a loan, it is more customary to use a pledge of movable property, mortgage, bank guarantee or suretyship. If it were necessary to secure a specific performance obligation, a deposit arrangement would be preferable since a creditor will be more likely to accomplish a specific result, in order to avoid losing an amount of a deposit.

Fine / penalty: A fine, or penalty, is the amount of money, as defined by statute or contract, that a debtor must pay to a creditor in case of default. There are different methods of calculating a penalty: (i) by way of accrued interest on the underlying subject-matter of the agreement, (ii) as a multiple of the amount of the obligation not performed or improperly performed obligation, or (iii) as a lump sum expressed in monetary units.

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[1] *See* Article 329 of the RF Civil Code.

Pledge: The essence of a pledge is that the creditor is generally able, in case of default, to obtain satisfaction of the obligation from the value of the pledged property over other creditors[2].

According to Article 336 of the Civil Code, almost any property may be subject to a pledge. This includes tangible as well as intangible assets. The pledge may only be made by the owner of the asset. However, a pledgor need not necessarily be the debtor under the main obligation, a third party - pledgor can provide security to secure the obligation of the primary obligor, if the commercial structure of the transaction justifies this.

There is an imperative requirement to register the mortgage interest with the state. Otherwise, a mortgage is ineffective. Further, in certain cases, the pledge of certain types of property must be recorded in particular registers (e.g. a pledge of non-documentary shares must be recorded in the shareholders' register of the pledgor, or pledge of movable property must be recorded in the pledge book kept by the company-pledgor).

Retention: This is a security measure whereby a debtor transfers possession of property/assets to a creditor, or other person indicated by a creditor, permitting the creditor to retain such property until such time when the respective obligation of the debtor is performed[3].

Suretyship: This is a traditional security type dating back to Roman law. The essence of this security measure is that a third person undertakes to perform the contractual obligation of the debtor in case of his default. This type of security is widespread and is frequently used in Russia. A contract of suretyship may also be granted to secure an obligation that will arise in the future.

Bank guarantee: Under a bank guarantee a bank, a credit institution or an insurance company (the guarantor) gives a commitment letter at the request of another person (the principal) to pay to a particular creditor (the beneficiary) an agreed upon sum of money upon the presentation of a written demand for payment[4].

One of the distinguishing features of the bank guarantee is its legal independence from the underlying (secured) obligation. The bank guarantee will be valid even if the underlying obligation becomes invalid[5].

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2 *See* Section 1 of Article 334 Civil Code.
3 *See* Section 1 of Article 359 of the Civil Code.
4 *See* Article 368 of the RF Civil Code.
5 *See* Article 370 of the RF Civil Code.

Deposit: A deposit is a monetary sum given by one party to a contract (the payor) to another party of a contract (the payee) to secure the performance of the payment obligation under a contract[6]. A deposit as a security interest also serves as proof of a contract's existence. Because a deposit can be used as partial payment of the secured obligation, only monetary obligations can be secured by a deposit. In situations where the payor does not perform under the contract, the payee is entitled to keep the deposit. In situations where the payee does not perform under the contract, double the amount of the deposit must be returned to the payor.

Immovable or real property

A mortgage is the most common form of security interest taken with respect to immovable property. All issues related to a mortgage are primarily governed in the RF by RF Law "On Mortgage", dated July 16, 1998 (as amended). Under the mortgage agreement, a party who is the creditor (mortgagee) secured by the mortgage obligation is eligible to receive satisfaction of its monetary claims from the other party (mortgagor) from the value of the collateral with a priority over other creditors.

The mortgage agreement is subject to state registration, without which the agreement is deemed null and void. Registration of the mortgage agreement shall be reflected in the "RF State Register of Rights to Immovable Property and Transactions Therewith". An extract from this register with respect to any mortgaged property will reflect a clear indication that such a mortgage is established and is *prima facie* evidence of the mortgagee's rights.

Under Russian law, it is not possible to impose a contractually agreed upon lien or privilege on immovable property. Such an arrangement would simply be unenforceable, since it would unlikely be registered in the State register, and without such registration, the legal validity of such liens or privileges is highly questionable.

Granting of security

A security interest may be granted by both law and contract. The performance of an obligation may be secured by contractually agreed upon security interests, and in some cases, the security interest is established automatically by law.

For example, retention, to a certain extent, is a statutory security interest. Further, Section 5 of Article 488 of the RF Civil Code expressly provides for

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[6] *See* Section 1 Article 380, under which levy of execution on pledged property may be denied by a court if the debtor commits an immaterial breach of the obligation secured by the pledge and the pledgee's (creditor's) claim is manifestly disproportionate to the value of the pledged property of the RF Civil Code.

another example of security interest granted by law unless otherwise provided under a sale contract. From the moment of transfer of the goods to the purchaser until the moment of payment thereof, such goods are deemed pledged in favor of the seller to secure the purchaser's obligation to pay for such goods. The same rule is applicable to real estate sale and purchase transactions.

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

Foreclosure on collateral for the satisfaction of the claims of the pledgee (or mortgagee) (the creditor) may be levied in cases of non-performance or improper performance by the pledgor (or mortgagor) (debtor) of the obligations secured. Such foreclosure must be levied via court procedure, unless the parties agree otherwise, after the default on the main underlying obligation occurs. Enforcement of a pledge on immovable property without a court procedure is allowed on the basis of a notarially certified agreement of the pledgee with the pledgor concluded after the contractual default giving the basis to levy execution on the subject of the pledge.

Therefore, while extra-judicial foreclosure exists as an option for enforcing a pledgeholder's rights under Russian law, this option is viable only when the debtor does not resist foreclosure. In practice, debtors often challenge such foreclosure through various means. Therefore, in many cases, judicial involvement will nevertheless be required.

The collateral should be sold at an auction (no private party-to-party (direct sale) is allowed). In practice, organizing such an auction is quite a cumbersome procedure over which the creditor has no control. Therefore, foreclosing on collateral under Russian law is not quick and easy. As stated above, first, a court decision allowing foreclosure must be obtained, and second, the auction to sell the collateral must be organized and successful.

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

Who can initiate the proceeding?

What are the criteria used for opening the proceeding?

Who are the main actors: court, administrator, receiver, trustee, receiver, controller, representative of creditors, state representatives etc.

Does the debtor remain "in possession" of the business?

Bankruptcies in Russia are primarily governed by special Bankruptcy Law (the "Bankruptcy Law") which applies to both Russian and foreign creditors, and to both individuals and legal entities. In Russia, commercial disputes, including bankruptcies, are the exclusive competence of the state "arbitrazh" courts.

Initiating proceedings

A bankruptcy case is commenced by filing an application with an arbitrazh court, either voluntarily by the debtor or by a "bankruptcy creditor" or by an "authorized body"[7] in certain circumstances.

The Bankruptcy Law provides that a bankruptcy creditor to whom money is owed may file a bankruptcy application with an arbitrazh court upon the expiry of 30 days after an execution writ issued on the basis of a court /or an arbitrazh court judgment, is delivered to the bailiff and a copy thereof is served to the debtor. A debtor may file a voluntary bankruptcy application with an arbitrazh court if its bankruptcy is anticipated and circumstances exist clearly evidencing that the debtor will be unable to perform his payment obligations and/or make mandatory payments when due.

It should be noted that neither an arbitrazh court nor a prosecutor (as a representative of the state) may initiate bankruptcy proceedings on their own initiative.

Criteria used for opening the proceeding

Pursuant to Article 3 of the Bankruptcy Law, a debtor is a legal entity unable to satisfy its debts and/or to pay its tax, if such taxes were not properly paid during the three-month period starting from the date due. Usually, the amount of outstanding obligations and/or taxes are determined as of the date of filing the bankruptcy application.

To initiate a bankruptcy proceeding, in addition to being insolvent, as described above, an arbitrazh court must establish that a debtor legal entity has unpaid debts in the amount of 100,000 rubles (approximately $3,770) or more. For purposes of initiating a bankruptcy case, a court must take into account only the creditors' claims that have been confirmed by a judicial act issued by a court or an arbitrazh court[8].

[7] For the purposes of the Bankruptcy Law, an "authorised body" means a governmental authority that is charged with collecting certain payments, such as taxes.

[8] *See* Article 4 of the Bankruptcy Law.

Brief overview of Russian bankruptcy proceedings

Under Bankruptcy Law, bankruptcy proceedings start with "supervision". The preliminary bankruptcy procedure in accordance with Section 1 of Article 62 of the Bankruptcy Law, states that "supervision shall be introduced subsequent to the results of consideration by an arbitrazh court of the grounds for the applicant's claims".

Once a company is placed under supervision, all proceedings related to the collection of debts from the debtor under execution orders are stayed. All further claims against the debtor may be brought only as part of the ongoing bankruptcy proceedings. In addition, the debtor is, among other things, prohibited from distributing dividends or making other payments on its securities[9].

During supervision, subject to further court order, restrictions are placed on the management of the debtor, which generally maintains day-to-day control over the debtor's business. For this stage, an arbitrazh court appoints an interim receiver (a temporary manager) to supervise the debtor, preserve the debtor's status quo, analyze and evaluate the financial condition of the debtor, maintain a register of creditors' claims, take measures to preserve the debtor's assets, and convene the first creditors' meeting[10].

During the first creditors' meeting, the debtor's creditors must, *inter alia*: (i) elect which bankruptcy proceeding to pursue (their choices include "financial rehabilitation," "external administration," "receivership," or settlement); (ii) determine the size and authority of the creditors' committee (the "creditors' committee"); and (iii) elect the members of the creditors' committee.

Financial rehabilitation is a bankruptcy procedure to restore the creditworthiness of a debtor under the supervision of the current management of the debtor. An arbitrazh court may order financial rehabilitation upon a petition by the debtor's shareholders or third parties that agree to provide financial support to the debtor during the rehabilitation[11]. Financial rehabilitation must be implemented in accordance with the recovery plan approved by the creditors and the schedule of settlement of the creditors' claims. While the debtor's management is generally entrusted with ensuring that the recovery plan is complied with (unless otherwise petitioned by a court-appointed arbitrazh manager), a court-appointed arbitrazh manager monitors its implementation[12].

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9 *See* Article 63 of the Bankruptcy Law.
10 *See* Article 67 of the Bankruptcy Law.
11 *See* Articles 77-78 of the Bankruptcy Law.
12 *See* Articles 82-83 of the Bankruptcy Law.

Like financial rehabilitation, external administration is a bankruptcy procedure to restore the creditworthiness of the debtor. However, upon the debtor being placed into external administration, the right to manage the debtor is transferred from the existing management to an external arbitrazh manager[13]. While the external manager is responsible for restoring the debtor's solvency, he must nevertheless consult with or obtain the consent of the debtor's corporate governing bodies on certain decisions, such as the sale of all of the debtor's assets or the issuance of additional shares. In external administration, the external manager can consider changing the company's business profile, ending unprofitable production, liquidating accounts receivable, selling some of the debtor's property, assigning the debtor's claims, settling the debtor's obligation, or selling the debtor's business (as noted above, making of some of these decisions would require consent of the debtor's corporate governing bodies).

If external administration fails or the debtor cannot be made solvent within the time frame approved by the arbitrazh court, the arbitrazh court may order "receivership proceedings." During the course of a receivership proceeding, a court appointed receiver sells the debtor's assets. The receiver is responsible for marshalling the debtor's assets, having the debtor's property appraised and preparing a proposal on the sale procedure, which must be approved by the creditors' meeting or the creditors' committee as the case may be[14]. Proceeds from the sale of the assets are distributed to creditors according to the priorities set forth in the Bankruptcy Law.

During the course of any of the aforementioned procedures, a debtor and its creditors may terminate the bankruptcy proceeding at any stage thereof by settlement. A settlement is made pursuant to a settlement agreement between the debtor and its creditors that provides for the settlement of claims against the debtor under certain specific terms. The settlement agreement is adopted at the creditors' meeting (provided that all secured creditors vote in its favor) and is subject to the further approval by the arbitrazh court[15]. A prerequisite to the arbitrazh court approving a settlement agreement is the repayment in full of the claims of the first and second priority creditors[16].

Role of an arbitrazh manager

It should be noted that under the Bankruptcy Law, bankruptcy proceedings are controlled and managed by an arbitrazh manager, who is supervised by the court. Depending on the type of the bankruptcy proceeding commenced with respect to a debtor, an arbitrazh manager is called "temporary manager"

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13 *See* Article 94 of the Bankruptcy Law.
14 Article 139 of the Bankruptcy Law.
15 Article 150 of the Bankruptcy Law.
16 Such priorities are described in Section 6 below.

or “interim receiver” if the proceedings are supervision, “administrative manager” if the proceedings are financial rehabilitation, or “external manager” if the proceedings are external administration and “receiver” if the proceedings are receivership proceedings.

An arbitrazh manager must conduct the bankruptcy proceeding using the statutory powers granted to him under the Bankruptcy Law and is subject to liability for not performing his tasks properly. There are general obligations that apply to an arbitrazh manager acting during any bankruptcy proceeding, which include an obligation to protect a debtor’s assets, to analyze the financial standing of the debtor, to reimburse the debtor, debtor’s creditors and third parties for any damages incurred during the performance of an arbtirazh manager’s duties on the basis of a relevant court decision.

Thus, the Bankruptcy Law establishes tasks and goals that an arbitrazh manager is responsible for completing generally and also during a particular bankruptcy proceeding, rather than listing each and every specific action that he must take.

Other persons participating in a bankruptcy case

According to Article 35 of the Bankruptcy Law, the following persons may participate in a bankruptcy case: a representative of the debtor’s employees; a representative of the owner of property of a debtor if debtor is a state-owned (unitary) enterprise; a representative of the debtor’s founders (shareholders / participants); a representative of the creditors meeting or the creditors committee; a representative of the federal executive body in charge of ensuring the security of state secrets, if the exercise of authority of the arbitrazh manager is connected with access to data constituting state secrets; other persons specified by the Arbitrazh Procedural Code of the Russian Federation and federal law.

Representative of creditors: Article 17 of the Bankruptcy Law provides that the legal interests of the bankruptcy creditors and authorized bodies shall be represented by a creditors’ committee. The creditors’ committee monitors the activities of the arbitrazh manager and also exercises other powers conferred thereon by the creditors’ meeting. The creditors’ committee is selected at the creditors’ meeting (if the number of the creditors is not less than 50): first, the creditors’ meeting determines how many members should be selected for such a committee (not less than 3) and then, each proposed member is voted on by the creditors.

To perform the functions vested therein, the creditors’ committee may: (i)

demand that the arbitrazh manager or the head of the debtor provide information on the debtor's financial performance and on the progress of the bankruptcy proceedings; (ii) appeal the actions of the arbitrazh manager with an arbitrazh court; (iii) decide to convene a creditors meeting; (iv) decide to issue a recommendation to the creditors' meeting for removing the arbitrazh manager; (v) make other decisions and take other actions in the event such powers are conferred thereon by the meeting of creditors in the manner established by the Bankruptcy Law.

Any decision of the creditors' committee must be adopted by a majority vote of the creditors' committee. To exercise its powers during the bankruptcy case, the creditors' committee may elect a representative.

State representatives: The Bankruptcy Law allows federal executive governmental bodies, acting as "authorized bodies" and within the scope of their competent authority, to file and represent claims for mandatory payment and the claims of the Russian Federation relating to monetary obligations of a debtor in bankruptcy[17].

Court: Under Russian law, all bankruptcy cases in Russia may be considered only by arbitrazh courts – neither the courts of common law nor arbitration tribunals may consider bankruptcy cases. In doing so, the arbitrazh courts have broad control over each critical milestone of every bankruptcy proceeding.

The Bankruptcy Law and the RF Arbitrazh Procedure Code vest arbitrazh courts with the following powers: initiate a bankruptcy case in compliance with the established procedure and upon a proper application; approve the candidacy of the arbitrazh manager/receiver and consider an application to terminate his authority; make decisions on recognizing the claims of each specific creditor (and the extent to which such claims will be recognized); approve a decision of the creditors' meeting electing a certain bankruptcy procedure; and to terminate the bankruptcy proceedings and, respectively, the bankruptcy case.

Debtor "in possession" of the business

During the first stage of bankruptcy supervision the debtor generally remains "in possession" of its business by maintaining day-to-day control of the debtor's operations. However, certain restrictions are placed on the debtor's management as addressed above.

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17 Article 2 of the Bankruptcy Law defines "authorized bodies" as follows: "the federal executive governmental bodies authorized by the Russian Government to present in a bankruptcy case and in bankruptcy proceedings claims for mandatory payments and the claims of the Russian Federation relating to monetary obligations and also the executive governmental bodies of the Russian regions, the local governmental bodies authorized to present in a bankruptcy case and in bankruptcy proceedings claims relating to the monetary obligations of the Russian regions and the municipal entities respectively".

During financial rehabilitation, while the debtor's management is generally entrusted with implementing the recovery plan (unless otherwise petitioned by a court-appointed administrator), a court-appointed arbitrazh manager will monitor its implementation.

As noted above, like financial rehabilitation, external administration is a procedure to restore the creditworthiness of the debtor. However, upon the debtor being placed into external administration, the right to manage the debtor is transferred from the existing management to an external manager[18]. While the external manager is responsible for restoring the debtor's solvency, he must still consult with or obtain the consent of the debtor's corporate governing bodies on certain limited decisions, such as the sale of all of the debtor's assets of certain value or the issuance of additional shares.

However, during receivership proceedings, the situation completely changes. According to Article 126 (2) of the Bankruptcy Law, the powers of the management bodies of the debtor generally terminate on the date on which the arbitrazh court declares the debtor bankrupt and commences receivership proceedings, with the exception of a limited number of decision-making powers relating to certain major and special type transactions. From the date of approval of the receiver and until the date of termination of the receivership proceedings, the receiver shall exercise the powers of the chief executive officer and other management bodies of the debtor in the manner established by the Bankruptcy Law. Therefore, during receivership proceedings, the management bodies of the debtor generally cease to possess corporate representation powers with respect to the debtor.

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

The Bankruptcy Law provides several remedies for a creditor whose rights have been violated by a debtor. Article 103 of the Bankruptcy Law provides one of such remedies and states that an agreement made by a debtor (including an agreement to grant a security interest) may be deemed invalid by an arbitrazh court upon the application of the arbitrazh manager or a creditor on the grounds specified by federal law. For example, special grounds for a transaction's invalidity are established under the RF Bankruptcy Law, according to which the transactions concluded by the debtor on the verge of bankruptcy and which caused preferential satisfaction of a particular

[18] *See* Article 94 of the Bankruptcy Law.

creditor's claims may be deemed invalid. In addition, by virtue of Article 103 of the RF Bankruptcy Law, general grounds for a transaction's invalidity, established in Chapter 9 of the Civil Code of the Russian Federation (e.g. if the transaction was carried out in violation of the law, was fictitious or fraudulent, contemplated under duress, etc.), can also be applied during the bankruptcy case[19].

In addition, the following agreements may be invalidated during bankruptcy proceedings: (i) an agreement made between a debtor and any interested party, if its execution has caused or might cause damages to creditors or the debtor; (ii) an agreement made between a debtor and a particular creditor or a third party after an arbitrazh court accepted an application of a bankruptcy and/or within six months preceding the filing for bankruptcy if the agreement entails preferential treatment of specific creditors' claims over the claims of the other creditors; (iii) an agreement made by a debtor legal entity within six months preceding the bankruptcy filing to redeem a shareholder, if it violates the rights of creditors. Such an agreement made after an arbitrazh court accepts a bankruptcy application is null and void.

Consequently, the granting of a security right or interest to a specific creditor may be invalidated if such agreement violates the rights and legal interests of other creditors and/or meets other criteria outlined above.

5. Is enforcement of security rights treated differently in each type of proceeding?

Under Russian law, there are no formal pre-insolvency proceedings. During bankruptcy proceedings, the enforcement of a security right is only provided for during the receivership proceedings, as addressed below.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Pursuant to Article 134 of the Bankruptcy Law, the creditors' claims must be met in the following priority: (i) first priority for claims of individuals to whom a debtor is liable for personal injury to life or health or emotional distress; (ii) second priority for claims of labour compensation and remuneration under authorship (copyright) agreements; and (iii) third priority for all other claims[20].

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19 The Civil Code of the Russian Federation, Part One dated November 30, 1994.

20 Previously the Federal Law on Bankruptcy dated January 8, 1998, provided five priorities including the debts before budget (unpaid taxes, charges, etc.), as a fourth priority before other unsecured creditors.

It is important to note that claims secured by a pledge or mortgage of the debtor's property/assets shall be paid out of the funds received from the sale of the collateral prior to the other creditors, except for the obligations to the first and the second priority creditors in respect of such claims which occurred prior to the execution of a respective pledge or mortgage agreement. To the extent that the secured claim exceeds the amount of proceeds paid to such creditor, the unpaid balance of the secured claim shall be treated as part of third priority (regular unsecured creditors') claims. The sale of the subject of the pledge shall be effected in a public (open) auction[21].

The bankruptcy manager will make distributions to holders of the claims listed in the register of creditors' claims on a *pro rata* basis in accordance with the priority of each claim. The claims of creditors of each priority are satisfied after creditors of higher priority have been satisfied in full.

Should the debtor's funds be insufficient to satisfy creditors' claims of the same priority, the funds should be allocated among the creditors sharing a priority *pro rata* to the amount of their claims indicated in the register of creditors' claims. Creditors' claims not satisfied due to insufficiency of a debtor's property/assets are deemed discharged.

7. How can creditors protect their rights towards the debtor?

In order to protect his rights with respect to an unpaid debt confirmed by a court's judgment, a creditor (including the secured creditor) shall file an application of a bankruptcy creditor in written form with an arbitrazh court[22].

Further, another method of protecting creditor's rights is that a creditor may petition an arbitrazh court for interim measures to secure, inter alia, its claim implementing injunctive measures provided under the Arbitrazh Procedure Code (as was addressed above).

It is important to emphasize that creditors are empowered with another form of protection – the right to object to the actions of the arbitrazh manager to the arbitrazh court considering the bankruptcy case[23]. The creditor may also appeal to a higher court the respective judicial decisions and orders of the "bankruptcy" court itself, e.g. in relation to the assessment of the creditors' claims or declaring a debtor bankrupt.

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21 *See* Article 138 of the Bankruptcy Law.

22 The application of a bankruptcy creditor being a legal entity is to be signed by its head (e.g., General Director) or his representative, the application of a creditor being an individual is to be signed by himself or his representative.

23 *See* Article 17(3) of the Bankruptcy Law.

The Bankruptcy law provides creditors with a rather wide range of options to protect their rights and interests against the debtor during the bankruptcy proceedings.

8. How do creditors protect their rights towards guarantors?

Subject to Article 370 of the RF Civil Code, a bank guarantee is deemed to be an independent obligation from the secured obligation, i.e. the guarantor's obligation does not depend on the validity and/or enforceability of the principal secured obligation. Therefore, if a debtor fails to fulfill his obligation to a creditor, the creditor is entitled to make a claim against the guarantor. Thus, if a debtor defaults on a creditor's claim, a creditor may look to the guarantor who is responsible for paying the guaranteed amount[24]. Certainly, if a guarantor has reimbursed a creditor's claim for the debtor, the guarantor shall have the right of subrogation, i.e. the right to seek compensation of its payment under the guarantee from the debtor, including in the debtor's bankruptcy proceedings (if any).

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g., perfection)?

The Bankruptcy Law provides that all creditors (including secured creditors) must be notified in respect of the bankruptcy proceedings. However, it must be noted, that it is a creditor's responsibility to timely undertake all relevant actions in order to get treated as a bankruptcy creditor.

Pursuant to the Bankruptcy Law, all creditors' claims against the debtor must be filed during the bankruptcy proceedings and, if upheld by the arbitrazh court considering the bankruptcy case, such claims shall be included in the register of claims.

Creditors' claims filed during the bankruptcy proceedings, but after the full discharge of the creditors' claims having the same priority, are satisfied after the claims of all other priorities and from the debtor's remaining assets (if any).

It must also be noted that the failure of a secured creditor to comply with other legal requirements (for example, in relation to creation of the security interest) may affect their ability to protect their rights, because a court will review the legitimacy of the secured creditor's claim on the merits.

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24 *See* Articles 363, 323 of the Civil Code.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

According to Section 1 of Article 63 of the Bankruptcy Law, from the date the supervision proceedings begin with respect to a debtor, all matured claims must be brought against a debtor in the bankruptcy proceedings. Naturally, satisfaction of any of such claims separately at this stage is at risk of being invalidated. Likewise, as of the same date, execution orders against a debtor are stayed.

Therefore, the stay on satisfaction of matured claims applies to all types of claims, including secured ones, from the first date when the bankruptcy proceedings are initiated. Because the stay is mandated by law, there is no right of appeal.

This stay, however, does not apply to "current obligations"[25]. Current claims are not included in the register of the creditors' claims and creditors under these claims are not considered as the bankruptcy creditors. These claims are paid by the debtor on an ongoing basis from its assets without regard to the bankruptcy creditors' claims.

As to whether a secured party is permitted to foreclose or take other enforcement actions against the collateral during a pre-insolvency or insolvency proceeding, the Bankruptcy Law does not recognize pre-insolvency proceedings *per se*. The Bankruptcy Law mentions certain "measures aimed at preventing the bankruptcy of the debtor", but these measures cannot be qualified as "pre-insolvency" proceedings, given their extremely limited nature, and therefore, these measures are not addressed herein. With regard to other bankruptcy procedures, a secured creditor can foreclose on its collateral subject to the rules outlined above only during the receivership proceedings[26].

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25 *See* Article 5 of the RF Bankruptcy Law, according to which "Current obligations are monetary obligations and mandatory payments that have arisen after a bankruptcy petition by or against the debtor has been accepted for consideration, as well as monetary obligations and mandatory payments with respect to which the maturity date occurred after the implementation of the relevant bankruptcy proceedings."

26 This rule, as is clear from the above, is not applicable to the security of the current obligations, however, chances that the debtor secures its current obligations in practice are extremely low due to the very difficult procedure necessary to encumber its assets during the bankruptcy proceedings.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

A debtor may use or sell the collateral in which a secured party has an interest during "financial rehabilitation" but only with the consent of the secured creditor (unless otherwise provided by law or in the pledge agreement).

The second instance when a debtor (or more accurately the receiver) may use or sell collateral is during receivership proceedings during the foreclosure procedure as addressed above.

Lastly, collateral may be sold as part of the sale of enterprise (the debtor's business) during the external administration, provided the collateral is sold with the consent of all secured creditors and in accordance with the procedure of public auction established by Article 110 of the Bankruptcy Law.

With respect to the issue of specific treatment for cash collateral, Russian law does not expressly provide for specific treatment of "cash collateral". However, according to judicial practice[27], cash cannot be the subject of collateral and such pledge agreements will be invalid. It must be noted, however, that the paragraph above relates to cash collateral denominated in Russian Roubles. As judicial practice demonstrates, there are cases where the pledge of the rights to a bank account or a pledge of funds denominated in a foreign currency shall be permitted. In such cases, "cash" collateral is treated similarly with pledges of movable assets.

The granting of new security rights during bankruptcy proceedings is permitted only during financial rehabilitation. Pursuant to Article 79 of the Bankruptcy Law, in accordance with the "indebtedness payment schedule" a debtor's obligation can be secured by (created anew) pledge, bank guarantee, state or municipal guarantee, suretyship, and other securing measures not contradicting the Bankruptcy Law.

Under the Bankruptcy Law, no new security interests may be granted during the bankruptcy proceedings to the existing creditors.

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27 Information letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 26 dated January 15, 1998.

28 *See* Section 3 of Article 64 of the Bankruptcy Law.

12. What distribution will a secured creditor receive if a company is reorganised?

Some provisions of the Bankruptcy Law restrict the debtor from making decisions on reorganization[28] and the Bankruptcy Law does not provide for a reorganization as a type of the bankruptcy proceedings. At the same time, the Bankruptcy Law provides for the possibility of reorganization of the debtor during financial rehabilitation, provided that the creditors' meeting and/or the party providing the funds for such financial rehabilitation consents.

In addition, some quasi "re-organizational" procedures, such as the replacement of debtor's assets[29] and sale of the debtor's business can be performed during the external administration. In both of these cases the matured monetary obligations of the debtor are not included in the assets being sold in this quasi-reorganization procedures. That means that the assets sold as replaced assets (shares) or as the debtor's business (enterprise) must be transferred to the purchaser free and clear of liens. These options can be pursued only if all of the secured creditors unanimously approve such a replacement or sale of the debtor's business (enterprise). Therefore, presumably, the secured creditors may condition such consent on the undertaking of a purchaser that their security interests will follow the assets of the debtor as generally provided under Russian law.

13. Will the rights of a secured creditor over assets of a debtor "follow" the assets within the reorganised company?

This matter has been addressed in the answer to question 12.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

If the secured creditor's claims are under-secured, the unsecured portion of such creditor's claim will be ranked with the third priority unsecured creditors on a *pro rata* basis without any preference[30].

Where a claim is over-secured, after pledged property has been disposed at an auction as established by law, the amount by which the creditor's claim is over-secured (after payment of principal, interest and costs) must be transferred to the bankruptcy estate to be used for the settlement of the claims of the other creditors in the relevant priority[31].

28 *See* Section 3 of Article 64 of the Bankruptcy Law.

29 Under Article 115 of the Bankruptcy Law, replacing a debtor's assets essentially means that on the basis of the debtor's assets, new joint stock company(ies) are organized and the shares of such company(ies) are sold at the public auction in order to raise funds to satisfy the bankruptcy creditors' claims.

30 Section 2 of Article 138 of the RF Bankruptcy Law.

31 Section 6 of Article 350 of the RF Civil Code, Section 9 of Article 110 of the RF Bankruptcy Law.

South Africa

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

Under South African law two types of security are distinguished, namely personal security and real security. Personal security normally occurs in one main form, namely suretyship. Although cession *in securitatem debiti* is also sometimes categorised as a form of personal security, these rights are in practice treated more like the rights of a pledgee and in practical terms regarded as security rights. Real security rights can arise *ex contractu* (by contract) or *ex lege* (by operation of law). Real security rights that arise by contract include pledge, notarial bonds and mortgage. Real security rights that arise by operation of law include tacit hypothecs, liens, certain statutory rights and judicial pledge.

In the case of real security the creditor acquires a limited real right in property owned by the debtor with which he can enforce payment of the principal debt. In the case of personal security the creditor can require a third party, the surety, to contractually bind himself to stand in for the debt of the principal debtor should the principal debtor not be able to meet his commitments to the creditor in terms of the principal debt.

Movable property

Pledge

A pledge is an accessory right founded upon a contractual agreement between the pledgor and the pledgee, in which the pledgor agrees to offer one or more movable assets as security for a principal debt. All types of movable property, including intangible property, may be the subject of a pledge. There are no prescribed formalities for the conclusion of a pledge

agreement; and the agreement need not even be in writing. Instead, the conditions for the validity of the agreement are left entirely to the parties.

The contract itself only gives rise to a personal right to demand that the real security be given. The real right of security arises upon the physical delivery of the asset(s) pledged. It is essential that the pledgor agrees to voluntarily deliver the asset to the pledgee.

In respect of tangible assets, delivery of the pledged asset is a prerequisite for the creation of a pledge. Delivery may be achieved by either actual or constructive delivery. The fact that the asset is transferred into the possession of the pledgee effectively means that pledgor is prevented from alienating the pledged property and avoiding his or her obligations. In terms of the law, cession in security (see below) is classified as a pledge.

If an asset has been delivered as a pledge, the asset and all its fruits are subject to the pledge. The pledgee may not enjoy the use of the asset or its fruits unless otherwise agreed. The pledgee has an obligation to properly maintain the pledged item, and the pledgor has a right to be indemnified by the pledgee for such maintenance expenses incurred.

Mortgage

A mortgage is an accessory right founded upon a contractual agreement between the mortgagor and the mortgagee, in which the mortgagor agrees to offer property as security for a principal debt. All types of property including movable, immovable and intangible property, may be the subject of a mortgage. The contract itself only gives rise to a personal right to demand that the real security be given. The real right of security arises upon registration of the mortgage bond in the Deeds Office for the province in which the property is located. The same property may be subject to more than one mortgage bond. The asset may not be alienated by the mortgagor without the cancellation of the mortgage bond registered at the Deeds office. Such cancellation can only occur with the consent of the mortgagee.

Generally speaking, the major difference between a mortgage and a pledge is that a mortgagor remains in possession of the secured property. In the unusual event that the mortgagee takes possession of the property, the mortgagee shall be under a duty to maintain the property at the expense of the mortgagor.

Two types of mortgage bonds over movables are possible, including: (i) general notarial bond, which is a bond over movable property, that is

contained in a deed and executed notarially prior to registration; and (ii) special notarial bond over specially described movable property.

It should be noted that a 'general notarial bond' does not confer any real right to the mortgagee in respect of the property outside insolvency, unless the bondholder has 'perfected' the security by taking possession of the bonded assets. However, if the debtor becomes insolvent, the mortgagee will have a statutory preference over the concurrent creditors of the mortgagor. A variant of the general notarial bond, the 'special notarial bond', will confer real rights upon the mortgagee outside insolvency and without a so-called 'perfection clause', as if the property had been pledged. Once a special notarial bond has been registered in terms of the Security by Means of Movable Property Act, 1993 (with the Registrar of Deeds for the province in which the movables are located), the security has effect nationally and can be enforced wherever the movables are situated. These special bonds are limited to tangible movable property, specified and described in the bond in a manner that renders it 'readily recognisable'.

Cession in security

This refers to the situation where the debtor ceded a personal right to the creditor as security for the performance of his own obligation. For example, a debtor may cede his shareholding in a company, book debts, or a policy to the creditor as security. This type of security interest, which is classified technically as a pledge, is created by way of an agreement between the debtor and the creditor. The agreement may take one of two forms. (i) The debtor may cede his personal right to the creditor on the understanding that the creditor will cede this right back to the debtor upon repayment; or (ii) the personal right may be pledged as security for repayment, in which case the debtor will have a reversionary interest.

Tacit hypothecs

The most common example of a tacit hypothec is the landlord's tacit or legal hypothec. Essentially, the lessor of immovable property obtains a security interest over the movable property (including money) of the lessee, which is present on the property. The security interest allows the lessor to have the lessee's movables attached and entitles the lessor to be paid out of the proceeds of sale in the event of the debtor's insolvency. The secured claim is limited to a number of months, depending on the period for the payment of rent. Only movables on the leased property are subject to the tacit hypothec, and it only covers arrears rent. The tacit hypothec comes into being when the rent is in arrears and vests as a real security interest upon the insolvency of

the lessee. Outside of insolvency, the landlord's legal hypothec can only be exercised after following due legal process for the recovery of the arrear of rent owing. Movables subject to special notarial bonds at the time the hypothec vests, are not subject to the landlord's tacit hypothec.

Another example of a security interest arising by operation of law is the tacit hypothec that arises where property is purchased on instalments. Specifically, where the debtor has contracted to acquire property under an instalment sale transaction (prior to 1 June 2006 in terms of the now repealed Credit Agreements Act) or an instalment agreement (after 1 June 2006 in terms of the recently promulgated National Credit Act), a hypothec to secure the balance of the purchase price will arise upon the liquidation of the debtor's estate in terms of section 84 of the Insolvency Act. Property forming the subject matter of an instalment sale transaction or an instalment agreement, is not subject to the landlord's tacit hypothec if the landlord was aware of the ownership of the seller. A section 84 hypothec will only provide the creditor with real security in cases where the debtor's estate is placed under sequestration or liquidation.

Liens

A lien differs from a tacit hypothec in that actual physical possession by the creditor is a prerequisite for the creation and continued existence of the real security interest. A lien allows a creditor to retain possession of the debtor's property until the debt is paid. If the debt remains unsatisfied, the holder of the lien may have the property attached and sold subject to a court order. If the debtor becomes insolvent, the lien holder will be treated as a secured creditor of the insolvent estate.

Three types of liens are recognised in South Africa. (i) Debtor / creditor liens; (ii) salvage and storage liens; and (iii) improvement liens.

The debtor / creditor lien arises where the debtor and creditor contractually agree that the creditor will incur certain expenses in respect of something of the debtor's.

The last two types of lien are collectively referred to as enrichment liens. Such liens arise where a person in possession of another person's property has incurred costs in respect of that property without the consent of the owner. The lien arises because the owner of the thing is unjustly enriched. An example of this is where the creditor salvages the debtor's property. The debtor will be entitled to reclaim it, subject to reimbursing the salvage costs.

Hypothecs of the court

Where the court orders the attachment and sale of the debtor's assets to satisfy an outstanding debt, the creditor will obtain a preferential right to the proceeds of sale. However, if other creditors submit warrants of execution before the sale date, the creditors will share in the proceeds on a *pro rata* basis. The preference is limited if insolvency intervenes. Hypothecs of the court are subject to the interests of creditors holding real security rights.

Floating charge

It is not possible to execute a floating charge in South Africa. However, the general notarial bond under South African law is very similar in its nature and operation to the floating charge.

Immovable property

Mortgage

A mortgage is an accessory right founded upon a contractual agreement between the mortgagor and the mortgagee, in which the mortgagor agrees to offer property as security for a principal debt. All types of property including movable, immovable and intangible property, may be the subject of a mortgage. The contract itself only gives rise to a personal right to demand that the real security be given. The real right of security arises upon registration of the mortgage bond in the Deeds Office for the province in which the property is located. The same property may be subject to more than one mortgage bond. The asset may not be alienated by the mortgagor without the cancellation of the mortgage bond registered at the Deeds office. Such cancellation can only occur with the consent of the mortgagee.

Generally speaking, the major difference between a mortgage and a pledge (besides the fact that a pledge can only be taken over movables) is that a mortgagor remains in possession of the secured property. In the unusual event that the mortgagee takes possession of the property, the mortgagee shall be under a duty to maintain the property at the expense of the mortgagor.

Various types of mortgage bonds over immovable property are possible, including: (i) Special bond, which is a bond over immovable property, or any interest in immovable property, where the bond is imbedded in a pledge agreement and then registered; (ii) k*ustingsbrief* bond, which is a bond over immovable property being purchased, in order to secure the balance of the purchase price for the immovable property; (iii) covering bond, which is a

bond over immovable property used to secure future debts, such as bank overdrafts; (iv) statutory participation bond, which is a bond over immovable property held by a company, but in which the individual shareholders have their respective claims secured, pro-rata, by the bond.

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

Outside insolvency, unsecured creditors can enforce their rights by obtaining a court judgment. A default judgment will be available when the debtor does not oppose the application for judgment and provision is made for consent judgments. In the event that the debtor fails to comply with a court judgment or summary judgment, the creditor may obtain an execution writ and have this enforced by a sheriff of the court.

If a creditor has a secured claim under a mortgage or notarial bond, that claim must be registered with the deeds registry in the area in which the property is located. If the secured claim arises under a pledge agreement, the security need not be registered. In respect of pledge agreement, the law regards a cession of rights as security for a claim as a pledge. In respect of tangible movables, the pledgee will retain possession of the property until the debtor's obligation is fulfilled. Where a debtor fails to fulfil its obligation, the secured creditor can apply to the court to have the asset sold. Under certain circumstances this will not be necessary, and the creditor may sell the asset without court sanction. However, the South African Constitution limits the exclusion of access to the court.

In respect of the cession of rights (policies, book debts, shares, etc.), an agreement between the parties is usually sufficient and no registration is required. A right of action that has been embodied in a document and that cannot exist independently of the document, such as a negotiable instrument, or cases where an Act, or regulation, agreement, etc., prescribes formalities to complete the cession, should be distinguished from other rights of action which are evidenced in a document, but which exist independently of the document, such as a share in a company in respect of which a share certificate has been issued. Where the latter kind of action is ceded, neither delivery of the document to the cessionary nor compliance by the cedent with the doctrine of all effort is a requirement for the validity of the cession (the doctrine of all effort requires the cedent to do everything in his power to divest himself of his right). Delivery of the document is an important factor, possibly a decisive factor, when the question arises of whether or not the cession has been proved.

3 Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.

(d) Does the debtor remain "in possession" of the business?

Corporate pre-insolvency ('rescue') proceedings

There are four general forms of business enterprise in South Africa, namely the sole proprietorship, the partnership, the company and the close corporation. Since only companies and close corporations enjoy legal personality, the sole proprietorship and the partnership will not be discussed here (the estates of these entities are sequestrated and not liquidated, and are therefore not dealt with in the same manner as corporate entities). Companies and close corporations cater for the needs of groups of persons who wish to participate jointly in an enterprise and who want to enjoy the benefits of legal personality. The registration of a company or a close corporation endows such a body with separate legal personality and as such it acquires its own rights and liabilities. The risk carried by the contributors of capital extends no further than the loss of the amount which they have contributed to the venture as capital. The company and close corporation also afford the benefit of perpetual succession as their continued legal existence is not influenced by any change in membership. Close corporations differ from companies in that they are usually small business enterprises and do not have to comply with all the formalities associated with companies. Most of what is stated hereunder applies to both companies and close corporations, although in certain cases there are differences between the formalities that have to be complied with.

South Africa does not a have a true rescue or pre-insolvency proceeding, but there are two procedures that serve a similar purpose under South African law. These two procedures are section 311 compromises and arrangements (which can also be used during a liquidation proceeding) and judicial management. These two procedures only apply to companies (although section 72 of the Close Corporations Act also makes provision for a composition between a close corporation and its creditors).

In the case of a section 311 compromise where a compromise or arrangement is being proposed between the company and its creditors or between the company and its members, the application can be brought by the company, any creditor or member of the company, by the liquidator if the company is being wound up, and by the judicial manager if the company is under judicial management. A judicial management order may be sought by the company itself, one or more of its creditors, one or more of its members, jointly by all the above-mentioned parties and, if the company is being wound up voluntarily, by the Master of the High Court or any member or creditor of that company.

In the case of a section 311 compromise or arrangement, there are no criteria for opening the procedure other than a party seeking an order of court convening a meeting to consider the offer of compromise or arrangement. In the case of a judicial management order, there are a number of criteria that need to be met before the court will grant a provisional judicial management order. It must be proved to the court that the company – by reason of mismanagement or some other reason, is unable to pay its debts or is probably unable to meet its obligations, and has not become or is prevented from becoming a successful concern, and there is a reasonable probability that, if it is placed under judicial management, it will be enabled to pay its debts or to meet its obligations and become a successful concern, the court may, if it appears just and equitable, grant a judicial management order.

The main parties to a section 311 compromise or arrangement are the company, the Court, the offeror, the receiver, the liquidator (if the company has already been placed in liquidation) and the creditors and / or members of the company. The main parties in a judicial management procedure are the Court, the Master of the High Court, the creditors, the members and the judicial manager.

South Africa does not have a ‘debtor-in-possession’ procedure.

Corporate liquidation proceedings

Under South African law a company may be wound up voluntarily or by the court. The winding-up of companies is regulated mainly by the provisions of the Companies Act, although by virtue of section 339 of the Companies Act the insolvency law also finds application to companies that are unable to pay their debts.

Voluntary winding-up

A distinction is made between a voluntary winding-up by members and a voluntary winding-up by creditors. In both cases the procedure is commenced by the passing of a special resolution by the members of the company. The main parties to the liquidation proceeding are the members of the company, the Master of the High Court, the Companies and Intellectual Property Registration Office (CIPRO), the creditors (in the case of a voluntary winding-up by creditors) and the liquidator.

In the case of a voluntary winding-up by members the company is solvent and there is no need for the holding of creditor meetings. The company auditor must certify that there are no debts or, if there are debts, security must be provided in order to cover the full value of the liabilities of the company before the resolution to wind up the company will be registered. The resolution normally also includes the nomination of a liquidator and the determination of the person's remuneration.

In the case of a voluntary winding-up by creditors, the company is insolvent and creditor meetings will be held. The resolution must state that the voluntary winding-up is a voluntary winding-up by creditors, and the date of liquidation is the date upon which the resolution is registered. Once the resolution has been registered the procedure for winding-up the company is the same as in the case of a winding-up by the court.

Winding-up by the court

A company may be wound up by the court voluntarily or compulsorily on the basis of insolvency provided for by the provisions of the Companies Act. An order for the winding-up of a company may only be granted by the High Court (although in the case of a close corporation a magistrates court or the High Court may grant a winding-up order). The criteria for the commencement of the proceeding is a duly adopted resolution in terms of which the court will be approached to grant a liquidation order, or the presence of a valid ground of liquidation in terms of the provisions of the Companies Act. The main parties to this type of liquidation proceeding are the court, the creditors, The Master of the High Court and the liquidator.

Personal / consumer insolvency

Under South African law the Insolvency Act, 1936 makes provision for the voluntary surrender as well as the compulsory sequestration of a debtor's estate. In both cases (and because the order affects the status of the debtor) the order may only be granted by the High Court.

Voluntary surrender

In the case of a voluntary surrender the debtor brings an *ex parte* application him or herself requesting the court to place the estate in question under sequestration. Before a court will grant an order of voluntary surrender it must be satisfied that the prescribed formalities have been complied with (dealing mainly with notice to creditors), that there is sufficient free residue in the estate to cover the costs of the application, that the person is factually insolvent (in terms of a balance sheet test) and that the sequestration will be to the advantage of the creditors. In particular, the last requirement is problematic in practice, as the courts will not grant an order of sequestration if it cannot be proved to be to the advantage of creditors. The main parties to this procedure are the debtor, the court, the Master of the High Court, the creditors and the trustee.

In addition to the above, if the applicant debtor is a partnership the court will not entertain the application if all the partners simultaneously apply for the voluntary surrender of their own estates.

Compulsory sequestration

In the case of compulsory sequestration one or more creditors bring an application on notice requesting the court to place the debtor's estate under compulsory sequestration. In order to obtain the order the applicant creditor will either have to prove that the debtor is factually insolvent, or that the debtor has committed an act of insolvency as provided for by section 8 of the Insolvency Act. In addition the applicant creditor will have to provide security for the costs of the application, and prove that there is reason to believe that the sequestration of the debtor's estate will be to the advantage of the general body of creditors. The main parties to this procedure are the creditors, the debtor, the court, the Master of the High Court and the trustee.

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

In terms of section 88 of the Insolvency Act, if a bond over immovable property or a special notarial bond over movable property in terms of section 1 of the Security by Means of Movable Property Act, 1993 is registered within 6 months of the insolvency of the debtor, and the debt secured thereby was older than two months at the time of the registration of the bond, then

the bond will grant no preference or security rights to the creditor in respect of that debt. In such a case the creditor will only obtain security rights in respect of the bond in question if the bond has been registered for at least six months.

The Supreme Court of Appeal has ruled that if a creditor prefects its security in terms of a clause of *parate executie* (summary execution, in most cases without first following due legal process) contained in a general notarial bond, even if only one day prior to insolvency, the fact that the creditor obtained a valid form of security (pledge) at such a short period prior to insolvency, is not a voidable preference if the perfection took place in terms of the provisions of the bond. After a number of cases dealing with the constitutionality of *parate executie* clauses, it is accepted today that a general notarial bond cannot be perfected without first following due legal process.

5. Is enforcement of security rights treated differently in each type of proceeding?

Generally speaking the enforcement of security rights are treated the same in each type of proceeding, especially as regards liquidation and sequestration proceedings. It is however possible that a section 311 compromise could vary the rights of creditors in regard to their security rights, but since this is done in consultation with and with the approval of the various creditors, this aspect will not be discussed. In the case of judicial management all the assets of the company fall under the custody and control of the Master of the High Court until a judicial manager is appointed, after which the assets fall under the custody and control of the judicial manager. Although there is not an automatic stay in the case of judicial management, the court may be requested to impose a moratorium. Such a request would appear to be standard practice when an application for judicial management is brought. The granting of a stay by the court would prevent any secured creditor from exercising their security rights while the company is under judicial management. Unless the sale of property is in the ordinary course of the company's business, the judicial manager may not sell property of the company without the leave of the court.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Pre-insolvency or rescue proceedings

In terms of a section 311 compromise the rights of creditors may be varied by agreement. Under judicial management the same priorities that apply under insolvency law will apply, with the one exception that pre-judicial management creditors may agree to a preference for post-judicial management creditors that rank in preference to the claims of the pre-judicial management creditors. If such a preference is agreed to by the pre-judicial management creditors, such preference will apply even if the company is subsequently placed in liquidation.

Insolvency proceedings – corporate liquidation

Secured creditors

The proceeds of secured assets are firstly applied in paying the administration expenses relevant to the liquidation proceeding. The cost of realising, conserving and maintaining the asset are paid first, as are the liquidator's fees, the Master's statutory fee and a pro rata portion of the costs of providing security for the proper administration of the estate. Finally, if the security consists of immovable property, any outstanding taxes owing to a municipality or other local authority have to be paid in priority to the claims of the secured creditors. Secured creditors receive priority treatment in that their claims are paid first from the proceeds of the security that they held prior to liquidation (after the administration expenses referred to above have been paid). If there is any shortfall on their claims, including post-liquidation interest, after the proceeds of their securities have been paid to them, the balance of their claims are treated as unsecured (concurrent) unless such a creditor has elected to rely solely on the proceeds of its security.

In certain cases claims by the Land and Agricultural Development Bank of South Africa will receive priority treatment over the claims of normal secured creditors.

Unsecured creditors

Unsecured creditors can be divided into two categories, namely statutory preferent and concurrent creditors. Both of these sub-classes of creditors are paid from the free residue of the estate.

Statutory preferent (priority) creditors

Statutory preferent creditors are paid in a specific order of preference, and some sections contain a priority within the operation of the section itself. These preferences are dealt with in sections 96 to 102 of the Insolvency Act, and can briefly be summarised as follows: S96: preference for a maximum amount for funeral and death-bed expenses of the debtor; S97: administration expenses relating to the free residue, such as the taxed bill of costs for the application and the payment of the liquidator's fees on the free residue assets; S98: preference for a maximum amount for attorneys and the Sheriff for pre-liquidation execution orders; S98A: preferences for a maximum amount regarding employees' claims for arrear salary, wages, leave pay and retrenchment benefits (under South African law employees become entitled to retrenchment benefits where their services contracts are terminated – the amount payable is usually equal to one week's remuneration for every year of service), as well as contributions made to provident and other funds; S99: payments to certain government institutions, such as the South African Revenue Service, for arrear VAT and customs and excise duty; S101: preference for arrear income tax owing; S102: preference for general notarial bondholders who failed to perfect their security prior to liquidation (this includes a preference for special notarial bondholders whose bonds were registered prior to 7 May 1993).

Concurrent creditors

Section 103 of the Insolvency Act provides for the balance of the free residue to be distributed *pari passu* amongst the concurrent creditors. If any funds remain after the payment of the concurrent claims plus post-liquidation interest, these funds will be distributed amongst the shareholders / members in accordance with the share register.

Personal / consumer insolvency

The priorities in regard to personal insolvencies are the same as enumerated above, with the exception of surplus funds after the payment of all creditors' claims. In such a case the surplus funds will be deposited into the Guardian's Fund administered by the Master of the High Court, and paid to the insolvent debtor upon his or her rehabilitation.

7. How can creditors protect their rights towards the debtor?

In the case of mortgage bonds registered over immovable property, the creditor is protected by the registration of the bond against the title deed of the property. The property cannot be transferred until such time as the mortgage bond has been cancelled after payment has been made.

In the case of special notarial bonds registered over movables, the Security by Means of Movable Property Act creates a statutory pledge whereby the bonded property is deemed to be in the possession of the creditor bondholder. These special bonds are registered in the Deeds Office, which provides some measure of protection to the creditor.

In the case of liens, the landlord's legal hypothec and pledge, the creditor must ensure that he or she remains in possession of the property, as loss of possession usually results in the loss of the security right associated with that property. In the case of statutory hypothecs the creditor is normally protected by the legislation, even if the property is transferred to a *bona fide* third party.

In the case of general notarial bonds over movables, creditors may protect themselves by perfecting their security prior to the commencement of the insolvency proceeding. This must be done in accordance with judicial process. Bondholders who fail to perfect their security prior to the commencement of the insolvency proceeding, will only obtain a statutory preference over the free residue in terms of section 102 of the Insolvency Act.

8. How do creditors protect their rights towards guarantors?

The equivalent of a guarantor under South African law would be a surety. Surety agreements only provide for personal security and not real security (see the 'General' paragraph under question 1), although there are cases where real security is given in the form of a surety bond. The modern surety agreement in South Africa excludes most of the common-law remedies available to the surety, and for all intents and purposes a surety will sign an agreement as a co-principal debtor. The advantage for the creditor is that he or she can hold both the principal debtor and the surety (as co-principal) debtor liable for the full amount of the debt. In the case of insolvency the creditor is entitled to prove his or her full claim against the estate of the principal debtor and the surety.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g., perfection)?

In most cases creditors that have not complied with all the required processes for protecting their potential secured rights will lose the preference they would otherwise have had, and will be treated as concurrent (unsecured) creditors. In the case of the holder of a general notarial bond that has not perfected his or her security prior to insolvency, such creditor will be treated as a preferent (priority) creditor in terms of section 102 of the Insolvency Act. This priority ranks lowest in its preference, and is the last priority to be paid before concurrent creditors receive a dividend.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

Generally speaking secured creditors are not entitled to foreclose or take any other enforcement actions once the insolvency proceeding has commenced, and this will apply to all claims against the debtor. Provision is made for certain secured creditors to sell the object of their security during the administration process, subject to the proceeds being paid to the trustee / liquidator once the proceeds have been received. Such sales can only be made by the creditor prior to the second meeting of creditors. After the second meeting has been held only the trustee / liquidator may sell the property.

Under judicial management it would appear that a secured creditor may foreclose or take other enforcement actions if the court has not granted a stay of proceedings under section 428(2) of the Companies Act.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

Under insolvency proceedings it is possible that secured property may be used if the trustee / liquidator has continued trading, for whatever reason. Normally the benefits resulting from such use would fall to the secured creditor holding that property as security. Under judicial management the property may only be sold with the authority of the court, or when used in the ordinary course of the company's business. Under judicial management the granting of new security rights would be allowed if the creditors have consented.

12. What distribution will a secured creditor receive if a company is reorganised?

In the case of compromises under section 311, the distribution paid to a secured creditor will depend on the content of the proposal which will normally be by agreement. In the case of judicial management, which has a complete recovery of the company (with the payment of all claims) as its aim, the Companies Act makes provision for the same distribution rules as in the case of insolvency.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

Under section 311 compromises this is possible if the compromise makes provision for such an eventuality. However, since South Africa does not have a true reorganisation procedure, this question does not really apply.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

Over-secured claims

If the claim of a secured creditor is over-secured, the balance of the proceeds of the security, after payment of the secured creditor's claim together with interest thereon, will form part of the free residue of the estate (s 83(12) of the Insolvency Act) from which statutory preferent and concurrent claims will be paid (in terms of ss 96 to 103 of the Insolvency Act).

Under-secured

If the claim of a secured creditor is under-secured, the balance (unpaid portion) of the secured creditor's claim (including any interest post-liquidation) will be treated as a concurrent claim and such creditor will be paid a dividend on such balance from the free residue of the estate, should there be any. However, should a creditor elect to rely on the proceeds of its security at the time the claim is proved, then such creditor does not become entitled to share in the proceeds of the free residue and will not be treated as a concurrent creditor. In such a case the creditor takes whatever it can from the proceeds of the security, and will receive no further payment on its claim.

United Arab Emirates

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

UAE legal framework

The United Arab Emirates ("UAE") is a federal state made up of seven individual emirates. There are some differences among the laws and procedures in each emirate, although most commercial and civil laws are federal laws. The legal system is essentially a civil law system.

There are also a number of "free zones" or special economic zones within the UAE, which also have some differences in their laws and procedures from the law of general application in the UAE; in most cases, with some exceptions, these differences do not affect security or insolvency law. Both within and outside the free zones, specific regulatory requirements from administrative bodies can have a marked effect on the practical aspects of closing a business in the UAE.

The free zone known as the Dubai International Financial Centre ("DIFC"), a financial services free zone established in Dubai in 2004, is effectively a separate legal jurisdiction, with laws based on common law principles. While it does not yet play a major role in the economy, given the nature of the free zone, and the potential role it may play in international finance, there will also be a brief comment on the applicable DIFC law in each case.

Security rights

In respect of security rights and the related issues, under UAE law generally, there are different types of security, depending on the collateral and the person creating the security interest.

The primary form of security is the possessory pledge over movables under the Civil Code. A possessory pledge is a contract whereby the obligee is entitled to retain the item pledged (or it may be placed in the hands of a stakeholder), by way of security for a debt. Possession of a tangible object is the essence of the possessor pledge. Pledges of debts require delivery of the instrument confirming the debt, and notice to the debtor of the pledge.

However, the Commercial Procedure Law is relevant in the context of commercial businesses. A commercial business comprises a business's "material and abstract property" – but not the business premises if they are owned by the trader. Commercial pledges operate in a similar way to pledges under the Civil Code. In addition to movables, and debts, which can be pledged in a manner similar to that under the Civil Code, title deeds can be pledged by assignment by way of security registered with the body issuing the document. The Commercial Procedure Law also provides for mortgages over the commercial business itself (but not, it is generally assumed, the business's stock in trade), provided that the mortgage is granted to a bank or financial institution; the mortgage must be notarised and entered in the Commercial Register. These securities are not in widespread use.

Parties can also enter into security agreements structured as sale agreements whereby payment is deferred, and property is retained by the vendor pending payment.

Under DIFC Law, security rights are created as a matter of contract, and the parties can adopt whatever arrangements they wish. However, in terms of protecting and enforcing rights, the DIFC Security Law, based on the North American model, providing for "perfection" of "security interests", is the governing legislation; the rules governing perfection (normally through registration in the security register) will determine priority.

Common forms of security

Under general UAE law, pledges or mortgages of real property are governed by the Civil Code. The mortgage or pledge is a contract whereby the obligee obtains rights *in rem* in respect of real property allocated to satisfy his debt. The right gives priority over ordinary creditors and those ranking are subordinate to him. A pledge by way of security must be registered, and it ranks from the date of registration. Registration is a matter dealt with separately by each of the emirates which make up the UAE.

As discussed, there are a number of free zones within the UAE, in addition to the DIFC. While most land in the free zones is leased to the occupant (and is

therefore not used as security), in the Jebel Ali Free Zone (arguably the UAE's most important free zone), there is a system of registration of mortgages over the structures erected on land in the free zone (but not the land itself).

At the time of writing, there is no specific law governing real property in the DIFC. However, there has been a public consultation process on a draft law, based on the Torrens system used in Australasia and elsewhere. The central feature of the Torrens system is the primacy of the register of land, the determination of interests in land from the register, and the determination of priority by the order of registration. The principal form of security over land is the "mortgage" (strictly not a true mortgage, but a legal fixed charge).

Generally, under UAE law, the security interests are created by contract, but their priority and effectiveness will be determined by law. There are court procedures for obtaining attachment of assets, and security interests so arising exist only by operation of law.

The position is similar in the DIFC. At the time of writing, draft DIFC Court Rules (very similar to the English Civil Procedure Rules) have been released for public comment. It is likely that there will be procedures for attachment of assets and any security interests arising will exist by operation of law.

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

In respect of mortgages of immovable property, the creditor's right to enforce the mortgage must be by way of civil action against the debtor for sale of the property. If the court orders that the property be seized and then sold, the sale will proceed by way of public auction. The debtor has a number of opportunities to repay the debt. If the proceeds are insufficient to pay the debt, the creditor can claim against the debtor for the balance of the debt.

In relation to pledges of movable property governed by the Civil Code, the law relating to immovable property applies. Under the Commercial Procedure Law, the creditor may, seven days after requiring payment, apply to the court for an order to enable the sale of the pledged object. In relation to "pledged" debts under the Civil Code, the pledgee can obtain and retain payment from the pledgor's debtor, without the need for court intervention. Otherwise, any agreement which gives the pledgee a right to take possession of and sell the property, without taking into account the procedures outlined, is void.

In respect of deferred payment agreements in the event of bankruptcy, a creditor is allowed to reclaim property from the bankrupt's estate only if a claim for dissolution of the contract or return of the property has been commenced prior to the declaration of bankruptcy.

Under DIFC law, the creditor is the party primarily entitled to enforce security rights, by appointment of receivers to the assets of companies under the DIFC Insolvency Law, or exercising powers to take possession of and realise or retain both personal and real property.

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, liquidate, trustee, receiver, controller, representative of creditors, state representatives etc.

(d) Does the debtor remain "in possession" of the business?

Under general UAE law, only companies and "traders" can be the subject of insolvency proceedings (there is no equivalent of "pre-insolvency proceedings"). "Commercial Companies" can be dissolved following the liquidation and dissolution process conducted under the provisions of the Commercial Companies Law (or, for "Civil Companies" (non-commercial companies), the equivalent provisions of the Civil Code). In a dissolution, a liquidator (or several) is appointed, safeguards and liquidates the company's assets, and, after payment of the company's debts, distributes assets to the shareholders.

In general terms, dissolution is a process initiated by the shareholders (or partners), and is driven by whether the shareholders wish to continue the business, while bankruptcy is a judicial process, and is directed towards creditor interests.

However, "traders", which include corporate traders – except for joint stock companies – can also be subject to bankruptcy proceedings under the Commercial Procedure Law. Essentially the test for commencing bankruptcy proceedings is cessation of payment of commercial debts. A company can be made bankrupt, even if it is in the process of liquidation, although a

company cannot commence a liquidation once it has been declared bankrupt. There is no personal bankruptcy law except to the extent that "traders" may be individuals.

The bankruptcy procedure envisages the appointment of a trustee in bankruptcy upon any declaration of bankruptcy being made, followed by a composition of creditors, as proposed by the trustee. The composition must be supported by half the creditors (in number) holding two-thirds of the debts, and then ratified by the court. If the proposal for composition is not concluded, then the creditors are deemed to be, "in the state of union". The trustee for the union of creditors can then commence with winding up the debtor's affairs.

Under general UAE law, a bankruptcy does not ultimately extinguish a creditor's rights: while bankruptcy can lead to a composition, a debt waived in a composition continues as an obligation as a "natural debt"; and upon the termination of a "state of union" (i.e., the end of the bankruptcy), every creditor regains his right to seek execution against a debtor.

Under the DIFC Insolvency law, the DIFC Court can only exercise an inherent insolvency jurisdiction over DIFC companies and limited liability partnerships; some legislation specifically extends the jurisdiction to similar commercial entities, but there is no personal insolvency in the DIFC. The DIFC Insolvency Law recognises voluntary arrangements and receiverships (which can be characterised as pre-insolvency proceedings), and members' voluntary winding up, creditors' voluntary winding up, and compulsory winding up.

Parties who can initiate proceedings

Under general UAE law, initiation of liquidation and dissolution will depend on the nature of the company. Often the articles of incorporation or association will play an important role in determining whether a company can be liquidated and dissolved. However, in most cases, liquidation and dissolution is initiated by the shareholders or partners.

On the other hand, a bankruptcy declaration can be made upon the application of the trader itself, one of the trader's creditors, at the request of the Public Prosecution Service and on the court's own initiative (although this would normally follow a request from a creditor or the trader).

Under DIFC law, a company can initiate a voluntary arrangement, secured creditors initiate receiverships generally (subject to the specific requirements regarding "official" receiverships), shareholders can initiate voluntary winding

up proceedings, and a company, its directors or creditors (and some official bodies such as the Registrar of Companies) can initiate compulsory winding up proceedings.

Criteria used for opening the proceeding

Under general UAE law, the criteria for initiating liquidation and dissolution are the expiry of the company's term as provided for in its articles, the completion of the company's objective, the loss of most of its assets, a merger or a consensus of the shareholders regarding early dissolution. Non-limited liability companies can also be dissolved upon the death or bankruptcy of one of the partners.

In the event that a joint-stock company (usually a larger company with fewer restrictions on the transfer of shares) suffers losses of half of its capital, the board of directors may summon a shareholders' meeting regarding the company's continuation, and interested parties can apply to the court if they do not. In the case of a Limited Liability Company (a more closely-held company), if losses amount to half the company's capital, a shareholders' resolution sufficient to amend the company's articles is necessary to initiate dissolution, while in the event of loss of three-quarters of the company's capital, shareholders holding one-quarter of the capital can request the dissolution.

Bankruptcy can be initiated in respect of any trader who ceases to pay his commercial debts. A trader may request to be declared bankrupt by court order if he ceases to pay such debts, and is bound to do so 30 days after the date of cessation of payment; failure to do so is an offence of "negligent bankruptcy". A creditor owed a commercial or civil debt that is due may apply for an order upon proof that the debtor has ceased paying his debts, while a contingent or future creditor may seek an order if, in addition to proving non-payment of due debts, the creditor can prove that the debtor has no known domicile in the UAE, or he has closed his business or commenced its liquidation, or taken action prejudicial to his creditors.

Any commercial company (except a joint-stock company) can be declared bankrupt if it ceases to pay its commercial debts when due. However, a director or liquidator of a commercial company may not initiate bankruptcy proceedings without first obtaining the consent of the majority of the partners, or having obtained a shareholders' resolution regarding the same.

Under DIFC law, there are essentially no restrictions on the criteria for initiating a voluntary arrangement, although certain companies, primarily in the financial services sector, cannot seek a moratorium while the voluntary

arrangement is being approved. The criteria for receivership will depend on the terms of the security agreements. Voluntary winding up can be initiated in circumstances provided for in the company's articles or if the company so resolves (with specific provision in relation to winding up by reason of its liabilities). Compulsory winding up can be initiated on similar grounds, and also if the company is unable to pay its debts; it is deemed to be unable to do so if it fails to comply with a statutory demand for US$2,000 or more. There are also provisions in regulatory legislation providing for compulsory winding up.

Main actors of an insolvency proceeding

In the case of dissolution under the Companies Law, the main actor is the liquidator: he is appointed upon the commencement of dissolution, and the authority of the board of directors and management essentially ceases upon the appointment of the liquidator. He is responsible for safeguarding and liquidating the company's assets, he is capable of binding the company, but he has no authority to commence new undertakings.

In the case of bankruptcy under UAE law, the principal actors are the court (which will be the court which has jurisdiction over the bankrupt), the bankruptcy trustee and the overseers. The legislation envisages the court, through the bankruptcy judge, being closely involved in the bankruptcy process, to the extent of calling creditors' meetings and presiding over such meetings. The bankruptcy trustee is appointed by the court as a paid agent to administer the bankruptcy; if a composition is not accepted by him, and the creditors enter into a "state of union", they may seek to have a new trustee appointed, who is called "the trustee for the union of the creditors". The bankruptcy judge may appoint one or more overseers from amongst the creditors, who have a limited role in "overseeing" the conduct of the bankruptcy.

Under DIFC law, the court is the DIFC Court (which has exclusive jurisdiction in DIFC matters). In a voluntary arrangement, the person implementing a voluntary arrangement is a "nominee", who becomes a "supervisor" if it is accepted. In a receivership, the secured party appoints a "receiver" over the company's assets; if the assets are all, or substantially all of the company's assets, an "administrative receiver" is appointed. A winding up is conducted by the "liquidator", who liquidates the company's assets for the benefit of creditors. In the course of some applications for winding up, the court may appoint a "provisional liquidator". In administrative receivership, there may be a creditors' committee; in voluntary and compulsory winding up, there may be a liquidation committee representing creditors.

Does the debtor remain "in possession" of the business?

Under general UAE law, both in relation to dissolution and bankruptcy, the debtor does not remain in possession of the business. In a liquidation, management's authority is limited to those matters not within the sphere of the liquidator (which is very limited). Upon a declaration of bankruptcy being given, the debtor has no authority to manage or dispose of his property.

Under DIFC law, a debtor will only genuinely remain "in possession" in a voluntary arrangement.

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

Under general UAE law, assuming there is no basis to challenge the validity or effectiveness of the underlying contract as a matter of general law, the bankruptcy trustee can challenge certain transactions; these include gifts, early payments, payments other than in the ordinary course and pledges or other forms of guarantee and pledges. The transaction is open to challenge if it was entered into after the debtor has ceased payment, and before the date of bankruptcy. The beneficiary can be compelled to return to the bankruptcy administration that he obtained from the bankrupt. Also, pledges and liens recorded after the decision to issue composition proceedings may not be advanced against the union of creditors.

Under DIFC law, assuming there are no grounds to challenge the underlying contract, there is specific provision to challenge security interests if there was inadequate consideration, as well as provisions allowing for challenges to transactions at an undervalue and preferences, which may also be used to challenge security rights.

5. Is enforcement of security rights treated differently in each type of proceeding?

According to general UAE law, in the case of liquidations, security rights are not affected by the liquidation regime. However, in the case of bankruptcies, the trustee may require the pledgee of movable property (but not immovable property) to take steps to liquidate his collateral before the termination of the state of union; failure to do so allows the trustee to apply to the bankruptcy

judge for an order selling those goods, with proceeds being made available to the bankruptcy.

Under DIFC law, security rights generally appear to stand "outside" the insolvency proceedings, and are unaffected by them; the only exceptions are if there is a moratorium under a voluntary arrangement proposal; and in cases when more than one receiver is appointed.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Under general UAE law, both in liquidation and bankruptcy, in most cases, creditors holding security retain the priority of that security in an insolvency: under the Companies Law, the liquidate pays the company's debts proportionately, subject to the prior rights of secured creditors, while under the Commercial Procedure Law, holders of secured debts generally stand outside the general body of creditors.

In a bankruptcy, the distribution to creditors is carried out pursuant to the court order, and, after termination of the state of union, the creditor regains a right of distraint against the debtor. Under the Companies Law, after payment of debts, assets are distributed *pro rata* to shareholders, while, if a company is declared bankrupt, once a state of union has been reached, the court may order the dissolution of a company if the remaining assets are insufficient to continue business.

Under DIFC law, priorities in a voluntary arrangement are determined by the arrangement itself, while a receivership relates only to specific collateral, and does not affect priorities. The general principle of *pari passu* applies in winding up, and creditors rank ahead of shareholders.

7. How can creditors protect their rights towards the debtor?

Under general UAE law, creditors of a bankrupt cannot commence legal action against a debtor. They become part of the general body of creditors known as the union of creditors. However, secured creditors can continue action to realise their security. All creditors must submit documentation and proof of their debts to the bankruptcy trustee, which are determined by the trustee, with the assistance of the overseer and the bankrupt, and subject to final determination by the bankruptcy judge.

In a liquidation, the liquidator invites creditors to present their claims. There is, however, no automatic stay of proceedings. Therefore, a creditor is able to apply for a court order declaring the company bankrupt, on the basis that it has suspended payment, notwithstanding that it may already be in the process of liquidation.

Under DIFC law, in the event of a moratorium being granted in a voluntary arrangement, creditors cannot take any meaningful steps to protect their rights. In most other cases, secured creditors can secure their position by taking steps against the collateral whether the company is being wound up or not. After the commencement of compulsory winding up, unsecured creditors cannot commence or continue proceedings against the company except with the leave of the court. To make a claim in the winding up, they must lodge proofs of debt with the liquidator.

8. How do creditors protect their rights towards guarantors?

As a matter of general UAE law, an obligee can claim against a principal obligor or the surety, or may claim against them both, and this would presumably apply in the case of a liquidation. In a bankruptcy, it is specifically provided that the creditor retains the right to claim against other persons obligated in respect of a debt, and that person becomes entitled to participate in the bankruptcy in respect of any amount claimed. However, the Civil Code provides that, if a debtor becomes bankrupt, the creditor must prove for the debt in the bankruptcy, or his right of recourse against the surety shall lapse to the extent of the loss sustained by his not having done so. If a debt is due, a creditor must claim for it against the surety within six months from the date on which the debt fell due; otherwise the surety is discharged.

Under DIFC law, there is no specific step that is required in relation to guarantors, although it is likely that the general common law principles relating to guarantees will apply, and any action by the creditor prejudicing the potential position of the guarantor could discharge the guarantor's liability.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g., perfection)?

Under general UAE law, as most rights of enforcement for secured creditors rely upon the court process, such matters will be determined by the court process itself. Furthermore, as most security over moveable property requires some form of possession or assignment, perfection will, by its very nature, be self-enforcing.

Under DIFC law, the position of unperfected security interests appears to be that they enjoy no priority, but are still effective as contracts; non-perfection does not appear to render a security interest void as against a liquidator.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

General UAE law states that a secured party retains its rights to enforce its security during both a bankruptcy and a liquidation. There is no stay in a liquidation, and the stay does not apply in a bankruptcy. The secured creditors have the right to commence or continue any proceedings necessary to enforce their security against the bankruptcy trustee.

Under DIFC law, a company seeking to implement a voluntary arrangement can obtain a moratorium, during which time no action may be taken against the company by a secured or unsecured creditor. Receivership does not appear to affect any party's rights to take action against the company. Upon a compulsory winding up order being made, no action may be taken against a company "or its property" except with the court's leave. It appears likely that secured creditors will retain their right to realise their securities. There is to be no equivalent provision in relation to voluntary winding up.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

Under general UAE law, a bankruptcy trustee can require the holder with a pledge over movables to exercise any rights of security. If the pledgee does not do so, the bankruptcy trustee can apply to the court for permission to sell the pledged movable goods, although the pledgee can challenge this.

A secured party can recover goods in which it has "title" at the commencement of a bankruptcy, but essentially the goods need to have survived in a separate condition in the bankrupt's hands: for instance, in respect of cash, a claimant must prove title to the actual cash; in the case of a deferred payment obligation, the contract must have been dissolved (or proceedings commenced for its dissolution or a claim made for return) before the bankruptcy is declared.

Under DIFC law, collateral subject to security interests would stand outside the insolvency process. However, an administrative receiver appointed by a secured party can apply for a court order allowing the receiver to dispose of property subject to a third party's prior security interest, provided it would result in a more advantageous realisation of the company's assets.

There are specific provisions dealing with perfection of security interests over cash collateral, but otherwise cash is not treated any differently. Both receivers and liquidators have the ability to borrow money using the company's property as collateral, provided that such borrowing would not disturb any existing priorities.

12. What distribution will a secured creditor receive if a company is reorganised?

According to general UAE law, there is no "reorganisation", as a bankruptcy does not ultimately extinguish a creditor's rights.

However, under DIFC law, "reorganisation" is possible through the voluntary arrangement. In a voluntary arrangement, a meeting of creditors to approve such an arrangement may not approve any proposal affecting the rights of a secured creditor unless the secured creditor concurs.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

General UAE law does not provide for "reorganisation" as such.

Under DIFC law, if the secured creditor concurs, and the proposal is accepted (by 75% of the creditors present and voting), the secured creditor's rights will be determined by the voluntary arrangement.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

Under general UAE law, a secured creditor may only claim interest in a bankruptcy if the proceeds of sale of the security are sufficient to pay pre- and post-bankruptcy interest (after payment of principal first). If a secured creditor realises his security in a bankruptcy, and it is insufficient to satisfy his claim, he may claim in the bankruptcy for the balance of his debt (provided it is not for interest alone); if the security is over-secured, the bankruptcy trustee

is entitled to appropriate the balance to the benefit of the combined creditors.

Under DIFC law, if a secured creditor realises his security, and it is insufficient to satisfy his claim, he may prove for the balance of his debt (although, it appears there can be no claim for post-administration or post-liquidation interest). If the claim is over-secured, the secured party must account to the debtor or mortgagor for any surplus.

United States of America

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

(a) What are the common forms of security rights taken in respect of movable or personal property, including the taking of a pledge, lien, retention of title, fixed or floating charge?

(b) What are the common forms of security rights taken in respect of immovable or real property, including the taking of a mortgage, lien or privilege?

(c) Is the security interest granted by law, contract or both?

Personal or movable property

Generally speaking, in the United States, security interests in personal property are governed by state law, principally Article 9 of the Uniform Commercial Code (the UCC) which has been adopted, with modifications, by every state. Article 9 covers most types of consensual security interests in personal property, including fixtures (personal property attached to real property).

Under Article 9 of the UCC, a security interest arises when a debtor grants to a creditor (the secured party), pursuant to a security agreement, a security interest in specified collateral owned by the debtor to secure obligations owing by the debtor to the creditor. The grant of a security interest to the secured party entitles the secured party, upon default by the debtor on any such obligations, to seize the collateral covered by the security interest to satisfy the secured obligation. The security interest "attaches" to the collateral by the execution of a security agreement by the debtor and the giving of value by the secured party. The secured party may then take steps to give public notice of its interest in the collateral to the debtor's other existing and future creditors, and prospective purchasers of the collateral, by "perfecting" its security interest. Without perfection, the collateral is subject to attachment by other creditors, is subordinate to future perfected security interests of other creditors in the collateral and may be cut off by persons purchasing the collateral. Furthermore, without perfection, a secured party's interest in the collateral will not be respected as a secured claim in a bankruptcy case.

Filing a financing statement is the common method of perfection prescribed by Article 9 of the UCC for all forms of security interests. Under certain circumstances, possession, control, or delivery of the collateral are among other methods prescribed in Article 9 that will also allow the secured party to perfect its security interest. In fact, with respect to certain types of collateral, such as investment property (e.g. a certificate evidencing an equity interest in the issuer), a secured party with control over the collateral will have priority over a security interest previously perfected by filing.

Certain types of personal property are not governed by Article 9 of the UCC. For example, motor vehicles are generally covered by certificates of title issued on a state by state basis, and security interests in automobiles are generally covered by these certificates of title statutes. The perfection of a security interest in aircraft, railroad rolling stock and certain vessels are governed by federal law rather than state law, although the UCC governs most other aspects of a security interest in such property.

Real or immovable property

A security interest in real property is usually granted through a mortgage. A mortgage involves the transfer of an interest in land as security for a loan or other obligation. In a typical mortgage, regular installment payments of interest and, in some cases, principal are due pursuant to an agreed upon schedule. Mortgages are mainly governed by state statutory and common law, although they may also be regulated by federal law or a state or federal agency's regulations depending on under whose law the mortgagee (the provider of the loan or other interest given in exchange for the security interest) was chartered or established.

Statutory liens

Liens on personal and real property may also arise statutorily, or by operation of law. Such liens are usually neither contractual nor consensual. Examples include federal tax liens, mechanic's liens, carrier's liens and judgment liens. Such liens are typically governed by the individual statute that creates them, but their priority with respect to other security interests is generally dealt with in Article 9 (in the case of personal property) or other state law (in the case of real estate) or Federal law (in the case of liens created under Federal law such as Federal tax liens).

2. How are security rights enforced in your jurisdiction? Is a court process or out of court procedure required or both? What are the practical difficulties experienced when security is enforced?

The procedure for enforcing security interests will vary depending on whether the collateral in question is personal property or real estate. In the case of personal property upon a default, a lender would typically accelerate its debt and enforce its security interest by sending a default notice to the borrower providing notice to the borrower of its intention to enforce its security interest. The secured party is entitled to limited use of "self help" – the right to take possession of the collateral without breach of the peace (i.e. a situation where the lender creates a disturbance). If the lender commits a breach of the peace, the lender may be liable for damages. Often, the lender and the borrower negotiate for the "peaceful possession" of the collateral to be turned over to the lender so as not to breach the peace.

If the secured party is unable to repossess the collateral without breaching the peace, he must proceed with judicial action. In the case of personal property collateral, the secured party could pursue either an action in replevin or an action for claim or delivery, where the sheriff or similar public official is authorized by the court to repossess the collateral on behalf of the secured party. That judgment would need to be domesticated in all jurisdictions where collateral is located. After the relevant period of time under applicable state law passes, execution on and sale of those assets could be made to satisfy the lender's debts. Depending on the jurisdiction, the sheriff may either turn the collateral over to the secured party immediately, or hold it in escrow until the conclusion of the action. The secured party may foreclose on the collateral by disposing of it in the manner prescribed by Article 9 of the UCC, generally either though public or private sale. Perhaps the most important requirement under state law is that the creditor disposes of the collateral in a "commercially reasonable manner". With the consent of the debtor and of creditors with a subordinate lien on the collateral, the secured party may also foreclose its security interest by taking title to the collateral in satisfaction of all or an agreed portion of the outstanding debt owing to the secured party. This is referred to as "strict foreclosure."

With respect to real estate, the failure to make payments or the existence of other defaults under the mortgage permits the mortgagee to accelerate the entire mortgage debt, to declare it immediately due and payable, and to commence legal proceedings to foreclose (enforce) its mortgage. If the mortgage debt remains unpaid after the foreclosure judgment is entered, the mortgaged property may be sold to pay for the remaining mortgage debt. The foreclosure process depends on state law and the terms of the mortgage.

The most common processes are court proceedings (judicial foreclosure) or grants of power to the mortgagee to sell the property (power of sale foreclosure). Many states regulate the ability of the mortgagee to accelerate the debt, and override the express terms of the mortgage by creating a statutory payment grace period, granting the mortgagor a right to redeem the property to avoid foreclosure.

3. Describe the types of pre-insolvency and insolvency proceedings in your jurisdiction, including:

(a) Who can initiate the proceeding?

(b) What are the criteria used for opening the proceeding?

(c) Who are the main actors: court, administrator, liquidator, trustee, receiver, controller, representative of creditors, state representatives etc.

(d) Does the debtor remain "in possession" of the business?

There is no US analogue to formal pre-insolvency proceedings (although a company need not be insolvent to initiate a formal Chapter 11 proceeding). Typically, lenders will engage in a workout with a troubled borrower to evaluate the nature of the borrower's distress, its ability to repay its loans and the possibility for an out-of-court settlement between the lender and the borrower's other creditors. Depending on the outcome of the lender's analysis, it may make sense to restructure the outstanding debts between the borrower and the lender alone, together with the debtor's other creditors, or by having the borrower file a pre-packaged or pre-arranged bankruptcy. Neither of the first two options requires the intervention or imprimatur of a bankruptcy court (nor will it bind non-consenting creditors); a pre-packaged or pre-arranged bankruptcy will.

In the case of a pre-packaged bankruptcy, the debtor generally files its bankruptcy petition under Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") together with a proposed plan of reorganization and disclosure statement that has already been voted on by its creditors and shareholders although the debtor may file the case during the solicitation process. With a pre-arranged bankruptcy, the debtor's plan of reorganization usually has already received the approval of its primary creditors and may also have an equity sponsor prepared to fund the company's stay in bankruptcy and thereafter. The benefits of out-of-court workouts are expediency and efficiency: bankruptcy is very expensive and may be very

disruptive to the debtor's business. The benefits of a bankruptcy proceeding include the ability of the debtor to avail itself of the protection of the Bankruptcy Code and the bankruptcy court, including protection of the automatic stay from collection actions and lawsuits, the bankruptcy court's intervention in or supervision of litigation with creditors, vendors and regulators and the ability to bind non-consenting creditors and to "cram down" uncooperative creditors in a plan of reorganization.

Who may initiate the insolvency proceeding?

Under the Bankruptcy Code, any individual, partnership or corporation that resides, has a domicile, a place of business or property in the United States may file for voluntary bankruptcy protection under either (i) Chapter 7 of the Bankruptcy Code, which involves liquidation of the debtor's assets and distribution of the proceeds to the debtor's creditors and, for individuals, a discharge of liability; or (ii) reorganization under Chapter 11 of the Bankruptcy Code, which generally involves the filing of a "plan of reorganization" pursuant to which the debtor may retain possession of its assets, though the assets of the debtor and the debtor's future income are used to pay creditors. A debtor may also choose to liquidate its assets pursuant to a plan of reorganization as well. When the debtor itself files for bankruptcy protection voluntarily, the filing of the petition constitutes automatic entry of an order for relief under a particular chapter. An entity need not be insolvent to commence a voluntary case, but must have some prospect of financial distress.

Creditors may also file an involuntary case against the debtor under both Chapters 7 and 11. There are two grounds to force an entity into bankruptcy: (a) that the debtor is insolvent under the equity insolvency test (i.e. inability to pay debts as they become due) or (b) that within 120 days before the date of the filing of the petition, a custodian, other than a trustee, receiver, or agent appointed or authorized to take charge of less than substantially all of the property of the debtor for purpose of enforcing a lien against such property, was appointed or took possession. To commence an involuntary case, if the debtor has an aggregate of twelve or more creditors, there must be three petitioning creditors whose unsecured debt aggregates at least $12,300, none of which is contingent as to liability or the subject of a bona fide dispute as to liability or amount; and if the debtor has fewer than twelve creditors, there need be only one petitioning creditor whose unsecured claim is at least $12,300 and is not contingent as to liability or the subject of a bona fide dispute as to liability or amount. (These dollar amounts are effective for cases filed after April 1, 2004, and are adjusted every three years.)

If an involuntary petition is filed, the putative debtor has twenty days from service to either contest the filing or agree to "the entry of an order for relief." The twenty day period may be extended by agreement or by the bankruptcy court. If the putative debtor contests the filing and loses or the debtor consents to the entry of an order for relief, the case will proceed from that point as would a voluntary chapter 7 or 11 (depending on which chapter the involuntary petition is filed under.) An involuntary debtor can convert a chapter 7 case to a chapter 11 and vice versa. If the putative debtor contests the involuntary and prevails, the case is dismissed. If the petition is dismissed, the creditors who filed the involuntary may be liable for damages.

Chapter 11 provides a forum for a company to define and resolve its liabilities in a court-supervised process. In a Chapter 11 case, unlike one under Chapter 7, the debtor typically continues its normal business operations and manages its business as a debtor-in-possession. While the officers, subject to board oversight, manage the company's business as usual, any non-ordinary course activity is subject to approval of the bankruptcy court, such approval following notice to interested parties and a hearing. Common examples of activity outside the ordinary course include financing the debtor's business and asset sales.

The Bankruptcy Court

Jurisdiction under the Bankruptcy Code is initially vested in the United States District Court. The District Court is authorized to refer all cases under the Bankruptcy Code and any or all proceedings arising under the Bankruptcy Code or arising in or related to a case under the Bankruptcy Code to the bankruptcy judges for the applicable district. Most or all district courts have entered standing orders which automatically refer cases and proceedings to the bankruptcy judges. The reference may be withdrawn from the bankruptcy court, in whole or in part, by the district court "for cause shown".

The powers of the bankruptcy court are broad. Section 105 of the Bankruptcy Code provides that the court may issue any "order, process, or judgment necessary or appropriate" to carry out other provisions of the Code. This broad power can be exercised with respect to temporary restraining orders and preliminary and permanent injunctions. Injunctions may be used, for example, in relation to the automatic stay and adequate protection provisions, and to enjoin non-debtor party actions that will have an impact on the bankruptcy case. While the bankruptcy court's power under this provision is broad, the court may not ignore or suspend other provisions of the Code.

The Trustee

In cases filed under Chapter 7 of the Bankruptcy Code, a trustee will be appointed by the regional office of the United States Trustee, (subject to the right of unsecured creditors to select a different Chapter 7 Trustee) to administer the debtor's bankruptcy estate and distribute the proceeds of the estate to the debtor's creditors. In cases filed under Chapter 11, however, the debtor's management typically continues in possession of the debtor's property as a debtor-in-possession and is authorized to administer the bankruptcy estate. Generally, a reference in the Bankruptcy Code to "trustee" also refers to the debtor-in-possession if a trustee has not been appointed. The appointment of a trustee in Chapter 11 cases is an extraordinary remedy that is granted in rare cases (although under recent amendments to the Bankruptcy Code, that bar has been lowered significantly). A Chapter 11 trustee may be appointed (a) "for cause," including fraud, dishonesty, incompetence, or gross mismanagement by current management, either before or after the commencement of the case; (b) if such appointment is in the best interest of creditors and equity security holders and other interests of the estate; or (c) if grounds exist to convert or dismiss the case under Section 1112, but the court determines that the appointment of a trustee (or an examiner) is in the best interests of creditors and the estate. The general unsecured creditors may also select the Chapter 11 trustee.

The United States Trustee

United States Trustees supervise the administration of cases filed under the Bankruptcy Code, and their responsibilities include, among other things, (i) taking legal action to enforce the requirements of the Bankruptcy Code and to prevent fraud and abuse; (ii) referring matters for investigation and criminal prosecution when appropriate; (iii) ensuring that bankruptcy estates are administered promptly and efficiently, and that professional fees are reasonable; (iv) appointing and convening creditors' committees in Chapter 11 business reorganization cases; (v) reviewing disclosure statements and applications for the retention of professionals; and (vi) advocating matters relating to the Bankruptcy Code and rules of procedure in court.

Official Committees

The Bankruptcy Code provides that a committee of unsecured creditors shall be appointed by the United States Trustee in every Chapter 11 case, and that the United States Trustee may appoint other committees of creditors and equity security holders if necessary to assure adequate representation of creditors or equity security holders. These committees are allowed to retain

professionals and to actively participate in all aspects of the case in which their constituents are interested.

4. Could the granting of a security right or interest to a specific creditor be voided or be deemed a preferential treatment prejudicing the rights of the debtor or third parties? What are the grounds upon which the security right or interest can be challenged?

The Bankruptcy Code grants a trustee or debtor-in-possession the power to avoid a broad range of pre- and post petition transactions. Moreover, a creditors' committee has standing to exercise the avoidance powers on behalf of the estate either upon (i) a voluntary transfer by the trustee or debtor-in-possession of its avoidance powers to a creditors' committee or (ii) unreasonable refusal by the trustee or debtor-in-possession to exercise the avoidance powers.

The elements of transfers that may be avoided because they are deemed preferential are set out in Section 547(b) of the Bankruptcy Code. A transfer (broadly defined to include any transfer of an interest in property) of the debtor's property is preferential if (a) the transfer was to or for the benefit of a creditor, (b) the transfer was on account of an antecedent debt, that is, one owed before the time of the transfer, (c) the debtor was insolvent (in the balance sheet sense) at the time of the transfer, (d) the transfer was made to an insider (for example, an owner, officer, or director) within one year prior to the filing date, or to anyone else (i.e., a non-insider) within ninety days prior to the filing date, and (e) the transfer had the effect of giving the creditor more than it would have received in a distribution under Chapter 7.

Section 547(e) of the Bankruptcy Code provides that for preference purposes, a transfer (such as the granting of a lien or mortgage) is deemed to occur when the transfer is perfected. A transfer requiring perfection is perfected upon creation of the interest if perfection formalities are completed within thirty days. This will apply even if the petition is filed during the grace period. A transfer perfected before commencement but not within the grace period is perfected when all perfection requirements are completed. A transfer unperfected as of commencement (and not perfected within any applicable grace period) is deemed to have been made the day before the bankruptcy filing. Therefore, the granting of a security interest to a lender on account of an antecedent debt could constitute a voidable preference to the extent the security interest was unperfected on the date of the bankruptcy filing or was perfected outside of the applicable grace period and within the applicable preference period (i.e., one year, in the case of an insider, or 90 days, in the case of a non-insider). By

failing to timely (i.e., contemporaneously or within any applicable grace period) perfect a security interest granted for a contemporaneous advance by a lender (which would ordinarily pose no preference risk), the late perfection could result in the security interest being deemed to be on account of an antecedent debt and thus subject to challenge.

Under Section 545 of the Bankruptcy Code, the trustee or debtor-in-possession may avoid statutory liens that first become effective on the insolvency or bankruptcy of the debtor, that are not perfected or enforceable on the filing date against a hypothetical bona fide purchaser, excluding liens for rent or distress for rent.

The trustee may also avoid fraudulent transfers. Section 548 of the Bankruptcy Code provides that the trustee or debtor in possession may avoid any transfer or obligation made or incurred within two years of filing if (a) the transfer was made, or obligation incurred, with the actual intent to hinder, delay, or defraud any entity to whom the debtor was or became indebted – a so-called "actual fraud" or (b) the transfer was made, or obligation incurred, for less than reasonably equivalent value and the debtor (i) was insolvent (in the balance sheet sense) at the time of or became insolvent as a result of the transfer or obligation, or (ii) was engaged in or about to engage in business for which its remaining property was insufficient, or (iii) intended to or believed it would incur debts beyond its ability to pay when due – a so-called "constructive fraud." In general, "reasonably equivalent value" means that the transfer was made, or obligation incurred, for fair consideration.

Upstream and cross-stream guarantees (i.e upstream is a subsidiary's guarantee of its corporate parent's debt, and a "cross-stream" guarantee is its guarantee of a "sister" corporation's debt) which usually confer no direct benefit on the guarantor, and leveraged-buyout financings to the extent that the borrower serves as a conduit to pay out the former shareholders are common financing transactions which may be subject to challenge as fraudulent conveyances. If such an attack is successful, the lender would not be able to enforce the obligations under the respective guarantee or loan agreement or its rights with respect to any collateral securing such obligations.

In some situations, state law allows perfection within a set time period to relate back to the date on which an interest was created. This allows the holder of the security interest to defeat the rights of an intervening creditor. In addition as noted above, the preference provisions provide a post-petition grace period to permit perfection of a security interest. In such case, the trustee may not interfere with the security interest holder's right to post petition perfection.

5. Is enforcement of security rights treated differently in each type of proceeding?

Not applicable as there is no formal pre-insolvency proceeding available in the USA.

6. What are the relative priorities in distributions among creditors and shareholders of the debtor during a pre-insolvency or insolvency proceeding?

Because a debtor may have more than one obligation to a particular creditor, or a single claim may be divided into a secured claim and an unsecured claim, the Bankruptcy Code is organized in terms of "claims" rather than in terms of "creditors."

The Bankruptcy Code generally respects the priorities afforded to secured lenders described in Article 9. After secured claims have been satisfied, the Bankruptcy Code provides that particular types of unsecured claims receive priority in payment over other unsecured claims. Section 507 of the Bankruptcy Code sets out ten categories of such priority claims, including, for example, the debtor's domestic support obligations (in the case of individuals), expenses of administration of the bankruptcy case (including professional fees), certain enumerated taxes and amounts due under certain of the debtor's employment obligations. If the priorities are strictly enforced, all claims in a higher priority category must be satisfied in full before payment is made to lower priority categories. The court may not alter the scheme of priorities or create sub-priorities, and pre petition contractual provisions regarding subordination will be respected. These priorities apply generally in Chapter 7 and Chapter 11 cases although creditors may agree in a Chapter 11 plan (subject to certain limitations) to different treatment than that provided for in the statute or by contract.

Various sections of the Bankruptcy Code provide that some claims may be given super priority treatment. This means that certain administrative expenses, such as debtor-in-possession financing, may be paid ahead of some or all other administrative expenses.

As discussed above under question 3, there is no statutory provision for formal pre-insolvency proceedings although it is common for parties to engage in out-of-court workouts. The rules of priorities and classification in the Bankruptcy Code will provide a useful framework for such out-of court workouts, especially because unsuccessful workouts often find themselves in the bankruptcy court.

7. How can creditors protect their rights towards the debtor?

Generally, in order for a creditor's claim to receive a distribution in a bankruptcy case, the creditor or other appropriate person must file a proof of claim and an equity security holder may file a proof of interest. Filing a proof of claim generally is a mandatory prerequisite for the allowance of unsecured claims, including priority claims and under secured claims, unless the claim has been correctly listed on a Chapter 11 debtor's schedule of liabilities. Such scheduling constitutes prima facie evidence of the validity of the claim in Chapter 11 cases. However, if the claim or interest is not listed, is listed incorrectly, or is listed as disputed, contingent or unliquidated, a proof of claim or interest must be filed.

There is a time limit within which proofs of claim must be filed. In a Chapter 11 case, the court will fix the time within which proofs of claim must be filed, the last day of which is called the "bar date."

Note that as discussed below, a secured creditor is stayed from taking any action against its collateral. In order to enforce its rights, a secured creditor must make a motion in the bankruptcy court for relief from the stay, or requesting in the alternative adequate protection of its interests. See discussion of adequate protection under question 10 below.

8. How do creditors protect their rights towards guarantors?

The filing of a bankruptcy case against a borrower typically does not result in a stay of actions against the guarantor. Therefore, a lender may improve its prospects of collection by commencing action against the guarantor as soon as possible after the borrower files for bankruptcy.

9. What happens to secured creditors who have not complied with all the required processes for protecting their secured rights (e.g., perfection)?

As discussed above in question 4, the trustee (or debtor-in-possession) has certain rights to attack a security interest as either a preferential transfer or fraudulent conveyance under Sections 547 and 548 of the Bankruptcy Code. In addition, the Bankruptcy Code gives the trustee (or debtor-in-possession) the rights that certain creditors would have under applicable state law to attack prior unperfected or unrecorded transfers. This provision, referred to as the "strong arm" power, gives the trustee the status of a hypothetical lien creditor even though no such person need actually exist.

More specifically, section 544(a) of the Bankruptcy Code specifies that the trustee has the same power to avoid transfers that may be exercised under applicable state law by (a) a creditor that, as of the commencement of the case, had obtained a judicial lien; (b) a creditor that, as of the commencement of the case, had an execution returned unsatisfied; or (c) a bona fide purchaser of real property who had perfected its interest as of the commencement date.

Because the laws of most States allow these persons to prevail over unperfected or unrecorded interests, the trustee may be able to invalidate unperfected or unrecorded transfers or liens. When state law provides that such a person must file a notice of its interest in order to obtain special status, the trustee is deemed to have completed the filing.

In addition, Section 544(b) provides that the trustee may avoid any transfer or obligation of the debtor that, under state law, may be avoided by an actual creditor holding an allowable, unsecured claim. This section requires that such a creditor actually exist. However, a creditor within this section need not have reduced his claim to judgment or have executed upon it.

When the trustee asserts the avoidance rights of a creditor described in Section 544(b), the entire transaction is avoided. For example, the rights of a creditor with a $1,000 allowable unsecured claim may be exercised to avoid a $50,000 transaction. The estate will recover $50,000, not just the $1,000 that represents the extent of the creditor's claim.

10. During a pre-insolvency or insolvency proceeding, is the secured party permitted to foreclose or take other enforcement actions against the collateral? Does this stay apply to all claims against the debtor? Can the stay be challenged?

Prior to the commencement of an insolvency proceeding, the secured party is generally free to foreclose or take other enforcement actions against the collateral. The filing of a voluntary or involuntary petition, however, causes an umbrella of protection to open over the debtor and its property. This umbrella is the automatic stay, perhaps the most fundamental of all protections afforded by the Bankruptcy Code. Note that because the stay is automatic its provisions are effective regardless of whether a creditor knows of the bankruptcy filing.

The primary purpose of the stay is to protect the debtor from all manner of collection efforts and to provide it with relief from the financial pressures that

led to the filing. The stay maintains the status quo while giving the debtor the opportunity to reorganize and restructure its debts, or, if that is not possible, to see that its assets are liquidated and the proceeds are distributed to creditors in an orderly fashion. The collection rights of creditors are not altered, but enforcement is delayed. Despite this negative impact, creditors also obtain some benefits from the stay. By preventing diminution of the estate as a result of the acts of the more aggressive creditors, the stay promotes the Bankruptcy Code policy that equally situated creditors receive equal treatment.

The Bankruptcy Code lists eight broad categories of actions that are automatically stayed upon filing, including: (a) judicial, administrative or other actions or proceedings that were or could have been brought against the debtor before the filing; (b) execution and levy against pre petition property; and (c) creation, perfection, or enforcement of liens against property of the estate and property of the debtor.

The Code also includes a dragnet clause that stays “any act to collect, assess or recover” from the debtor on a claim arising before the filing. This provision is read as prohibiting “informal” collection actions such as harassing phone calls and letters.

The automatic stay provision applies only to actions against the debtor and property of the debtor. It does not apply to co-defendants in pending litigation. Nor will the stay apply to corporate affiliates or partners in debtor partnerships or with respect to actions against property of non-debtors. In appropriate circumstances, the bankruptcy court may enjoin actions against non-debtors to protect the orderly administration of the estate. The Bankruptcy Code expressly prohibits the service of legal papers arising from any proceeding upon the debtor.

The Bankruptcy Code requires that a secured creditor be provided with adequate protection of its interest in property to protect the creditor from diminution in value of its collateral during the pendency of the stay. Similarly, the concept of adequate protection is important for sections of the Bankruptcy Code dealing with the general authorization to use, sell, or lease property. Adequate protection also must be provided to existing lien-holders whose status would be negatively affected if the trustee obtains post petition credit secured by a senior or equal lien on the creditor’s collateral.

Despite its importance, the concept of adequate protection is not defined by the Bankruptcy Code. Rather, the Code provides a non-exhaustive list of what may constitute adequate protection. It should be noted that the court

will not provide adequate protection, but rather will decide whether the trustee or debtor-in-possession is providing adequate protection, i.e., whether the present circumstances or the measures proposed by the trustee or debtor-in-possession offer sufficient safeguards of the creditor's interest.

Adequate protection may be provided by making single or periodic cash payments to the creditor or by the grant of a lien to the creditor whose interest will be affected by the stay, or by the use, sale or lease powers. Although cash payments are useful in some cases, in many cases the debtor will not have sufficient cash flow to make periodic payments.

An additional or replacement lien is particularly appropriate in situations where, in order to continue the business, the trustee proposes to use or dispose of property subject to a creditor's floating lien such as inventory or accounts receivables. In such a case, an alternative lien in inventory or accounts receivable equal to the value of the original lien may provide adequate protection.

The Code also provides that a creditor may be granted adequate protection by being given the "indubitable equivalent" of its interest in the property. This alternative, which will apply when cash payments or replacement liens are not feasible, gives the parties great flexibility in fashioning appropriate protection with the sole requirement being the provision of "indubitably equivalent" value.

With the exception of cash collateral discussed in question 11 below, the burden of requesting adequate protection is upon the creditor who must prove that the continuation of the stay results in a diminution of the creditor's interest in the property. A creditor will generally petition the bankruptcy court for adequate protection, or, in the alternative, relief from the stay. As noted above, the trustee or debtor-in-possession may use the security creditor's collateral (other than cash collateral) without the consent of the creditors thereby placing the burden on the secured creditor to make a motion to protect its security interest. As a practical matter, parties often negotiate a stipulation providing for adequate protection rather than leaving the matter to the discretion of the Bankruptcy Court.

11. Can collateral in which a secured party has an interest be used or sold during a case? Is there specific treatment for "cash collateral"? Is granting of new security rights allowed?

As stated above, a trustee or debtor in possession may generally use property subject to a security interest or lien without the consent of the

creditor. Cash collateral is treated differently. The Bankruptcy Code defines cash collateral as cash, negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents whenever acquired. It also includes all proceeds, products, offspring, rents or profits of property subject to a security interest existing before or after the petition date. Cash collateral may only be used: (a) when each entity with an interest in the cash collateral consents to its use or (b) with court authorization after notice and hearing appropriate to the circumstances. This section is read to allow ex parte authorization to use cash collateral in rare circumstances where there may be no time for a hearing. The use of cash collateral (whether consensual or court ordered) will ultimately be conditional upon the secured creditor receiving some form of adequate protection.

If the trustee or debtor-in-possession is unable to obtain unsecured credit for operation during the Chapter 11 case, the court, after notice and a hearing, may authorize the trustee to obtain credit or incur debt: (a) with priority over other administrative expenses (a so-called "super priority claim"); (b) secured by a lien on unencumbered property of the estate; or (c) secured by a junior lien on property of the estate that is already subject to a lien. The court may also authorize the trustee to obtain credit or incur debt secured by a senior or equal lien on property of the estate that is already subject to a lien. However, the court may only authorize granting such a lien (a "priming lien") if (x) the trustee is unable to obtain such credit otherwise and (y) 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 to be granted.

12. What distribution will a secured creditor receive if a company is reorganised?

If a company is reorganised under Chapter 11 of the Bankruptcy Code, a secured creditor will generally receive a distribution with a present value equal to the value of the collateral securing its claim, and to the extent that its claim exceeds the value of the collateral securing the claim, such creditor will receive an additional distribution as an unsecured creditor to the extent of such excess. This is because the Bankruptcy Code generally bifurcates the claim of a secured creditor whose claim exceeds the value of its interest in collateral into two distinct claims: a secured claim to the extent of the value of the secured creditor's interest in the collateral securing the claim and an unsecured claim for the balance. The amount of the claim in excess of the value of the collateral is generally called the "deficiency claim". However, the Bankruptcy Code permits the secured creditor to elect (the so-called "Section 1111(b) election") to receive deferred cash payments equal to the total

amount of its claim, although in such case the present value of such deferred cash payments will equal only the value of the collateral securing the claim and the secured creditor will be required to forego any distribution on its deficiency claim.

Assuming that a Chapter 11 plan of reorganization is otherwise in compliance with the Bankruptcy Code and applicable law, the bankruptcy court will approve the plan on a consensual basis upon acceptance by the holders of two-thirds in amount and more than one-half in number of claims in each class voting on the plan. Acceptance of the plan by the requisite majorities will bind the non-accepting members of the class. Typically, each secured creditor is classified separately with respect to its secured claim (unless two or more secured creditors share the same collateral, in which case they are classified in the same class). Therefore, the secured creditors are free to accept any distribution that they deem appropriate. However, the acceptance by each class of claims is not the only means for the confirmation of a plan. Under section 1129(b) of the Bankruptcy Code, the court may also approve the "cramdown" of a particular class of creditors over their objection, if, among other things, (a) at least one impaired class of non-insider claims has accepted it and (b) the plan "does not discriminate unfairly" against and is "fair and equitable" to each rejecting class. These cramdown provisions essentially permit the debtor to force a restructured obligation upon a secured creditor under the plan.

A plan does not discriminate unfairly within the meaning of the Bankruptcy Code if a rejecting impaired class is treated equally with respect to other classes of equal rank. A plan is "fair and equitable" as to a class of *secured* claims that rejects such plan if, among other things, the plan provides (a) (i) that the holders of claims in the rejecting class retain the liens securing their claims, whether the property subject to those liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims, and (ii) that each holder of a claim of such class receives on account of that claim deferred cash payments equal to the present value of the holder's interest in the estate's interest in such property; or (b) for the sale of any property that is subject to the liens securing the claims included in the rejecting class, free and clear of the liens, with the liens to attach to the proceeds of the sale, and the liens on proceeds to be treated under clause (a) above or (c) below; or (c) for the realization by such holders of the indubitable equivalent of such claims, such as the return to the secured creditor of the collateral. In practice, these requirements have generally been understood to mean that a plan must provide for payment of the allowed amount of the secured claim together with a market rate of interest. However, the method for deriving the appropriate cramdown interest rate is not statutory and is subject to case law that is not uniform. In the context of a Chapter 13 plan (which

provides for the repayment of debts by a wage earner), the Supreme Court has addressed the interest rate required to provide secured creditors with such value. However, to date, the applicability of the Supreme Court's decision (applying a formula for adjusting the national prime rate based on the risk of non-payment), to a Chapter 11 plan of reorganization remains unsettled.

13. Will the rights of a secured creditor over assets of a debtor "follow" the asset within the reorganised company?

Unless otherwise provided for in the plan or order of confirmation, the confirmation of a plan revests all the property of the estate in the debtor, which property is free and clear of all claims and interests. As discussed above under question 12, a plan may provide for (a) the retention of liens, (b) the sale of the property subject to the lien, or (c) the indubitable equivalent of such lien.

14. What happens if a secured claim is over secured? What happens if a secured claim is under secured?

Claims under the Bankruptcy Code are initially divided into two categories: secured claims and unsecured claims. Allowed secured claims, to the extent of the value of the collateral, are satisfied before unsecured claims. An allowed secured claim is (a) an allowed claim, (b) secured by a lien, (c) on property in which the estate has an interest. The claim is secured to the extent of the value of the creditor's interest in the debtor's interest in the property. Alternatively, if there is a right to a setoff, the amount subject to setoff is treated generally as if it were a secured claim. An unsecured claim is one for which the creditor has not obtained a security interest to protect against default on the underlying obligation or for which the value of the collateral is less than the amount of the claim (the later being the so-called deficiency claim). See discussion of the bifurcation of secured claims under question 12 above.

If the collateral has a value greater than the allowed claim, the creditor is over secured. In this situation, the creditor will be allowed post petition interest and reasonable fees and costs provided for in the security agreement as part of its secured claim.

Valuation is important for the determination of secured status. A claim can only be secured to the extent of the estate's interest in the collateral, and to the extent of the creditor's interest in the estate's interest. As a result, valuation of these interests directly affects the secured status of a claim. Additionally, valuation is of great importance in determining whether adequate protection is required.

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