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INTERNATIONAL

# **When Liquidation is NOT an Option: A Global Study on the Treatment of Local Public Entities in Distress**

November 2022

# CONTENTS

Acknowledgement.....i

Foreword ..... ii

Contributors .....iv

Executive Summary .....vi

Collectivity and equality (*pari passu*) in the treatment of local public entities in distress ..... 1

Argentina..... 35

Australia..... 50

Bangladesh ..... 72

Belgium..... 93

Brazil .....107

Canada.....124

Croatia .....137

England and Wales.....156

France .....181

Ghana .....202

Italy .....218

Japan .....232

The Netherlands .....	252
Nigeria .....	279
People's Republic of China.....	296
Russian Federation .....	307
South Africa.....	326
Uganda .....	347
United States.....	362



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## Acknowledgement

In 2019, Eugenio Vaccari (Chair of INSOL ERA and a member of the Academic Steering Committee) approached INSOL International with a proposal to undertake a sizeable funded project on local public entities (LPEs) in distress. The project proposal was very ambitious and consisted of involving a number of academics from more than 20 jurisdictions, with the project itself consisting of various parts to be completed over three years.

Shortly after the project was approved by the Academic Steering Committee and the INSOL Executive Committee, demonstrating INSOL's commitment and support for its academic membership, the COVID-19 pandemic struck, which of course meant that the planned project was beset by delays and an inability to host conferences as part of the project proposal. Unfazed by this, Eugenio and his team (Yseult Marique and Laura Coordes) forged ahead with the project, in the end delivering the output for this project on time.

The results of Eugenio and his team's efforts are contained within the pages of this Academic Paper, a report on LPEs in distress covering 19 jurisdictions. In addition to the individual reports, there is also an Executive Summary and an introductory chapter looking at collectivity and equality (*pari passu*) in the treatment of local public entities in distress.

This report, which falls just short of 400 pages, takes an intriguing look at a relatively unexplored area of the law and provides fascinating insight into local public entities in distress. No doubt this is merely the beginning of wider research into this very relevant area of the law.

INSOL International acknowledges the kind contribution to this project by the mentoring group (Professor John Bell, University of Cambridge; Professor Maurice Sunkin, University of Essex; and Professor Georg Kodek, Vienna University of Economics and Business), as well as the contributions of all the authors to this project. INSOL International also wishes to extend hearty congratulations to Eugenio Vaccari, Yseult Marique and Laura Coordes on the completion of this project.

**November 2022**

## Foreword

The treatment of local public entities in distress is a largely unexplored area of law. Back in 2019, when we first established a research group and developed the idea underpinning this project, local public entities around the world were still recovering from the consequences of the Global Financial Crisis in 2007-09. That crisis caused an increase in demand for the services provided by local entities while affecting their ability to fund these services, either through direct taxation or indirect transfers of funds from regional and national authorities. Few among us foresaw that in the following years a global pandemic, trade tensions between some of the largest economies in the world and regional conflicts would have massively increased the demand for public services provided by local entities while further detrimentally affecting their ability to generate sufficient income to cover the costs needed to provide them. As this report is going to press (November 2022), inflationary pressures and a looming global recession are casting a sombre shadow on local public entities' ability to cope with new challenges in the years to come.

The treatment of local public entities in distress is a largely domestic, even parochial area of law. The rules in this area are largely unaffected by the influence of principles developed in other areas of law, including bankruptcy and restructuring law. In many of the countries considered in this study, when local public entities become insolvent, politics plays a major role in determining how to address the financial, societal and legal issues arising from these cases.

Compared to more traditional personal or corporate cases, it is undeniable that the distress of local public entities raises unique challenges. However, in undertaking this project, we were motivated by the belief that these unique and global challenges do not necessarily require *ad hoc*, special solutions outside a proper regulatory framework. We believed that it was possible to identify best practices, principles and procedural rules that countries could implement in their own laws to make the procedures for dealing with local entities in distress more equitable, more predictable and, ultimately, better suited to address the needs of the vulnerable users of their public services.

The rich material the national reports have produced allowed us to provide recommendations for a harmonised and principled treatment of these entities. The key priority of the recommendations proposed in this study is to ensure the continuity of essential public services without necessarily deviating from the established insolvency principles of collectivity and equality of treatment among creditors. However, the executive summary and the preambular chapter include a series of more tailored recommendations that national lawmakers should consider to reform or establish a national framework for dealing with local entities in distress and to be more prepared when similar events will occur in the future.

The authors are grateful to the members of the mentoring group (Professor John Bell, University of Cambridge; Professor Maurice Sunkin, University of Essex; and Professor Georg Kodek, Vienna University of Economics and Business), as well as to all the contributors in this

project, for making this research possible and for their insightful comments on the findings and proposed recommendations.

The research has been funded by a generous grant provided by INSOL International and its findings were presented at the INSOL International Academic Forum in London (25 June 2022). We are particularly grateful to Dr David Burdette for his steady guidance and support throughout the study, and to Ms Sanrie Lawrenson and Marcus Greet for their constructive criticism and accurate proof-reading of draft versions of the chapters. The collection covers literature and case law published before 1 May 2022. Needless to say, whatever errors and infelicities remain in the present work are attributable to the principal investigators alone.

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**November 2022**

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## Executive Summary

By Laura N Coordes, \* Yseult Marique\*\* and Eugenio Vaccari\*\*\*

### 1. The reasons for this research

Covid-19, a decreasing population, rampant inflation and rising costs related to social care, transport and utility mean that an increasing number of local public entities find themselves unable to meet their contractual obligations. Yet, the treatment of local public entities in distress is a significantly under-researched area of insolvency and public law, particularly outside of the United States of America. The treatment of local public entities in distress is seen mainly as a domestic matter subject to a significant degree of political interference. However, the distress of a local public entity may and frequently has a domino effect on other public local and central entities, as well as on businesses and the general population.

### 2. Goals of this research

The goals of this research are to:

- (1) identify strategies for reducing, or at least controlling, political interferences and risks;
- (2) learn lessons from developing and developed, small and large countries alike;<sup>1</sup> and
- (3) develop unifying principles and standards for the laws and regulations governing the financial distress of local public entities.

### 3. Content of this research

The overarching research questions of this study are:

- (1) if, and to what extent, the regulation of local public entities in distress should follow the same trends observed with reference to business rescue and liquidation; and
- (2) when, and to what extent, it is possible to deviate from the fundamental principles of collectivity and equal treatment of creditors in insolvency for the purpose of ensuring substantive fairness, protection of vulnerable users and local investors, and the predictability of the framework.

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<sup>1</sup> The jurisdictions covered in the study are (in alphabetical order): Argentina, Australia, Bangladesh, Belgium, Brazil, Canada, Croatia, France, Germany, Ghana, Italy, Japan, the Netherlands, Nigeria, People's Republic of China, the Russian Federation, South Africa, Uganda, the United Kingdom and the United States of America.

## 4. Classifications

This study shows that local public entities can be classified into two broad groups:

- (1) “basic” local public entities that include municipalities, cities, districts, councils, provinces, and other political sub-divisions; and
- (2) “hybrid” local public entities that include any publicly or privately owned entities (including corporations) that carry out fundamental services or are responsible for the production or distribution of essential goods at a local (territorial or regional) level.

The frameworks dealing with local entities in distress can be classified into the following families:

- (1) comprehensive special insolvency systems: the countries in this group have a special insolvency framework applicable to local public entities that are either in distress or insolvent;
- (2) comprehensive administrative systems: the countries in this group do not allow their local public entities to have access to “traditional” insolvency procedures. However, they allow these entities to have access to comprehensive administrative procedures designed to ensure the continuity of public services;
- (3) fragmented or special administrative systems: the countries in this group do not allow their local public entities to have access to “traditional” insolvency procedures. However, they have enacted some special rules designed to deal with these entities’ distress in an orderly manner; and
- (4) light-touch approaches to distressed local entities: the countries in this group do not have a special set of rules applicable to local public entities in distress, and do not allow them to use the procedures available to insolvent companies. Frequently, the rescue of distressed entities is achieved through informal workouts with the creditors or as a result of the financial support from higher-ranking entities or central authorities.

## 5. Findings of this study

### 5.1 Positive findings

The following positive findings were made during this study:

- systems where local public entities enjoy tax collection powers grant more autonomy and allow for longer-term planning over indirect transfers from central authorities, provided that strong corporate governance rules are put in place to ensure that local administrators are held accountable for the money that they spend;

- some countries (such as Italy and South Africa) adopt comprehensive modular approaches to the treatment of local public entities in distress, with different remedies available based on the severity of the entity's economic and financial situation; the existing management is rarely displaced (in the United States of America, Belgium, Italy and South Africa only when all other options have proven ineffective); and state intervention is subject to specific procedural and substantive checks to ensure that it is not applied in an arbitrary way;
- some countries (such as Belgium) introduce mechanisms to deal with financial distress at early stages with incentives for local public entities in distress to merge with each other. This is achieved through a reduction of their debt by means of a partial bail-out from a regional authority;
- entities may not dispose of those capital assets needed to provide the minimum level of basic municipal services (but these assets need to be identified in advance, so that third parties can clearly assess their risk in investing in that entity);
- the distress of local public entities is usually dealt with through collective procedures in which the local public entity is subject to the administrative supervision of external authorities or managers;
- many statutory frameworks are designed to ensure the provision of essential services and their continuity; and
- an automatic stay from executory actions is granted for the duration of the procedure, aimed at addressing the local public entity's financial difficulties.

## 5.2 Negative findings

The following negative findings were made during this study:

- there is a lack of co-ordination in domestic strategies for dealing with local public entities in distress, especially in federal countries;
- there are few incentives to deal with financial distress at early stages, particularly where the consequence of reporting financial issues is the displacement of the current management;
- there is a lack of effective accountancy rules and comprehensive provisions on the investigation of the conduct of the local public entity's officials;
- state intervention through consistent use of broad and unlimited guarantees for the local public entity's debt, or by putting some local assets beyond the reach of the entity's creditors, incentivises moral hazard or careless assumption of excessive debts by local directors, as local authorities are ultimately not accountable for their own debt; and

- in order to ensure the continuity of public services it is not always necessary to prevent local entities from being liquidated.

## **6. Recommendations**

### **6.1 General recommendations**

The following general recommendations can be made, namely:

- to introduce a unitary definition of “local public entity”;
- to limit political interference; and
- that no one-size-fits-all approach will have the requisite effect.

### **6.2 Recommendations as to the guiding principles**

The following recommendations can be made in respect of the guiding principles, namely to:

- strengthen the corporate governance framework;
- allow for the use of modular rescue and liquidation options, regulated either by insolvency or administrative laws; and
- seal with financial distress in a proactive manner.

### **6.3 Procedural recommendations**

The following procedural recommendations can be made, namely to:

- support and train existing management;
- use management displacing measures only as an *extrema ratio*;
- limit court involvement; and
- protect vulnerable players and local investors.

# Collectivity and equality (*pari passu*) in the treatment of local public entities in distress

By Laura N Coordes\*, Yseult Marique\*\* and Eugenio Vaccari\*\*\*

## 1. Introduction

This edited collection of chapters<sup>1</sup> sets out to detail and analyse how different national insolvency<sup>2</sup> law systems treat local public entities in distress. The main purpose of this study is to provide recommendations for a harmonised and principled treatment of these entities. The key priority of the recommendations proposed in the study is to ensure the continuity of essential public services without necessarily deviating from the established insolvency principles of collectivity and equality of treatment among creditors.

The financial distress of local public entities raises unique and challenging issues. Providing a definition of “local public entity” is a challenging task. Local entities differ in nature and size, with some providing a wide range of services for large numbers of people in urban environments, while others have fewer duties and rely on less generous budgets to serve a smaller population. Many states leave this concept undefined. In some instances, local, regional, and federal levels within the same state provide contradictory definitions.

For the purposes of this study, a “local public entity” is a public authority or entity partially or totally funded by tax levies. Such an entity provides public services, namely essential services with a collective or social dimension (such as transport, education, social housing and care, hospitals, and utility services), not necessarily or not always at market price, to local communities. If any such entity faces financial distress, special rules should be put in place to ensure the continued provision of essential services to local communities.

This collection of chapters distinguishes between “basic” and “hybrid” local public entities. Examples of basic local public entities include municipalities, cities, districts, councils, provinces, and other political sub-divisions. Alongside these basic local public entities, there are hybrid local public entities. These entities include any publicly or privately owned entities

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The chapter covers literature and case law published before 1 May 2022. The research has been possible thanks to a generous grant provided by INSOL International. The usual disclaimer applies.

<sup>1</sup> The jurisdictions covered in the study are (in alphabetical order): Argentina, Australia, Bangladesh, Belgium, Brazil, Canada, Croatia, France, Germany, Ghana, Italy, Japan, the Netherlands, Nigeria, People’s Republic of China, the Russian Federation, South Africa, Uganda, the United Kingdom and the United States of America.

<sup>2</sup> In the tradition of the United States of America, the term “bankruptcy” is frequently employed to refer to corporate insolvencies. Similarly, the notion of “corporate bankruptcy” is employed as a synonym of “corporate insolvency”. This preambular chapter employs the terms “insolvency” and “bankruptcy” in accordance with the British terminology conventions. Any mention of bankruptcy can be taken to mean personal bankruptcy, unless in direct quotations. Different rules are followed in some of the chapters included in this edited collection.

(including corporations) that carry out fundamental services, or are responsible for the production or distribution of essential goods at a local (territorial or regional) level. These may be incorporated under private or public law. These entities can be considered hybrid entities only if two conditions are met. Firstly, they need to carry out a public service and mission such as those mentioned above. Secondly, another local authority or municipality must ultimately be responsible, legally or politically, for all or part of their debts.

The notion of local public entities does not include, amongst others:

- state or locally-owned enterprises operating at the national level (except for very small states);
- banks or other financial institutions, unless their fundamental goal revolves around the development of collective projects and entrepreneurial activities at a local level and the local authority or municipality is ultimately responsible, legally or politically, for all or part of their debts; and
- state or locally-owned enterprises which are not carrying out any collective, social or public function, but are simply operating in the market in competition with other private enterprises.

Insolvency practitioners tend to know little about how local public entities in financial distress are managed. Globally, insolvency laws pertaining to local public entities are heavily influenced by local traditions, cultures, and historic developments. The treatment of local public entities in distress is a significantly under-researched area of insolvency and public law, particularly outside of the United States of America (USA). This is certainly not due to the marginal relevance of this phenomenon, as an increasing number of these entities find themselves unable to meet their contractual obligations. More and more jurisdictions are evolving and reforming their legal responses to meet the practical and conceptual difficulties arising from the treatment of insolvent or distressed local public entities. There are no easy solutions, it would appear. Additionally, the financial collapse of local entities may trigger a domino effect on the private sector (as many suppliers rely on payments from public local entities to meet their obligations), as well as on local, regional, and national communities.

In this preambular chapter, we draw some general observations from the country reports in the chapters that follow, and we comment on some of the main challenges faced by the laws considered under study. There are elements in our approach in this chapter which might loosely be classed within the functional method<sup>3</sup> often adopted in comparative law analysis.

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<sup>3</sup> There is of course a great deal of literature on the method. The standard starting point is K Zweigert and H Kötz, *An Introduction to Comparative Law* (transl by T Weir) (3<sup>rd</sup> ed, Oxford University Press, Oxford, 1998). The main question for these authors is ensuring that what is compared is really comparable. They want to ensure that the general conclusions drawn from the comparison are really based on generalisable concepts. See also R Michaels, "The Functional Method of Comparative Law", in M Reimann and R Zimmermann (eds), *The Oxford Handbook of Comparative Law* (2<sup>nd</sup> ed, Oxford University Press, Oxford, 2019) at 345-389 who provided the following list: (i) for the United States, J Reitz, "How to do Comparative Law", *AJCL* (1998) 46 617 at 620-623;

We draw from the evidence provided by the country reports to assess whether, overall, the national laws promote a principled approach to the treatment of local public entities in distress.

Of course, the functional method is not without critics.<sup>4</sup> However, for practitioners and policy makers, it remains a useful (albeit possibly narrow) method for looking at discrete aspects of good or poor practice while avoiding over-generalisation.<sup>5</sup>

Additionally, some of the usual critiques of the functional method are ill-suited when applied to this work. As evidenced below, the study adopts a solid theoretical framework which clearly discloses its “inputs” and foundational principles. On this point, the distinction between basic and hybrid local public entities emerged from the study itself and from discussions with the commentators. It was not imposed by the leading investigators of this project.

The study is certainly interested in how law works in practice, as this is a significant portion of each national analysis. The study also acknowledges the role of local legal cultures and contexts, as it explicitly investigates the role that some external factors (such as politics) play in creating the legal framework on the treatment of local public entities in distress. Finally, the study is not Western-centered, as it adopts a global approach to the investigation of the treatment of local public entities in distress.

One of the most common reproaches to functionalism is that such method assumes that the law always serves a function. In this area, it is argued that the law does serve the purpose of reducing or at least controlling political interferences and risks. The law seeks to bring a

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and M Reimann, “The Progress and Failure of Comparative Law in the Second Half of the Twentieth Century”, *AJCL* (2003) 50 671 at 679; (ii) for France, M Ancel, *Utilité et méthodes de droit comparé* (Editions Ides et Calendes, Neuchâtel, 1971) at 97, and 101-103; and M Ancel, “Le problème de la comparabilité et la méthode fonctionnelle en droit comparé”, in R H Graveson and others (eds), *Festschrift für Imre Zajtay* (Mohr Siebeck GmbH & Co KG, Tübingen, 1982) at 1-6; (iii) for England, H Collins, “Methods and Aims of Comparative Contract Law”, *Oxford J Leg Stud* (1989) 11 at 396-406; and P de Cruz, *Comparative Law in a Changing World* (3<sup>rd</sup> ed, Routledge-Cavendish, London, 2007), at 236-238; (iv) for Germany, H Kötz, “Comparative Law in Germany Today”, *RIDC* (1999) 51 753 at 755; and U Kischel, *Rechts-vergleichung* (C H Beck, Wissen, 2015) at 6-7 and 93; (v) for Scandinavia, M Bogdan, *Concise Introduction to Comparative Law* (Europa Law Publishing, Paris, 2013) at 46; (vi) for a socialist perspective, I Szabó, “Theoretical Questions of Comparative Law”, in I Szabó and Z Péteri (eds), *A Socialist Approach to Comparative Law* (Kluwer Academic Publishers, Leyden, 1977), at 9 and 36-38; and (vii) for rise and fall in Italy, P G Monateri, “Critique et différence: Le droit comparé en Italie”, *RIDC* (1999) 51 at 989 and 991.

<sup>4</sup> The functionalist method has been criticised for (amongst others) its objectives (imposing one solution and forcing similarities), its positivist approach, and its lack of sensitivity to the context, the law in practice and culture. Amongst others, see J Hill, “Comparative Law, Law Reform and Legal Theory”, *Oxford J Leg Stud* (1989) 9 at 101; M Siems, *Comparative Law* (2<sup>nd</sup> ed, Cambridge University Press, Cambridge, 2018) at 39-48; and J Husa, “Farewell to Functionalism or Methodological Tolerance?”, *The Rabel Journal of Comparative and International Private Law* (2003) Bd 67, H 3, at 419-447 (suggesting to place functionalism in comparative law in a legitimate but restricted position as an interesting and sometimes even fruitful, but certainly not exclusive form of comparative methodology within the field of legal studies).

<sup>5</sup> M Bussani, “Deglobalizing Rule of Law and Democracy: Hunting Down Rhetoric Through Comparative Law”, *Am J Comp Law* (2019) 67(4) at 701.



degree of legal certainty and predictability for creditors and investors, thus promoting investments in a badly under-funded sector.<sup>6</sup>

The functional method adopted in this study could be described as “problem-solving functionalism”.<sup>7</sup> This study considers both differences and similarities among legal approaches, and the ensuing recommendations are at a general level. The study flags some aspects that the law should deal with, and the most common issues that may arise. It is not prescriptive as to the exact solutions to be adopted, as it recognises that different legal backgrounds may approach similar problems in unique manners.

This comparative study, however, is not simply about the treatment of these entities. It is also first and foremost about the principles that should govern their treatment. One of the main research questions of this study is if, and to what extent, the regulation of local public entities in distress should follow the same trends observed with reference to business rescue and liquidation. These trends could be described as a progressive mitigation of the principles of collectivity and equality of treatment among creditors to achieve communitarian<sup>8</sup> and substantively fair<sup>9</sup> outcomes. These purposes are the protection of vulnerable<sup>10</sup> and non-adjusting creditors in liquidation procedures and rewarding the contribution of new value in restructuring procedures.

As a result, paragraph 2 of this chapter engages in the normative criticism of the purposes underpinning the treatment of local public entities in distress. This critique is based on a

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<sup>6</sup> Organisation for Economic Co-operation and Development (OECD), *Unlocking infrastructure investment: Innovative funding and financing in regions and cities*, (OECD Publishing, Paris, 2021), available [here](#).

<sup>7</sup> E Orucu, “Methodological Aspects of Comparative Law”, *European Journal of Law Reform* (2006) 8(1) 29 at 33.

<sup>8</sup> E Warren, “Bankruptcy Policy”, *The University of Chicago Law Review* (Summer 1987) 54(3) at 775; E Warren, “Bankruptcy Policymaking in an Imperfect World”, *Michigan Law Review*, (1993) 92 at 336; and K Gross, “Taking Community into Account in Bankruptcy: An Essay”, *Washington University Law Quarterly* (1994) 72 at 1031. For an outline of the different visions of corporate insolvency law, see amongst others, V Finch, “The Measures of Insolvency Law”, *Oxford Journal of Legal Studies* (Summer 1997) 17(2) 227 at 230-242; and E Vaccari and E Ghio, *English Corporate Insolvency Law: A Primer* (Edward Elgar Publishing, Cheltenham, 2022) at chs 1-2.

<sup>9</sup> J Rawls, *Justice as Fairness. A Restatement* (3<sup>rd</sup> ed, Harvard University Press, Cambridge, 2003); I Mevorach, “Equitable Distribution and Accountability” in I Mevorach, *Insolvency within Multinational Enterprise Groups* (Oxford University Press, Oxford, 2009) (arguing that insolvency law should be concerned with fairness in distribution); M Radin, “Fair, Feasible and in the Public Interest”, *California Law Review* (1941) 29(4) 451 at 454-455; A W Cappelen *et al*, “Fairness in Bankruptcies: An Experimental Study”, *Management Science* (2019) 65(6) at 2832; R J Mokal, “On Fairness and Efficiency”, *Modern Law Review* (2003) 66 452; and S Paterson, “Debt Restructuring and Notions of Fairness”, *London School of Economics and Political Science Research Paper* (2017) at 2, available [here](#).

<sup>10</sup> People and companies differ in their resilience towards external disrupting factors, such as failure. According to vulnerability theories, legislative frameworks should be geared towards protecting non-adjusting vulnerable creditors rather than non-vulnerable ones. For an outline, see J L L Gant, “Optimising fairness in insolvency and restructuring: A spotlight on vulnerable stakeholders”, *International Insolvency Review* (2022) 31(2) at 1. For a more general outlook to vulnerability theories, see M A Fineman, “The Vulnerable Subject: Anchoring Equality in the Human Condition”, *Yale Journal of Law and Feminism* (2008) 20(1) at 1; and M A Fineman, “Vulnerability and Inevitable Inequality”, *Oslo Law Review* (2017) 4(3) 133 at 135. For an application of these theories to the field of corporate insolvency law, see D R Korobkin, “Vulnerability, Survival, and the Problem of Small Business Bankruptcy”, *Capital University Law Review* (1994) 23(2) at 413.

revised communitarian framework developed from Rawls, Finch and Radin's social justice concept of fairness.<sup>11</sup>

In this chapter, fairness is understood as a substantive and procedural concept.<sup>12</sup> It is submitted that procedural fairness is the propensity to rely on replicable and transparent procedures to deal with the interests of different parties in procedures involving local public entities in distress. Substantive fairness is the propensity of the system to deviate from "horizontal equity"<sup>13</sup> under the law (for instance, by means of preferential treatment for certain categories of creditors) or when adjudicating disputes between parties with conflicting interests in an insolvency process. An insolvency process is understood as procedurally and substantively fair if it considers issues of justice and respects the interests of affected parties by allowing such parties not simply access to, but also respect in, the decision-making process.

This normative analysis is followed by the comparative findings of the study. The chapter concludes with a series of principled recommendations for regulatory reform.

This study is significant for at least two reasons. Firstly, it is the first project to map in detail and to comparatively analyse the treatment of local public entities in distress in a variety of jurisdictions and legal traditions. The philosophy behind this project is that lessons could be learnt from developing and developed, small and large countries alike. For instance, we believe that one of the most advanced, principled, and effective statutory frameworks for dealing with local public entities in distress is the South African one (at least on paper, as South African municipalities have been afflicted by financial problems for many years),<sup>14</sup> despite the fact that its corporate framework is rarely set as an example in international fora.

Secondly, this is the first project to examine the treatment of distressed local public entities on a global scale, and the first to attempt to articulate unifying principles and standards for the laws and regulations governing the financial distress of these entities. This project provides guidance on the implementation of principled approaches to deviate from the fundamental principles of collectivity and equal treatment of creditors in insolvency while ensuring the substantive fairness and predictability of the framework.

Principles should be implemented with a view to the local conditions. These differ from country to country. Therefore, this collection of chapters does not advocate for one-size-fits-all solutions, but rather for general recommendations to approach domestic reforms in the area in a principled manner.

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<sup>11</sup> E Vaccari, "Broken Companies or Broken System? Charting the English Insolvency Valuation Framework in Search for Fairness", *Journal of International Banking Law and Regulation* (2020) 35(4) at 135. For an implementation of this theoretical framework, see E Vaccari, "Promoting Fairness in English Insolvency Valuation Cases", *International Insolvency Review* (2020) 29(2) at 285.

<sup>12</sup> S Paterson, "Debt Restructuring and Notions of Fairness", *Modern Law Review* (2017) 80(4) at 600.

<sup>13</sup> E E Zajac, *Political Economy of Fairness* (MIT Press, Cambridge, 2001) at 120.

<sup>14</sup> M D Glasser and J Wright, "South African municipalities in financial distress: what can be done?", *Law Democracy and Development* (2020) Vol 24 at 413.

## 2. Collectivity, *pari passu* and principles of fairness

Legal rights – such as contractual rights, property rights, rights in equity, and so on – really matter when there is a contest, when different people are claiming rights to the same assets, and when these assets are insufficient to meet these claims. This situation gives rise to what has been described as the “common pool problem”.<sup>15</sup> In legal terms, the common pool problem has been defined as the problem that arises when individuals’ self-interested actions fail to achieve a socially optimal result.<sup>16</sup> This is the context in which insolvency law operates.<sup>17</sup>

Insolvency law is not simply about the technical provisions and regulations in the statute books. It is about identifying the principles that should regulate this contest, and the goals that should be promoted through its use.

Insolvency law is a collectivised debt collection device.<sup>18</sup> Despite some arguments to the contrary,<sup>19</sup> collectivity is essentially a procedural principle – one that outlaws devices that would by-pass the collective regime such as individual enforcement of rights.<sup>20</sup> The principle entails the “essential condition for claimants to accept a limitation to their autonomy and freedom of action and – in certain cases – (unilaterally amend) their mutual obligations with the debtor”.<sup>21</sup> The way it operates in practice reminds us that collectivity is not simply designed to protect the debtor’s assets, but also to provide collective remedies for the benefit of all creditors.<sup>22</sup> A proceeding is collective under the law not simply because all creditors take part in it, but also because their relative entitlements against the debtor are not

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<sup>15</sup> Borrowed from the law and economics literature, the “common pool” metaphor suggests that the fishermen who fish at a single “pool” may fish too much and deplete the pool if they cannot bargain with each other to limit their activity. It would be in the general interest of each fisherman to limit their fishing practice: in the long run, this would result in a higher return for them (because fish would be allowed to procreate and multiply). On the other hand, selfish, short-term practices would lead to over-fishing, for fear that others will do the same. See T H Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press, 1986) at 11-12.

<sup>16</sup> T H Jackson, *The Logics and Limits of Bankruptcy Law* (2<sup>nd</sup> ed, Harvard University Press, Cambridge, 2001) at 10, and 12-14.

<sup>17</sup> Traditional common pool problems are complemented by other types of problems, such as semi-commons (H E Smith, “Semicommon Property Rights and Scattering in the Open Fields”, *J Legal Stud* (2000) 29 at 131) and anti-commons (M A Heller, “The Tragedy of the Anticommons: Property in the Transition from Marx to Markets”, *Harv L Rev* (1998) 111(3) at 621; L A Fennell, “Commons, Anticommons, Semicommons”, *University of Chicago Public Law and Legal Theory Working Paper No 261/2009* (2009) at 9-16, available [here](#); and R J de Weijjs, “Harmonisation of European Insolvency Law and the Need to Tackle Two common Problems: Common Pool and Anticommons”, *Int Insolv Rev* (2012) 21 at 67).

<sup>18</sup> T H Jackson, *The Logic and Limits of Bankruptcy Law* (2<sup>nd</sup> ed, Harvard University Press, Cambridge, 2001) at chs 1-2; and L N Coordes, “Bespoke Bankruptcy”, *Florida Law Review* (2021) 73 359 at 366.

<sup>19</sup> L Chan Ho, “England” in L Chan Ho (ed), *Cross-Border Insolvency: A Commentary on the UNCITRAL Model Law* (4<sup>th</sup> ed, Global Law and Business, London 2017) at 163.

<sup>20</sup> K Van Zwieten, *Goode on Principles of Corporate Insolvency Law* (5<sup>th</sup> ed, Sweet & Maxwell, London, 2018).

<sup>21</sup> E Vaccari, “The Ammanati Affair: Seven Centuries Old, and not Feeling the Age”, *The Chicago-Kent Law Review* (2018) 93(3) 831 at 832.

<sup>22</sup> *Re Wojakovski* [2020] EWHC 2737 (Ch). See also the UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation (2013) at 69-72, available [here](#); and Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings OJ L 141/19, art 2(1).

disregarded for the advantage of equally or lower-ranking creditors.<sup>23</sup> The absence of a uniform regime to regulate insolvent local public entities may affect the importance of the principle of collectivity in insolvency.

The notion of collectivity is strictly linked with the concept of equality. Under the latter concept, the debtor's assets are administered, and creditors' claims processed without any regard to the chronological order in which they were acquired or created (*par est condicio omnium creditorum*). The *pari passu* principle is one of the most fundamental principles of corporate insolvency law.<sup>24</sup> It holds that unsecured creditors shall share rateably in the assets of the insolvent company that are available for residual distribution. The *pari passu* principle ensures a rateable distribution of the proceeds generated from the sale of the debtor's assets among a company's general, unsecured creditors. It operates whenever there is a distribution, even in those procedures aimed at rescuing companies.

Collectivity and equality have been hailed as mechanisms to promote procedural fairness. It has been argued that procedural fairness is a multi-faceted legitimising concept used to justify the design of decision-making processes.<sup>25</sup> According to this multi-faceted narrative, procedural fairness is based on three underpinnings: instrumentality, dignitarian and public accountability. The first element is the system's instrumental capacity to deliver substantive justice, namely the correct outcome in the given case. The instrumental view of procedural fairness requires predictability and minimal deviations from agreed practices. The dignitarian element is seen as the right to a fair trial, and that is the right of the participant to be allowed to join the process and assert (in theory but also in practice) their interests and preferences.<sup>26</sup> The third element of public accountability requires the public to see the model as inherently fair. A corollary of this last element is the transparency of the decision-making process. Kirkham also observes that the institutional design may promote thinner or thicker models of procedural fairness.<sup>27</sup> In thinner models, the focus is mainly on establishing procedurally fair rules on paper (that is, in the statute books). Thicker models rely on mechanisms (such as alternative dispute resolution practices) to enhance the perception of procedural fairness among users.

In the insolvency context, a procedurally fair interpretation of the collectivity and equality principles results in the promotion of legal predictability against alternative normative approaches, including the communitarian argument for distributional fairness. It has been observed that in systems geared towards the promotion of procedural fairness, the focus is

<sup>23</sup> V S J Buccola, "Law and Legislation in Municipal Bankruptcy", *Cardozo Law Review* (2017) 38 1301 at 1306.

<sup>24</sup> However, for arguments claiming that the *pari passu* principle should not be treated as a fundamental principle, see R Mokal, "Priority as Pathology: The *Pari Passu* Myth", *Corporate Law Journal* (2001) 60(3) at 581.

<sup>25</sup> R Kirkham et al, "The procedural fairness limitations of fitness to practise hearings: a case study into social work", *Legal Studies* (2019) 39 339 at 340.

<sup>26</sup> D Galligan, *Due Process and Fair Procedures* (Oxford University Press, Oxford, 1996); D Hovell, *The Power of Due Process: The Value of Due Process in Security Council Sanctions Decision-Making* (Oxford University Press, Oxford, 2016), at 76; and J Kirshner, "The (false) conflict between due process rights and universalism in cross-border insolvency", *Cambridge Law Journal* (2013) 72(1) at 27.

<sup>27</sup> R Kirkham et al, "The procedural fairness limitations of fitness to practise hearings: a case study into social work", *Legal Studies* (2019) 39 339 at 344-345.

on making decisions that look right, irrespective of the lack of participation from the interested parties.<sup>28</sup> It is also generally understood that saving businesses and avoiding liquidation outcomes may require a deviation from the “traditional” insolvency pillars of collectivity and equality of treatment among creditors.

Communitarian scholars argue for a shift in the normative approach to corporate insolvency. These scholars consider a procedural interpretation of these principles as *passé*<sup>29</sup> – no longer in line with the mutated reality of globalised and inter-connected businesses on the one hand, and micro and small enterprises on the other. It follows that the goals of keeping companies operating and protecting vulnerable players are becoming increasingly hard to reconcile with the use of procedurally fair, collective, and egalitarian procedures.<sup>30</sup>

It is well known that in most business insolvency cases, unsecured creditors receive no distribution. As a result, insolvency procedures have become mechanisms to reorganise the capital structure and not to redistribute assets.<sup>31</sup> In many countries around the world, procedurally fair, collective, and egalitarian liquidation-oriented procedures have been complemented by more flexible mechanisms, designed to rescue distressed yet viable businesses and to prioritise the treatment of selected (categories of) creditors. These preferential treatments apply alongside the contractual priorities bargained for by the parties in solvent times, for instance by means of secured claims or by introducing clauses in contracts that produce similar effects.<sup>32</sup> However, it is argued that these deviations should be principled, that is, part of a framework designed to promote “substantive fairness”.

Substantive fairness is achieved when deviations weigh the interests of a broad range of different constituents, including the community and society at large.<sup>33</sup> In contrast to the creditor wealth maximisation approach, which advocates the promotion of individual rights, the communitarian approach promotes value redistribution so that in the event of corporate insolvency, high priority claimants may give way to others, including the community and society at large, in sharing the value of an insolvent company.<sup>34</sup>

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<sup>28</sup> *Idem*, at 339.

<sup>29</sup> R Mokal, “Priority as Pathology: The *Pari Passu* Myth”, *Corporate Law Journal* (2001) 60(3) at 581. See also T A Sullivan, E Warren and J L Westbrook, *As We Forgive Our Debtors* (Beard Book Inc, Frederick, Mariland, 1999).

<sup>30</sup> See S J Lubben, “Fairness and Flexibility: Understanding Corporate Bankruptcy’s Arc”, *University of Pennsylvania Journal of Business Law* 23 at 132.

<sup>31</sup> S Paterson, *Corporate Reorganization Law and Forces of Change* (Oxford University Press, Oxford, 2020).

<sup>32</sup> These clauses provide to the innocent party a quasi-security right over the debtor’s assets. Examples of such clauses include retention of title clauses, hire-purchase agreements, and similar. Where permitted under the law, termination and other types of *ipso facto* clauses also provide preferential treatment for the innocent party. For a global analysis of these clauses, see J Chuah and E Vaccari (eds), *Executory Contracts in Insolvency Law: A Global Guide* (2<sup>nd</sup> ed, Edward Elgar Publishing, Cheltenham, 2022).

<sup>33</sup> K Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (Yale University Press, New Haven, 1997); V Finch and D Milman, *Corporate Insolvency Law: Perspectives and Principles* (3<sup>rd</sup> ed, Cambridge University Press, Cambridge, 2017); and E Warren, “Bankruptcy Policy”, *University of Chicago Law Review* (Summer 1987) 54 at 775.

<sup>34</sup> E Warren, “Bankruptcy Policy”, *University of Chicago Law Review* (Summer 1987) 54 at 775.

In restructuring procedures, substantive fairness is achieved by prioritising the beneficiaries' contribution to the restructured entity without unduly affecting the position of vulnerable claimants. In business liquidations, substantive fairness is achieved when deviations from collectivity and equality of treatment among creditors are motivated by efforts to protect the vulnerable position of certain non-adjusting creditors. In general, substantive fairness is achieved by granting relief that is legally available actually available.<sup>35</sup>

It is questionable whether current corporate insolvency frameworks achieve this goal. For instance, it has recently been observed that the selectivity of some restructuring procedures impairs the collective and even treatment of creditors in insolvency, especially when the use of such selectivity is illegitimate.<sup>36</sup> However, this debate falls outside the scope of this collection of chapters, which revolves around the treatment of local public entities in distress.

Local public entities are not run for profit in the same way as businesses – they are entities established to provide essential services to local communities. Technically, nothing prevents these entities from being liquidated, restructured, merged into other entities, or replaced by other providers of essential services. It could, therefore, be argued that a principled approach to the treatment of local public entities in distress should allow deviations from the procedurally fair concepts of collectivity and equality of treatment designed to:

- protect the vulnerable position of certain non-adjusting creditors in both liquidation and restructuring-like procedures; and
- reward the beneficiary's contribution to the restructured entity in restructuring-like procedures.

The unplanned, sudden or untimely termination of the provision of essential services is never a desirable outcome. Nevertheless, this outcome is not frequent in practice. Even in cases where the distressed entity is dissolved, in practice such entity survives its termination. In fact, it is likely that a newly created entity charged to provide education, local transport, or health services (amongst others) to local communities will continue using at least part of the facilities of the dissolved entity, as well as some of its staff. As a result, it is preferable to conceptualise the treatment of local public entities in distress as akin to the treatment of businesses undertaking a restructuring procedure.

Does this suggest that a principled approach to the treatment of local public entities in distress should prioritise and reward the beneficiary's contribution to the restructured entity over the protection of vulnerable, non-adjusting creditors? Several reasons suggest that the

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<sup>35</sup> C Ondersma, "Overlooked human rights concerns in the restructuring and insolvency context" in P Omar and J Gant (eds), *Research Handbook on Corporate Restructuring* (Edward Elgar Publishing, Cheltenham, 2021).

<sup>36</sup> S Paterson and A Walters, "Selective Corporate Restructuring Strategy" (15 September 2021), available [here](#). See also I Mevorach and A Walters, "The Characterization of Pre-insolvency Proceedings in Private International Law", *European Business Organization Law Review* (2020) 21(4) at 855.

selective treatment of creditors observed in business procedures should not necessarily be replicated when dealing with local public entities in distress.

Firstly, in most procedures involving local public entities in distress, the “common pool” problem may only be apparent. Local public entities can often mitigate cash-flow and balance-sheet issues through a variety of mechanisms, including increased support from central or regional authorities, and higher revenues in the form of direct or indirect tax levies.

Additionally, proceedings involving local public entities in distress affect a larger number of non-adjusting and vulnerable stakeholders than most corresponding liquidation or restructuring business procedures. It is uncommon for business liquidation or restructuring procedures to require detailed considerations of the interests of stakeholders that are not in the debtor’s books. Cases such as Purdue Pharma, which dealt with many tort claimants, or Johns-Manville Corp, which featured egregious breaches of environmental and health laws, are (thankfully!) comparatively rare. On the contrary, in all cases involving local public entities in distress, the main contributors to the entity’s income are usually the beneficiaries of their services. This makes for a powerful argument for including their interests in any debate on the restructuring of the local public entity, even if they are technically qualified as contributors rather than creditors of the local public entity.

These considerations suggest that substantially fair deviations from the principles of collectivity and equality of treatment should not be justified primarily by the beneficiary’s ability to contribute new value to the restructured entity, as happens in business rescue procedures. They suggest that deviations from those principles should also be designed to protect the vulnerable and non-adjusting beneficiaries of the services provided by local public entities. This draws a limited parallelism of purposes (but not outcomes) between business liquidation procedures and procedures involving the treatment of local public entities in distress. The next part builds on the comparative analysis of the study to determine to what extent the interests of vulnerable and non-adjusting claimants are protected and promoted in procedures involving local public entities in distress.

### **3. Finding a fair principle of continuity of public services?**

#### **3.1 Classification of the states considered in the study and other preliminary findings**

Overall, our study showed that countries around the world adopt very different approaches to the treatment of local public entities in distress. Our analysis shows that it is possible to categorise these frameworks into four big families:

- (1) Comprehensive special insolvency systems: the countries in this group have a special insolvency framework applicable to local public entities that are either in distress or insolvent.

In our study, we believe that the only country that falls into this group is the USA.

- (2) Comprehensive administrative systems: the countries in this group do not allow their local public entities to have access to “traditional” insolvency procedures. However, they allow their entities to have access to comprehensive administrative procedures designed to ensure the continuity of public services. Because of the highly developed nature of these frameworks, intervention of the state in the form of a discretionary bail-out is – at least on paper – generally not necessary.

In our sample, we believe that the following frameworks should be included this group: Belgium, Brazil, Italy (where the conditions for state bail-outs are clearly set out in the law), Japan, the Netherlands<sup>37</sup> and South Africa.

- (3) Fragmented or special administrative systems: the countries in this group do not allow their local public entities to have access to “traditional” insolvency procedures. However, they have enacted some special rules designed to deal with the local public entity’s distress in an orderly manner. Because these frameworks are of special or fragmented nature, intervention from the state in the form of a bail-out is likely whenever the local entity faces serious distress or insolvency. The conditions for the state intervention are mainly discretionary.

In our sample, we believe that the following frameworks should be included in this group: Australia, France, Germany, the People’s Republic of China (with reference to state-owned enterprises), the Russian Federation and the United Kingdom (UK).

- (4) Light-touch approaches to distressed local entities: The countries in this group do not have a special set of rules applicable to local public entities in distress, and do not allow them to use the procedures available to insolvent companies. Frequently, the rescue of distressed entities is achieved through informal workouts with the creditors or thanks to the financial support from higher-ranking entities or central authorities.

In our sample, we believe that the following frameworks should be included in this group: Argentina, Bangladesh, Canada, Ghana, Nigeria, the People’s Republic of China (with reference to public entities) and Uganda.

The categorisation does not reflect the effectiveness of each system in reaching the goals laid out in the law. For instance, there is no recorded case of a bail-out of a local public entity from central authorities in the People’s Republic of China, probably by reason of the stringent control of central authorities over local finances. On the other end of the spectrum, the analysis of the South African framework shows that a range of practical issues affect statutory interventions in municipalities, even though the system is on paper capable of dealing with these issues without the need for discretionary state or central support.

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<sup>37</sup> For the Netherlands, this categorisation is valid only with reference to basic local public entities. In this country, basic entities can have access to “traditional” insolvency procedures. However, they never file for such procedures due to the presence of a well-developed comprehensive administrative system. Hybrid entities can and do file for traditional insolvency procedures.



Local authorities across the world share some common characteristics. Unlike private companies, their revenues are supplemented by local taxes and other types of levies. In many cases, local authorities receive significant financial support from central governments in the form of direct transfers or ring-fenced funds.<sup>38</sup>

This should ensure a constant and relatively predictable stream of money to the local authorities. However, local authorities are not always free to complement their funding with additional sources. In states such as the UK and South Africa (amongst others), they are limited in the amount of money that they can charge for the services provided. In Canada, local public entities are only able to access debt through their municipality, which issues the debentures in the municipality's name.

Sometimes, local public entities have very limited autonomy to determine their goals and policies, or to increase their revenue capacity through taxation. Local public entities enjoy wider autonomy and revenue collection powers in federal states. This is, for instance, what happens in Belgium and Germany.

In general, states place significant constraints on the financial activities that can be undertaken by local public entities. A notable example is Canada. This approach had the benefit of limiting the number of entities that has needed assistance or support over the years. If an entity is limited in how much it can borrow, it is less likely it will find itself in a condition of insolvency or financial distress. However, this is no guarantee that cases of local public entities in distress will not happen at all, as corporate scandals and major economic shocks have had and continue to have an impact on local public entities and their ability to service their debt. For instance, in Canada, despite the existence of strict borrowing rules, several local public entities defaulted on payments in the 1930s. Nowadays, local public entities in Canada (and around the world) face similar issues, as they operate in a market characterised by rising costs and dwindling revenues. Not dealing with the possibility that one of these entities may default on their payments is the equivalent to "looking for trouble".

Additionally, some states, as in the case of Ghana and Nigeria, do not allow local entities to levy their taxes autonomously. These taxes are paid to central authorities, and then redistributed to local entities based on pre-agreed criteria. However, these criteria are subject to constant political negotiations between local and central authorities, and central authorities may fail to pay promptly or pay as much as promised to local public entities. Finally, there are states like the Russian Federation where some types of unitary legal entities do not own assets provided to them by public law entities. These entities (usually companies created by public law entities) acquire special rights of economic or operational management

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<sup>38</sup> For example, in the USA, intergovernmental (primarily state) aid may be a significant source of local public entity revenue. L N Cordes and T Reilly, "Predictors of Municipal Bankruptcies and State Intervention Programs: An Exploratory Study", *Kentucky Law Journal* (2016-2017) 105 493 at 505.

on certain assets, some of which are put out of the reach of creditors, thereby reducing the chances that creditors may be successful in enforcing claims against these entities.<sup>39</sup>

Our analysis shows that the revenue-generating capacity of local public entities differs greatly from state to state. Overall, it seems that systems where local entities enjoy tax collection powers grant more autonomy and allow for longer-term planning over indirect transfers from central authorities, provided that strong corporate governance rules are put in place to ensure that local administrators are held accountable for the money they spend. A system of direct collection from local authorities increases the local administrator's accountability towards local communities and reduces the discretionary and political interference from central or higher-ranking authorities.

Except for Italy, South Africa and the USA, our study shows that few countries around the world feature a robust and well-developed insolvency or administrative framework for dealing with local public entities in distress. Even in countries such as the USA where this framework is well-developed, there are difficulties in assessing its scope, as the definition of "municipality" (the equivalent of "local public entity" in American English) is far from settled.

Italy is a very interesting case study. There is a special code, known as *Testo Unico delle leggi sull'ordinamento degli enti locali* (TUEL), which deals with any issues surrounding local public entities in distress. This includes situations of financial imbalance and distress. The Italian TUEL adopts a modular approach to the treatment of these entities, with different remedies available based on the severity of the entity's economic and financial situation. Even in the most serious cases requiring the appointment of special experts, the local management is not displaced (unless in the case of criminal or grossly negligent behaviour), and the state intervention is subject to specific procedural and substantive checks, to ensure that it is not applied in an arbitrary way.

The less-known experience of South Africa has provided significant material for our study. South Africa also provides a modular approach to the treatment of local public entities in distress. This framework encourages local entities to deal with financial shortcomings by raising revenues and reducing expenses. If this proves ineffective, the provincial authority will intervene, first to support the local entity, and only eventually to replace its management to devise a more comprehensive restructure. Local public entities may also be placed in administration. Finally, in cases of serious or persistent material breach of financial commitments, provincial or state authorities are obliged to intervene and - potentially - displace the management of the insolvent entity.

There is also the peculiar case of Uganda. Under Ugandan law, local public entities are not subject to "traditional" corporate insolvency procedures. The government has discretionary power to intervene when these entities are struggling financially. However, in some of these

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<sup>39</sup> Please note that the Russian Civil Code, art 212 expressly provides that private, state, municipal and other forms of property are recognised in the Russian Federation. As a result, local public entities can and do own assets.

cases, the government decided to use “traditional” procedures, such as administration, receivership or (as a last resort) liquidation, to offer an orderly and fair process to all stakeholders. It follows that, at least in this country, there is no apparent valid justification for not extending the scope of the existing insolvency framework to local public entities.

Therefore, our study evidenced a very fragmented approach to the treatment of local public entities in distress. Despite some minor commonalities (evidenced below in paragraph 3.3), the treatment of local public entities in distress is mainly a domestic matter subject to a significant degree of political interference. As it stands, few of the considered frameworks achieve any form of procedural fairness, let alone a substantive degree of protection for vulnerable stakeholders.

The urgency to intervene in a principled way in the area is compounded by the fact that many countries are relying to an increased extent on public-private partnerships to deliver essential services to local communities.<sup>40</sup> This factor makes the distinction between local public entities and private providers even more challenging to discern. It also raises additional problems as to their qualifications, and as to the regime applicable to them should they experience a condition of insolvency or financial distress.

One of these cases is China, as the country does not have specific provisions dealing with local public entities in distress. However, many of its state-owned enterprises provide public services and are subject to the general insolvency rules. The same occurs in most of the African countries considered in this study (Nigeria, Ghana and Uganda). In these countries there is some evidence that informal debt resolution mechanisms have proven successful over time.

We believe that a praiseworthy example of how to deal with public-private partnerships comes from South Africa. In terms of South-African law, public-private partnerships are subject to the control of a “parent municipality”. Should the partnership fail to meet the financial requirements prescribed by the law, the parent municipality will be able to impose a restructuring plan on the partnership, using the same powers granted to provincial authorities dealing with basic local public entities in distress. Alternatively, the parent municipality will be able to liquidate it, relying on powers not recognised to provincial authorities under South African law.

Other countries, such as Italy and the Netherlands, provide for special rules and procedures applicable only to basic local public entities, while hybrid entities are subject to the general insolvency provisions. The effectiveness of this approach is analysed below.

The next parts expand the comparative analysis to other areas considered in this study and assess them against the normative framework provided in paragraph 2. We distinguish critical and unco-ordinated approaches to the treatment of local public entities in distress

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<sup>40</sup> For England, see Y Marique, *Public-Private Partnerships and the Law: Regulation, Institutions and Community* (Edward Elgar Publishing, Cheltenham 2014).

(paragraph 3.2) from what we describe as best practices. These best practices ensure the continuity of public services and the protection of vulnerable stakeholders (substantive fairness) without deviating too much from the procedural funding principles of insolvency law (paragraph 3.3). The final sub-section of this part draws our conclusions on the findings of this study.

### **3.2 Unco-ordinated approaches or critical aspects in the treatment of local public entities in distress**

Our study shows that some aspects of the current treatment of local public entities in distress result in unco-ordinated approaches among different actors, as well as in the promotion of practices that are incompatible with the existence of a procedurally collective, equal, and fairness-oriented insolvency framework.

#### **3.2.1 *Unco-ordinated approaches***

Many reports show a lack of co-ordination in domestic strategies for dealing with local public entities in distress. This is particularly evident in federal countries such as Australia, where regulation is undertaken by respective state governments. A similar trend is also apparent in the UK, where there are significant discrepancies in the treatment of local public entities among the states in the Union, as well as in Canada, where restrictions on “municipalities” and their financial activities differ from state to state. Yet another example is Argentina, where each municipality is governed by *ad hoc* provincial law, and the treatment of distressed municipalities varies from province to province.

Another federal state where there is an evident lack of co-ordination among the different branches of the state is Nigeria. In this African country, local public entities are not subject to special insolvency procedures, and the Constitution does not provide for their dissolution. However, several federal states have enacted special laws, which allow for *ad hoc* dissolution procedures for special local public entities. The lack of a co-ordinated approach between central and federal entities often results in the central government having to bail out the debts of local entities on a case-by-case basis.

Bail-outs are far from being an optimal solution, as evidenced by the Ugandan case. In that country, in 2016 the government spent the equivalent of USD 300 million to bail out distressed companies (including state-owned companies and local entities), as they were considered viable and still capable of contributing to the economy. Such initiative was later criticised for being politically motivated. It is undeniable that bail-outs have a political, rather than simply financial, cost.

#### **3.2.2 *Insufficient incentives to early filing***

Many country reports observe that there are few incentives to deal with local public entities in distress at an early stage. This includes reports from countries such as Italy that have a working and comprehensive framework for dealing with local entities in distress.

This situation is not limited to Italy. The UK report, for instance, notes that there are perverse incentives not to disclose the ongoing financial difficulties, as this would lead to the existing management being supervised and eventually replaced by independent commissioners appointed by the government. This is because the only way of dealing with local public entities in distress under English law is by means of section 114 notices. When these notices are issued, the local authority needs to convene a council meeting to discuss the actions that need to be taken to address the financial challenges. These consequences usually result in the approval of a rescue package with the support of the government, as well as in the ousting of the existing management.

The harshness of the consequences associated with section 114 notices have been designed to push councils to take timely decisions and, therefore, avoid experiencing serious financial pressures. Yet, the punitive and draconian consequences associated with section 114 notices also have the unwanted and collateral effect of incentivising the existing management to hide the magnitude of the local authority's financial problem until it is too late to devise solutions at a local level, for the sole selfish purpose of avoiding being replaced.

Similar punitive and management-displacing approaches have been observed in many other countries. For instance, in Australia there is legislative power for persons, such as governors, to dismiss all civic offices in relation to a council where a public enquiry on their financial soundness has been held, and where the Minister has recommended that the governor make such a declaration. In Croatia, as local public entities are not subject to general insolvency law, they can be admitted to a special rehabilitation procedure carried out by higher-ranking public entities with the purpose of ensuring the continuity of public service. This rehabilitation procedure results in the management being displaced for a period of up to two years.

The lack of incentives to file is also compounded by the fact that in many cases the state or federal oversight may result in the dissolution of the local public entity. Cases of this type were recorded in the UK, while in Australia there is legislative power to merge local authorities.

There are some exceptions to this trend of offering no incentives to deal with distress at an early stage. In Belgium, distressed entities that jointly propose a merger can, in principle, enjoy a reduction in their debts through a partial bail-out from regional governments. The portion of such debt is pre-determined by the law, and it is linked to the number of inhabitants of the merged authorities. We argue that this is a very good example of tackling local financial distress in a principled way. In general, under Belgian law, debts must be paid as originally agreed. However, deviations are possible under pre-identified conditions and standards, and only for the purpose of ensuring the provision of essential public services to local communities. In other words, collectivity and equality of treatment of creditors are displaced only when no other option is available, for the purpose of promoting substantive fairness, and on the basis of pre-arranged and identified criteria.

Not all countries require the removal of local officials upon the opening of a procedure involving local public entities in distress. In terms of the law in the USA, Chapter 9 of the

Bankruptcy Code allows those in charge of the distressed entity to remain in charge during the proceedings. State laws may also provide for mechanisms of additional oversight over the existing officials to ensure that inefficiencies and existing problems are addressed in a timely manner. Other states such as Belgium provide for “special oversight” and limited powers for higher-ranking entities to take decisions on behalf of local authorities. Only in exceptional circumstances, such as manifest unwillingness or negligence on the part of a local administration to comply with its legal obligations, can the higher authority displace the management of the local entity by means of “coercive supervision”. This approach is similarly followed by South Africa, where management displacement is seen as the *extrema ratio*. Finally, in Italy, “extraordinary liquidation bodies” are called in by the local public entity to try to settle its debts with the creditors, while the management of the entity remains in place to perform ordinary obligations and functions, as well as to remove the causes of the financial distress.

### 3.2.3 *Ineffective corporate governance rules*

Management-displacing aspects and lack of co-ordinated approaches to local public entities in distress are not the only elements that corroborate the trend for late filings. Another aspect is the lack of effective accountancy rules and of comprehensive provisions on the investigation of the conduct of the entity’s officials.

Where strict accounting and reporting rules are implemented (such as in Belgium, Canada, France, Germany, Japan, the Netherlands and the Russian Federation), local public entities are less likely to experience financial distress or insolvency. Particularly praiseworthy is the Japanese system, which features an alert system based on different financial and accounting ratios used to determine the financial soundness of the local public entity. Where the distress is unavoidable – for instance, because the failure is due to external factors such as mass migration, closure of main industries (for instance, the mining industry) or natural and man-made disasters (for instance, radioactive contamination) – the higher-ranking authorities can intervene and provide support at an early stage.

With reference to managerial accountability, while previous management are generally subject to the general criminal and company law provisions on directors’ conduct, it seems that states do not enforce these provisions with a robust prosecution system. Some notable exceptions apply. This is, for instance, the case in the Netherlands, where provincial executives (civil servants acting as a board on behalf of the provincial governments) have the power to, at any time, initiate a financial investigation regarding the entity’s financial policy, albeit only with reference to basic local public entities. Notably, such investigation does not automatically result in the displacement of the existing management. We believe that not displacing the existing management at the first sign of crisis, or when investigations are initiated, is one of the aspects that countries should closely scrutinise in any reforms of their frameworks on local public entities in distress. The fact that this investigation is carried out by

civil servants is, however, a reason of concern.<sup>41</sup> A process of administrative and internal overview does not ensure the same level of transparency (and, therefore, public accountability procedural fairness) as a process carried out by an independent, third-party authority.

A country that seems to have a well-developed corporate governance system is South Africa, at least on paper. In terms of South African law, local public entities are subject to detailed rules on financial management, including reporting and borrowing rules. The South African Constitution mandates that municipal budgets and budgetary processes must promote transparency, accountability and the effective financial management of the economy, debt, and the public sector. There are reporting obligations if the entity fails to perform to the statutory standards and, if the allegations are proven, the entity can be put in administration and its directors may be forced to pay damages to the entity itself. Additionally, a failure to adhere to the substantive statutory requirements, especially the limits on lending, may lead to the invalidity of the transaction with the creditor. According to the South African commentator, however, this is a case where the three underpinnings of the multi-faceted notion of procedural fairness do not result in a substantially fair framework.

The reason for such failure is to be ascribed to the discretionary, somewhat arbitrary state intervention in these procedures. In South Africa and in many other countries (such as in the UK and Canada), state intervention frequently results in the provision of broad and unlimited guarantees to the local public entity's debts. One such egregious case is Uganda, where the state stands *in loco parentis* and is responsible for any legal remedies, such as damages, arising from the contracts signed by the local authority. State intervention also results in putting some assets beyond the reach of the debtor's creditors, as in France, Belgium and the Russian Federation, amongst others. These measures incentivise moral hazard or careless assumption of excessive debts by local directors, as evidenced by several country reports (see, for instance, the Chinese one). This is debt for which, ultimately, the local public entities are not accountable. The existence of these guarantees does not encourage the local public entity's creditors to check the financial solidity of the entity before investing in it, or to hold the entity's directors accountable for their actions. As a result, serious issues are only disclosed when the only option left is bail-out by the state.

Despite being marred by unwanted political interference, the South African framework suggests a potentially promising approach for dealing with these situations. Under South African law, entities may not dispose of a capital asset needed to provide the minimum level of basic municipal services, regardless of their financial distress. Such assets – but only such assets – are excluded from the entire framework dealing with financial distress. This may represent an acceptable compromise position, provided that these assets are identified in advance, so that third parties can clearly assess their risk in investing in that entity.

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<sup>41</sup> Such concern was not raised in the Dutch chapter. In comments to a draft version of this chapter, the Dutch commentators observed that the oversight carried out by the provincial executive is independent, transparent, and compliant with a national framework (*gemeenschappelijk toetsingskader*). Besides this financial investigation, the commentators observed that there are other independent financial checks under Dutch law, including from external accountants, which ensure the independence and transparency of this assessment.

Japan has adopted a form of state intervention that is not political in nature. Its law provides for national financial assistance in the form of state-guaranteed bonds if a local public entity finds itself in financial difficulties. The law outlines clear criteria and ratios to have access to this type of support, meaning that political discretion is minimal. In other words, this is a form of state intervention devoid of political discretion and capable of ensuring procedural fairness. However, this approach is not in itself sufficient to ensure substantive fairness. Similar yet less technically rigorous approaches are also implemented in other countries included in this study. For instance, in Germany, the law (including the country's Constitution) clearly outlines the local public entities' sources of income, and the subsidiary support from the federal state. There are also clear prohibitions on becoming over-indebted, thus ensuring once again high levels of accountability and procedural fairness.

### **3.3 Commonalities in the treatment of local public entities in distress**

Despite the fragmented framework described so far, our study also evidences common elements and shared approaches to the treatment of local public entities in distress. Their implementation by the states results in minimal deviations from the traditional, procedural tenets of insolvency law. At times, it also shows a willingness to promote substantively fair goals. This suggests that a principled approach to the treatment of local public entities in distress is within reach.

#### **3.3.1 Unitary purpose-based definition of local public entity**

As mentioned above, local authorities are charged with providing essential services to local communities. These services are provided either directly by these entities, or through private or semi-public companies. In the USA, the law describes local public entities as, *inter alia*, an "instrumentality" of the state. Case law in the USA clarifies that to assess whether a local public entity is an instrumentality of the state, reference needs to be made to the purpose of that entity as well as to the level of control from other higher-ranking authorities. It follows, therefore, that there is some agreement that to determine the public nature of these entities it is necessary to look not simply at the controlling structure, but also at the purpose and nature of the services provided.

Many more countries, however, do not provide for a single definition of local public entities. At times, local, regional, and central definitions are contradictory. As evidenced by several country reports, this causes uncertainty and confusion in the application of the law. Other country reports, such as the Ghanaian one, highlight that the law does not distinguish between local public entities and local governments, thus bringing into question the ability of the system to cater for the specific needs of local entities, especially when it comes to the needs of vulnerable stakeholders. Where well-drafted unitary definitions are provided, clarity may be enhanced, thus improving the framework's ability to deal with a situation of financial or economic distress of these entities.

In some instances, the local nature of these entities is questioned. For instance, in Ghana, essential services are provided by state-owned companies that operate at a national level.



These entities have local branches, but the structure of the corporation is unitary. These corporations can become insolvent but in practice they are never formally dissolved.

### **3.3.2 *Promotion of collective outcomes***

Despite the lack of co-ordinated approaches in many of the areas discussed above, the laws analysed in the study generally ensure a procedurally collective approach to the treatment of these distressed local public entities. This result is often achieved by means of administrative supervision, even if some jurisdictions such as the USA opt for judicial oversight, and others like Italy for a mixed system where administrative judges support the work of externally appointed experts and existing managers. In a similar fashion, in France the collective nature of the procedure is ensured even if the entity is dissolved or merged with another authority, as the process is governed by laws or orders (ordinances).

In corporate insolvency cases, restructuring plans are often agreed out of court. The collective nature of insolvency procedures does not represent an obstacle to negotiate extra-judicial solutions to the debtor's distress. It is, therefore, notable to observe that in some jurisdictions such as the USA and Croatia, mediators and similar professionals are employed to assist the parties in negotiations designed to achieve an amicable solution to any disputes arising during the insolvency procedure. Their intervention is not designed to challenge the procedurally collective nature of these procedures, but only to facilitate a compromise between the affected parties.

### **3.3.3 *Ensure the continuity of public service***

As it appears, many of the procedures covered in this study are management-displacing and they lack incentives to deal with financial distress at an early stage or in a co-ordinated manner. Despite this, local public entities are not left without support. The protection of public services features in a prominent role in almost all the frameworks considered in this study. Many frameworks are designed to ensure the provision of essential services and their continuity, irrespective of their level of sophistication.

For instance, the UK report observes that, while the concept of "continuity of public service" is not embedded in the legislation, much of the current law is clearly geared towards achieving this goal. This also applies to companies strictly connected to local authorities but formally independent from them. Under English law, the issuance of a section 114 notice results in a prohibition of incurring new expenses. However, this prohibition does not cover statutory services, including safeguarding vulnerable people, and existing commitments and contracts will continue to be honoured.

The Australian report reaches similar conclusions on this point, as it observes that the concept of "community" is central to the laws dealing with local public entities in distress. The report goes on to observe that, although the avoidance of insolvency is not mentioned specifically, continuity of public service is a clear part of providing a sustainable, flexible and effective system of local government that delivers to local communities. Similar provisions also apply

to Bangladesh, which *de facto* extends the scope of the principle of continuity of public services to private companies (owned by the state) delivering essential services to local communities.

Some states grant special protection to the principle of continuity of public services. In Belgium, this is a general principle of administrative law, which takes priority over competing demands from the creditors to seize the entity's assets and sell them in satisfaction of their claims. The same goes for France, with the result that if public utility establishments are dissolved, the essential services that they provided fall back to another local authority. A similar approach is also followed in Italy, where guaranteeing the functions and services provided by local public entities is one of the specific goals of the procedures applicable to these entities (and recognised by the case law). Moreover, it is expressly stated that an important aim of the South African legislative framework is to secure the continuation of public services despite their financial distress. Finally, some states such as Germany include not only the principle of continuity of public services, but also the more general principle of continuity of municipal entities in their constitutions.

Other states such as the Netherlands do not clearly state in their laws the need to comply with a principle of continuity of public services for hybrid entities. However, they do allow their hybrid local public entities to take part in procedures such as "suspension of payment". These procedures have the effect of giving the distressed entity a period of relief from executory actions against their assets, so as to regain their financial viability. With reference to basic local public entities, the continuity of public services is ensured by the special administrative provisions applicable to them. Such provisions are geared to address the basic local public entity's financial distress, thus indirectly ensuring the continuation of public services.

Similarly, in Argentina, some of the provinces set limits on what may be accomplished via judicial foreclosure of municipal assets so as to maintain the provision of essential public services. And in Brazil, local public entities cannot be insolvent or liquidated, and public debt renegotiations must be formalised through a complementary law.

Finally, there are states such as China where, even though insolvency procedures are not available to local public entities in distress, the law allows those entities to terminate, amend, or assign the contract when it is considered in line with "social interests". It is submitted that, in a situation of financial distress, the notion of "social interest" is equivalent to ensuring the continuation of public services.

Therefore, we believe that all states considered in the study have geared their frameworks and actions to ensure that instances of substantive fairness (particularly the protection of vulnerable stakeholders) prevail over competing calls to ensure the procedural tenets of corporate insolvency law.

Nearly all the states considered in this study ensure the continuity of essential public services by preventing local public entities from being liquidated, as clearly stated under the laws of the USA, France and Belgium (amongst others). However, these two aspects are not

consequential. Essential services could be provided by neighbouring local authorities, which could hire some of the workers and purchase some of the equipment of the distressed local public entity. In other words, the resolution of the entity's financial distress could well take the form of a merger, pre-packaged sale, or scheme of arrangement with another entity. There is no valid reason to in principle prevent the dissolution of a local public entity in distress. In France, for instance, the law created a principle of last-resort state liability for the debts of legal entities governed by public law. In practice, the mergers mentioned above are processes for liquidating local public entities.

The Belgian report argues that dissolution could not be possible for the disruptive effects that such outcome would have on federal, state or other local authorities. This argument is legally flawed. It is the purpose of the law to provide mechanisms for the regulated administration of an entity in distress. Prohibiting liquidation is not the same as prohibiting insolvency, unless local public entities are also prevented from taking on any form of debt.

While preventing the dissolution of local entities might not be justified, there might be a case for ensuring that local entities are protected against executory actions promoted by their creditors, at least for the duration of the turnaround or restructuring efforts. However, provisions ensuring the suspension of individual proceedings against local public entities are not common under the laws considered in the study. The notable exceptions are, once again, the laws of the USA and Italy, which provide for an automatic stay against all collection actions against the debtor. South African law provides for similar relief in liquidation procedures only.

Despite the absence of general provisions or an automatic stay, the case studies discussed in this project do not evidence a generalised trend towards the depletion of the local public entity's assets before or during the collective procedures affecting local public entities in distress. This may be since some of the assets used by these entities belong to the state, and cannot be seized or sold by the entity's creditors (as is the case, for instance, in Belgium, France, Japan and the Russian Federation, amongst others).

### 3.4 Concluding remarks of the comparative analysis

Legislators are usually reluctant to disrupt contracts negotiated between the parties at arm's length. "Freedom of contract is the order of the day and the orthodox philosophy is that parties should live with the bargains they have struck."<sup>42</sup> Yet, the principle of continuity of public services encourages deviations from this narrative, when it is objectively fair to do it. The importance of promoting substantially fair and procedurally collective and rateable treatment of creditors is indirectly recognised by some national laws. These laws identify the principles of "continuity of public service" and transparency as general principles of public policy governing the treatment of these entities.<sup>43</sup> It does not provide legal certainty to have

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<sup>42</sup> D Milman, "The rise of the objective concept of "unfairness" in UK company law", *Company Lawyer* (2010) 286 1 at 1.

<sup>43</sup> The importance of this principle is also recognised at international level. See Council of Europe, "Recommendation No. R (97) 7 of the Committee of Ministers to Member States on Local Public Services and

cases, like the ones described in the Croatian report, where it is not clear how local public entities that were previously in serious financial distress have been given additional funds and rescued. These findings represent the foundations upon which we have provided a series of harmonised recommendations on the treatment of local public entities in distress.

#### 4. Recommendations

Despite notable exceptions (as in the case of Belgium), several commentators around the world have raised concerns that local public entities face various challenges in maintaining fiscal sustainability. These entities face escalating demands on resources due to inflationary trends and growing demand from an aging and poorer population, while simultaneously experiencing dwindling revenue-creating capacity. The absence of vision and purpose in dealing with distressed local public entities causes uncertainty among creditors and in the financial markets.

Several commentators also observed that the lack of an appropriate framework for dealing with local public entities in distress does not result in preventing these entities from going insolvent. It only results in unprincipled, last resort and *ad hoc* procedures featuring the intervention of a higher authority to cover existing debts with taxpayer money. The lack of a principled statutory framework for their treatment means that whether this assistance will actually be forthcoming, what form it will take, and any conditions that may be attached to it, are questions of politics rather than of legislative interpretation.

This system is neither efficient nor effective in ensuring the continuity of essential public services to local communities in a substantially and procedurally fair manner. It does not result in creditors being treated collectively and fairly. As a result, we believe that the states should reform their systems and opt for either of these two approaches, ranked in order of preference:

- (1) a special insolvency framework with options for liquidating, restructuring, or merging local public entities. Its rules should largely replicate the domestic procedures available to companies in distress and uphold the procedural tenets of corporate insolvency law. Deviations from these insolvency rules should only occur in order to protect vulnerable parties and reward the beneficiaries' contribution to the local entity (substantive fairness);  
or
- (2) a special administrative framework with options for liquidating, restructuring, or merging local entities. Its rules should uphold the procedural tenets of corporate insolvency law. These administrative rules should be designed to protect vulnerable parties and reward the beneficiaries' contribution to the local entity (substantive fairness).

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the Rights of their Users", available [here](#) (see, in particular, principle 3 entitled "continuity of essential services").

To achieve substantive fairness while not significantly departing from the procedural tenets of corporate insolvency law, we believe that the following recommendations should be implemented.

#### 4.1 General recommendations for dealing with local public entities in distress

##### 4.1.1 *Introduce a unitary definition of "local public entity"*

As mentioned in the introduction, definition matters. As observed by the Canadian commentator, the absence of a single coherent definition of "local public entity" or its equivalent precludes statutorily codified mission statements and defining elements. When this unitary framework is provided – such as in Italy, France or in Japan, where the notion of "local public entity" is found in their constitutions – it is important that the activity of local public entities is restricted in scope. When "local public entities" are allowed to provide products largely available in a competitive market beyond local users as any other for-profit company, the justification for any form of special procedure or treatment of these entities in distress disappears.

Despite the Italian commentator describing the possibility of agreeing on a unitary definition of "public entity" at the domestic level as "utopian", we believe that states should agree on an encompassing definition of local public entities<sup>44</sup> based on the functions they perform as well as on the ownership of the entity itself. In other words, national legislators should rely on institutional and functional approaches to the conceptualisation of public entities in law (see, for instance, the South African and Italian approaches).

The institutional definition should be qualified by the functional approach, as not all public entities are local or provide essential services. Local public entities should be seen as organs or agents<sup>45</sup> of the state, invested with public and regulatory (unless these powers are not needed for the performance of their functions) but not statutory authority.

Clear criteria should also be introduced to determine the notion and treatment of private-public partnerships when they are the sole providers of essential services in a given local community. There is a case for treating these entities in the same way as "traditional" local public entities considering the similar functions that they perform, even if some states (such as Uganda) apply "traditional" company and insolvency rules to these partnerships and companies and "special" rules to local public entities.

This study suggested distinguishing between basic and hybrid local public entities. Basic local public entities have been described as a public authority or entity partially or totally funded by tax levies which provides essential services (such as transport, education, social housing and care, hospitals, and utility services), not necessarily or not always at market price,

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<sup>44</sup> Italy, for instance, adopts a unitary definition of "local public entity".

<sup>45</sup> R C Picker and M W McConnell, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy", *University of Chicago Law Review* (1993) 60 425 at 427.

to local communities. Hybrid entities have been described as publicly or privately owned entities (including corporations) with varied sources of revenue and that carry out fundamental services or are responsible for the production or distribution of essential goods at local (territorial or regional) levels. These services must represent the prevailing business of these hybrid entities, must be provided at competitive prices, and another local authority or municipality must ultimately be responsible, legally or politically, for all or part of their debts. We suggest that these definitions could be used as model definitions by domestic legislators.

We acknowledge, however, that these definitions may not work for socialist economies (such as China), where (some) companies are still owned by the people, and where there is no conceptual difference in the powers exercised by state-owned enterprises and local public entities.

#### **4.1.2 *Limit political interference***

In non-unitary insolvency frameworks, states and regional authorities should be allowed to provide for mechanisms to assist financially distressed local public entities under pre-identified criteria (as in the case of Japan), to ensure public accountability procedural fairness. Significant interference from state and regional authorities may detrimentally affect the ability of the parties involved in these procedures to shape a satisfactory and agreed outcome of the case. It is welcomed, therefore, that in states such as Bangladesh the judiciary clarified that the central government cannot interfere in the functions ordinarily carried out by local public entities. Unfortunately, in Bangladesh these entities cannot be liquidated or rescued unless with the prior permission of the government.

In general, deviations from agreed and statutorily codified practices should be kept to a minimum, to ensure that the continuity of essential public services is not achieved at the expense of the other procedural tenets of insolvency law. Special treatments can be envisaged for those entities that are essential for the country's security, or for public policy reasons. However, it is envisaged that only few local entities may meet the stringent "national security" or "public policy" criteria mentioned above (for instance, in cases of large municipal transport systems).

What must be avoided at all costs is the perception that the legislative framework is unevenly applied, and that interventions from higher-ranking authorities are in practice entirely within those executives' discretion. This widespread perception – supported by empirical evidence from academic studies – may well explain why the South African advanced framework for the treatment of local public entities in distress performs poorly in practice.

## 4.2 Recommendations as to the guiding principles for dealing with local public entities in distress

### 4.2.1 *Strengthen the corporate governance framework*

As evidenced by several commentators, particularly from Nigeria and Ghana, the absence of fiscal autonomy is a major drawback to the development of a comprehensive framework for the treatment of local public entities in distress.

National states should strengthen the rules applicable to accounting standards and reporting for local public entities. National states should also enforce strict budget rules and put in place a system of independent checks and balances that allows independent parties to intervene in a timely manner when local public entities are deviating from balanced budgetary rules. As mentioned in the Chinese report, the establishment of effective credit systems and stricter lending rules can operate as a pre-insolvency system by preventing entities, including local governments, from becoming over-leveraged.

As it rightly happens in Ghana, these strict accounting and reporting rules should also apply to local state-owned corporations charged with providing essential services. More in general, if local public entities operate by means of companies or partnerships subject to traditional company laws, deviations from traditional accounting standards should be considered if the local public entities are directly or indirectly responsible for their debt, or if these companies and partnerships provide essential services to the local community.

There is evidence that stricter accounting rules result in financially wealthier local public entities. Where these strict rules are implemented and local public entities are granted either sufficient autonomy in setting their revenue (such as in Belgium and France) or predictable transfers from higher-ranking authorities, the financial situation of local public entities is generally good.

Cases like subsequent rescue deals negotiated by the mayor of London with the UK Department of Transport to keep the local transport company (Transport for London) afloat are to be avoided as much as possible. Where there is no pre-agreed and binding transfer plan, higher authorities have a perverse incentive to not negotiate long-term funding deals in order to exercise political control over local authorities. While this may at times be justified to keep labour costs under control, this practice has the unwanted effect of preventing the local authority from making long-term investment plans and improving the service provided to local communities. Lack of funds invariably results in lack of investment in environmentally-friendly policies, in safety hazards, in customers' dissatisfaction and in the need to agree on further emergency support at a later stage.

The accounting and reporting measures should be complemented by an expansion of the investigatory powers exercised by prosecution and independent authorities, to ensure that local managers are held accountable for gross misconduct, negligence, fraud, or

corruption.<sup>46</sup> These powers should be exercised by independent authorities, or at the minimum by civil servants from a higher-ranking public entity acting only to ensure compliance with the law, and not on merits, in order to avoid any claim of collusion or political use of statutory powers (thus, once again, affecting the public accountability facet of procedural fairness). Like the Croatian approach, egregious cases of breaches of accounting rules should result in civil and criminal liability for the perpetrators. Croatian law also dictates that, if the failure of the local public entity is due to political interference by another local public entity, the latter can be held accountable for any damage caused to the distressed entity.

There are states that have introduced effective measures to hold a local public entity's managers accountable. One of these is South Africa. In this country, the managers of these entities can reach rescue agreements with the entity's creditors. Once a rescue has been agreed to, the entity must report monthly to the provincial government on such implementation. If it fails to do so, the provincial government may dissolve the municipal council and appoint an administrator to oversee the management of the municipality until a new council is elected. While we are not sure of the need for monthly reports, it is certainly praiseworthy that monitoring mechanisms introduced by the law exercise significant oversight on managers, who are dealing with entities in difficult financial conditions.

An issue associated with effective corporate governance is the adoption of effective measures against corruption and collusion. These problems have been raised in several reports, particularly from African countries (see the Nigerian report). At European Union level, the Conditionality Regulation especially includes local public entities within its scope of application and provides for mechanisms to address instances of corruption and collusion in its member states, and thus to ensure the effective implementation of anti-corruption and anti-collusion frameworks.<sup>47</sup> Finally, it was welcome to observe that some countries hold municipalities accountable when a board forces hybrid local public entities to take unprofitable decisions that, eventually, lead to their insolvency. In the Russian Federation, for instance, the Supreme Court confirmed that municipalities can be held liable for the activities of hybrid entities created by them if these entities forced the controlled companies to supply services at under-cost and denied financial support when needed.

#### **4.2.2 Allow for the statutory liquidation and rescue of local public entities**

As a general principle, local public entities should be allowed to be liquidated or dissolved, without this affecting the provision of essential services to local communities.<sup>48</sup> This is what

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<sup>46</sup> In this regard, see the United Nations Convention Against Corruption (New York, 2004), arts 10 and 11.

<sup>47</sup> Conditionality Regulation 2020/2092 of the European Parliament and of the Council of 16 December 2020 on a general regime of conditionality for the protection of the Union budget, OJ L 433I, 22.12.2020, p 1-10, recital 8, art 2(b) (scope of application), and art 4(1) (about addressing breaches with a "seriously risk [of] affecting the sound financial management of the Union budget or the protection of the financial interests of the Union").

<sup>48</sup> We acknowledge that this principle may be controversial, especially for states such as Germany that have included in their Constitutions the principle of "continuity of municipal entities" (German Constitution, art 28(2)). This article does not secure the existence of an individual municipality. In principle, care must be taken



happens in some of the countries analysed in this study, such as France and the Netherlands,<sup>49</sup> amongst others. Other countries, such as China, are considering the introduction of such system in their insolvency laws.

This special framework should be largely based on the rules applicable in the corporate field, even if some deviations from mainstream corporate rules may be needed to ensure substantive fairness and the protection of vulnerable parties. We find it preferable not to introduce either special administrative frameworks, even if this approach has proven successful in some countries such as Italy, or special procedures applicable only to local public entities. Despite this, some states, such as the Russian Federation with interim financial administration and the UK with section 114 notices, have introduced special procedures applicable only to local public entities in distress. These administrative rules are still preferable to a framework where the state is called to bail out entities unable to service their debts.

It is also important that the power to liquidate and rescue local public entities is exercised when needed and is not subject to political interference. In Ghana, for instance, state-owned enterprises that provide public services are subject to “traditional” insolvency procedures. However, in recent times there had only been one recorded case of a state-owned enterprise pushed into formal liquidation (*Ghana Airways*). In that case, the government was forced to push the company into liquidation because its international creditors started seizing its planes abroad.

The need to ensure the continuity of public service may justify deviations from the principles of procedural collectivity and equality of treatment among creditors. One such deviation may, for instance, apply to the role of general creditors in these procedures, as in the case of South Africa, thus affecting the dignitarian facet of procedural fairness. This is because, in ensuring that essential services are provided, local authorities may make decisions that are against the best interests of the creditors. Therefore, it is unlikely that the creditors would ever approve such decisions.

However, these deviations from the general statutory rules applicable to “traditional” insolvency procedures need to be outlined by the law, rather than applied on an *ad hoc* basis. In other words, states may resort to the traditional rescue procedures under their laws to promote a settlement among the entity’s creditors or the adoption of a rescue plan. Mergers with other local public entities should be encouraged as a mechanism to reach a settlement with the creditors and ensure the long-term viability of the distressed entity, even if this may lead to further legal complexities.<sup>50</sup> In other words, deviations from dignitarian fairness should be instrumental to achieving institutional and substantive fairness.

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to ensure that that the needs of the community can be met. However, this could also be done by reorganising the administrative tasks as a result of the entity’s reorganisation or merger with a different one.

<sup>49</sup> For the Netherlands, this is limited to hybrid local public entities. As mentioned above, basic entities could in theory be liquidated but in practice, they are subject to special administrative provisions designed to restructure their debt and ensure the continuity of public services.

<sup>50</sup> The Italian commentator observed that mergers may result in entities changing their legal status.

Besides the need to ensure the protection of public services, there is no compelling reason to deviate significantly from the established procedures applicable to corporate entities. In countries like France, public utility establishments which provide essential public services are still subject to general corporate insolvency and restructuring procedures. Their liquidation or merger with other authorities is regulated by the law and does not result in an interruption of public services. This could represent an effective approach for dealing with local public entities in distress. In countries like South Africa, there is a specific framework for local public entities (although these entities cannot be liquidated). Additionally, local entities that operate through companies can be rescued using the mechanisms available to private companies, with only minor amendments needed to ensure the continuity of public services.

The South African experience is particularly apt for the purposes of this study for the modular approach to local public entities in distress. Local entities are given wide latitude to deal with financial issues unless their solutions appear ineffective. They are then placed under the supervision of local authorities and only in the end, as an extreme solution, are they placed under the control of the central government. A similar approach is also followed under Italian law, as evidenced in paragraph 3.1.

#### **4.2.3 Deal with financial distress in a proactive way**

States should introduce in their laws mechanisms to encourage the early detection of signs of distress affecting local public entities. This could be done by pre-determining the amount of financial support that could be granted by higher authorities should the entities in distress decide to merge into a larger authority (as it happens in Belgium).

Mechanisms to financially support the entity should be pre-determined (to avoid political bargaining) and not dependent on the time of filing, as this money is designed to protect vulnerable users. Mergers should be incentivised because they generally result in lower fixed and administrative costs for the provision of essential services.<sup>51</sup> However, mergers are frequently not considered by the existing management, because they would result in the loss of their jobs. Together with incentives, states could foresee a system of disincentives for late filing, in the form of harsher fines for directors and auditors,<sup>52</sup> and mechanisms for their automatic displacement if they unreasonably delay the request of assistance.

It is important that the effectiveness of these measures is not hampered by conflicting provisions, for instance by the introduction of generally applicable management displacement mechanisms (discussed in paragraph 4.3.1). Especially when the local public entity's distress has not yet resulted in a situation of insolvency or when it has not been caused by the management's fraudulent or negligent behaviour, the existing management should be supported in taking the measures needed to restructure the entity's business (as it is

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<sup>51</sup> This is despite the existence of risks associated with mergers, such as more bureaucracy and less ability to tailor the service to the needs of the local population (amongst others).

<sup>52</sup> This is, for instance, what happened in the case of the collapse of Carillion, a public company involved in many public procurement contracts. In this regard, see K Makortoff, "KPMG to be fined £14m for forging documents over Carillion audit" (*The Guardian*, 12 May 2022), available [here](#).

usually the case in Belgium, Italy, and the USA). Equally, the local public entity's management should not be required to obtain pre-emptive state authorisation to file for collective insolvency or restructuring procedures, as this would disincentivise their use.

One way of promoting early filing is by means of a comprehensive package of relief measures for the distressed entity. These measures may well take the form of suspensions from executory actions, as evidenced in paragraph 3.3.3 above. Relief does not mean restricting the assets available for distribution for the benefit of the creditors. As correctly observed by the Russian Constitutional Court, this outcome is unsatisfactory to the extent that it creates the risk for abuse by local entities and allows public owners to shield themselves from most business-related liability.

An alternative approach could be to limit, under the law, the subsidiary liability of the state towards local public entities in distress. This is what happens in the Russian Federation, where the law provides that the higher-ranking entities shall bear subsidiary liability only for personal injury caused by the budget institution.<sup>53</sup> The issue, however, is not to deviate from this predicament for political reasons.

Other measures, such as compulsory mediation and conciliation procedures, could also be introduced under the law to deal with the local public entity's distress in a proactive manner. Another complementary approach consists in providing uniform provisions for interim financing, in order to ensure that private investors can support the restructuring efforts of the local public entities. This is, for instance, the approach followed by the Dutch legislator, which allows for new or interim finance to be acquired and protected during any of the insolvency and restructuring procedures available to hybrid local entities in distress.

The importance of these measures appears clearly from the Nigerian report. As creditors are not prevented from suing local public entities for executory actions, and in the absence of an insolvency framework dealing with local public entities in distress, the government is always forced to bail out local states and entities. Because the Nigerian system does not hold directors to account, the local public entities have a perverse incentive to exceed their budgets, knowing that the government will eventually "pay the bill". The same findings emerge from the Ghanaian report, although this report seems to suggest that effective negotiations between creditors and local authorities may result in a less frequent need for the national government to step in and support the local public entity.

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<sup>53</sup> However, this limitation is controversial, as the Russian Constitutional Court held in 2020 that such provision is unconstitutional to the extent that it excludes liability of the owner (eg, state or municipality) of the liquidated budget institution for its obligations arising from a public contract.

### 4.3 Recommendations as to the procedure for dealing with local public entities in distress

#### 4.3.1 *Support and train without necessarily displacing the existing management*

There is no reason to make rescue mechanisms conditional to the removal of the existing management, unless there is evidence that such management is responsible for gross mismanagement, negligence, fraud, or corruption, or they have otherwise proven unable to comply with legal obligations. Managing a local public entity is a complex task, and external managers from the private sector may not be familiar with the way that the entity operates. Special commissioners (as in Germany), private managers or qualified practitioners (as, for instance, in the Ugandan experience) may nevertheless be useful to support, supervise and suggest innovative ways to deal with the local public entity's distress. If these professionals are allowed to provide assistance to local public entities in distress, the law should clarify their duties and responsibilities to ensure that these professionals will not replace democratically elected officials in carrying out their core functions and duties.

An example of such approach is the practice in the USA, evident in some states, of appointing emergency managers or oversight boards to assist the distressed debtor. Another good example is the Belgian approach, which provides a more stringent form of "special" oversight and a "coercive supervision" (with a management-displacing component) only where the general or special oversight had proven ineffective. Japan follows a similar approach, with a system of "yellow" and "red" cards based on the magnitude of the local public entity's debt and distress. Neither in the case of a yellow nor in the case of a red card is the local public entity's management displaced in favour of external managers or administrators.

These success stories should be replicated where possible, provided that the costs of providing professional assistance are kept at reasonable levels. If management is displaced, there is the need to ensure that such decision is taken by independent parties. Such decision could, for instance, be taken by a pool of public managers, trained to deal with situations of financial distress. "Training" is a key word, as many reports evidenced the need for more experienced managers to deal with public finance. Trained local public entity managers and distressed specialists are likely to ensure a higher level of accountability and compliance with national and local roles, as well as to reduce the need for external financial support from other authorities.

Administrative oversight (implemented in countries such as Italy and the Netherlands) may prove more cost effective, but less efficient in terms of outcomes, as public authorities may refrain from taking the tough decisions that are needed to deal with the local public entity in distress. Unlike the Netherlands, the large number of recurring filings in Italy seems to suggest that independent oversight is preferable to administrative oversight. Equally, states should explore the use of alternative dispute resolution mechanisms to facilitate negotiations with the local public entity's creditors.

However, one commentator from a country where the existing management is not displaced in such procedures (South Africa) doubted the wisdom of retaining failed leadership in the

municipalities. In some of the examples provided in that report, it was apparent that more effective and successful rescues had been implemented when the existing management was displaced in favour of externally appointed administrators. The report shows that, in reality, there had been several cases of ineffective co-operation between the existing management and the supervisory administrator. Therefore, we argue that the solution lies in introducing incentives to make this co-operation more effective. Some of these incentives may also include a harsher treatment of the existing management in case the local public entity's distress was worsened by their lack of co-operation with the externally appointed supervisor.

#### **4.3.2 *Limit court involvement***

If court involvement is envisaged under national law and the state opts for a revised insolvency system applicable to local public entities in distress, it appears sensible to give jurisdiction to the same courts responsible for company insolvency procedures. There is no need to provide courts with additional supervisory or discretionary powers to deal with local public entities in distress, as the goal of ensuring the continuity of public services can be achieved without special powers being granted to judicial authorities. If states opt for a revised administrative framework applicable to local public entities in distress, there is a case for giving jurisdiction to special administrative courts, provided that these courts already deal with all matters related to local public entities (as it happens in countries like Italy).

A corollary of the limited court involvement in these procedures is that more power should be given to independent practitioners. In the country reports considered for this study, it is clear that states rely on different types of private and administrative professionals (that is, public employees) to support local public entities in distress. While not advocating for uniform solutions on this matter, it may be worth exploring if existing local, independent and qualified insolvency practitioners are able to efficiently and effectively support the drafting of a restructuring or liquidation plan for a local public entity in distress while not adding excessive costs to the procedure.

Some countries like Belgium, Italy and the Russian Federation, have well-established mechanisms of administrative oversight for local public entities in distress. If these mechanisms work well in practice, they represent a useful tool to improve the accountability of local managers and reduce the risks of moral hazard. However, we argue that such solutions may increase the complexity of the insolvency framework. As a result, we argue that it is preferable to rely on existing corporate rescue procedures, and to tweak them in light of the peculiar needs of local public entities and their vulnerable stakeholders.

#### **4.3.3 *Protect vulnerable parties and local investors***

Even if local public entities are frequently rescued, deviations from the principles of collectivity and equality of treatment should not happen on an *ad hoc* basis. The circumstances where deviations are possible should be institutionalised in the law. The exceptions to the general procedural principles of insolvency law should be designed to protect vulnerable and non-adjusting creditors, as well as local investors. This is because - as

evidenced in paragraph 2 of this preambular chapter- “collectively”<sup>54</sup> taxpayers are both contributors to these entities and the beneficiaries of local services. As a result, substantive fairness requires that their interests are prioritised over those of other claimants. In no case should the implementation of “traditional” or administrative rescue and liquidation mechanisms have the effect of not ensuring the continuity of essential and effective public services at reasonable costs for local users.

## 5. Concluding remarks

This critique has sought to draw on the rich materials that the country reports have produced to provide guidance to practitioners and make recommendations for minimum standards of regulatory reform. The material is extremely varied, and it reflects the local culture of the jurisdictions considered in the study. Some jurisdictions have extremely sophisticated frameworks, which feature concepts such as cram-down of dissenting classes of municipal creditors, at a time where other countries only recently or have yet to introduce such option for corporate creditors.

It is hoped that this analysis of the key themes covered in the country reports has gone some distance to show that, despite the policy concerns about preservation of value in the context of the treatment of local public entities in distress, powerful arguments can be made for the promotion of unified principles for the treatment of local public entities in distress.

Despite the significant disparities in the treatment of local public entities across national jurisdictions, we argue that there are powerful reasons not to deviate from the “traditional” procedural pillars of collectivity and rateable treatment of creditors in dealing with the distress of these entities. However, states should implement mitigating measures to ensure the provision of essential public services at reasonable levels and cost. This is because substantive fairness plays a prominent role in the treatment of local public entities in distress, as evidenced in paragraph 2. The domestic legislators should acknowledge that substantive fairness is a guiding principle for the treatment of local public entities in distress. They should also acknowledge that, in case of conflict with the procedural principles of collectivity and rateable treatment of creditors, the need to ensure the provision of essential services and protect the beneficiaries of such services should prevail.

Rather than suggesting an optimal or model procedure for dealing with these entities, this preambular chapter leaves to national legislators the *onus* of devising principled judicial or administrative procedures for dealing with local public entities in distress. The comparative and comprehensive nature of this collection of chapters may represent the starting point to promote a national debate on the strategies to be followed in reforming local laws based on the recommendations provided above.

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<sup>54</sup> The word “collectively” is used to show that there might not necessarily be direct symmetry between taxpayers who rescue a local public entity and taxpayers who benefit from its services. If state funds are used to rescue such an entity, taxpayers from different entities will contribute to the provision of services that they never use.

There is no one-size-fits-all approach to deal with the challenges discussed in this preambular chapter. That is very much because the approach followed by one jurisdiction may not work well in another. For example, the question of what constitutes an “essential” public service may well vary from jurisdiction to jurisdiction, and even from locality to locality.<sup>55</sup> Further, the fact remains that whether we are referring to a civil law country or a common law one, insolvency law interacts and intersects with different established laws – both private and public.<sup>56</sup> That means any solution, whether simple or complex, is likely to produce a knock-on effect elsewhere in the wider body of law.

It is thus enriching for practitioners, policy makers and scholars of insolvency law to experiment with good practices elsewhere, while keeping an eye on the wider legal tapestry. The challenges we face are global, but uniform global solutions are unlikely to be achieved in the short term and may in any case be inadequate to deal with local issues. This is the main reason we advocate that, in determining the rules applicable to local public entities in distress, domestic legislators should pursue territorial solutions based on the uniform, “traditional” principles of collectivity and equality of treatment of creditors. Deviations from these founding pillars should be granted only when necessary to ensure the continuity of public services.

In closing, the editors are especially grateful to the project team for their sterling, accurate and timely work in producing such a readable volume of often technical material. This preambular chapter covers literature and case law published before 1 May 2022. The usual disclaimer applies.

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<sup>55</sup> M W Anderson, “The New Minimal Cities”, *Yale Law Journal* (2014) 123 at 1118-1223.

<sup>56</sup> J-B Auby, “Public/Private” in P Cane *et al* (eds), *The Oxford Handbook of Comparative Administrative Law* (Oxford University Press, Oxford, 2020) at 467-480.

## Local public entities in distress - a critical analysis of the Argentinian approach

By Sergio Díaz Ricci,<sup>\*</sup> Gabriela Ábalos<sup>\*\*</sup> and Héctor José Miguens<sup>\*\*\*</sup>

### 1. Introduction

The purpose of this study is to present the legal framework applicable to Argentine local public entities facing financial difficulties.

Municipalities are Argentina's local public entities, and are necessary entities in the Argentine federal system. Therefore, in the event of an economic-financial crisis, the insolvency or bankruptcy procedures for the private sector in terms of Argentine legislation are not applicable to municipalities.<sup>1</sup> There is however no general procedure determined by law to aid Argentine municipalities in navigating financial crises.

#### 1.1 Legal nature

In contrast to the model in the United States, the Argentine federal model is based on three levels of territorial power division: the national state, the provinces (including the autonomous city of Buenos Aires) and the municipalities.

The federal state has nationwide powers, allowing it to legislate and control defence, foreign affairs, customs, and common legislation throughout Argentina. The 24 provincial states (which together make up the entire national territory) have residual powers circumscribed to their respective provincial limits. The municipalities make up the third level of government and have powers relating to local interests. Their authority is limited to the spatial scope individually delimited by the provincial law of their creation in each particular case.

Therefore, municipalities are one of the three necessary levels that make up the Argentine federal system. Municipalities are constitutional subjects of the federal state together with the national state and the provincial states. Each municipality is created by a provincial state that establishes a provincial law. As necessary subjects of the Argentine federal system, municipalities are of a public nature. Due to their public nature, municipalities will not be liquidated in the event that they are financially distressed, but will be returned to

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<sup>1</sup> A municipality's financial distress is to be addressed by public law; therefore, the National Bankruptcy Law (Law 24.522/1995, as amended by Law 26.684/2011) is not applicable to municipalities as they are not amongst the subjects included (National Bankruptcy Law, art 2).



solvency through the utilisation of mechanisms that are analogous to those used by federal and provincial states in times of distress.

Municipalities are constitutional subjects formed by the federal Constitution, and are imposed on the provinces as a federal mandate. Each provincial state is obliged to incorporate and regulate in its local constitution the regime that regulates the mode of creation, the model of government organisation, and the competences assigned to the municipalities that it creates in order to manage local issues, which is guaranteed by the federal Constitution.<sup>2</sup>

Because municipalities are of a constitutional nature, they must exist. This means that a province is prevented from absolutely prohibiting the presence of municipalities or totally eliminating them from its internal structure, either by local constitutional provision or by local legislative decision. These prohibitions apply even when a municipality is experiencing economic or financial loss. Once a municipality has been created, it cannot cease operating through the actions of those controlling it. However, under provincial law, a municipality can be divided into several municipalities or merge with others to form a larger one.

A municipality is democratically governed, meaning that its authorities (a mayor with executive function and a deliberative council with normative functions) are elected by popular vote. There are even municipal political parties.

Argentine local public entities are subject to public law and governed by federal and provincial constitutional and provincial public law. The new Civil and Commercial Code (Law 26.994/2014) recognises this in article 146 by dictating that “[p]ublic legal entities are:...the National State, the Provinces, the Autonomous City of Buenos Aires, the municipalities, the autarchic entities and the other organisations established in the Republic to which the legal system attributes that character”. Therefore, the rules governing the legal relationships of private persons are not applicable to municipalities. Article 147 of the new Civil and Commercial Code makes this clear by dictating that “[p]ublic juridical persons are governed as to their recognition, beginning, capacity, operation, organization and end of their existence, by the laws and ordinances of their constitution”. As mentioned previously, in cases of insolvency, the judicial procedure of the National Bankruptcy Law (Law 24.522/1995, as amended by Law 26.684/2011) does not apply since municipalities (and provincial states) are not amongst the subjects included in the list of entities subject to the National Bankruptcy Law.

## **2. Local public entities - regulatory framework**

Under the Argentine constitutional system, the federal state ensures that the provinces guarantee, within their local constitutional order, the autonomous municipal regime. However, provinces determine the concrete local configurations of the municipal

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<sup>2</sup> Federal Constitution, arts 5 and 123.

organisations under their jurisdiction. Accordingly, provincial constitutions dictate the competences, organisation, categories, and other matters regarding municipalities. The terms relating to municipalities vary between provinces.

The framework governing municipalities stems from the federal Constitution, the provincial constitution where the municipality is located, the organic law of municipalities, the law creating the municipality, and the municipal charter.

## 2.1 Federal Constitution

The municipality as an entity of local management in Argentina was created in 1853 with the sanction of the federal Constitution (the third oldest text in force in the world after that of the United States and Norway). The federal Constitution made it mandatory for provincial states to establish a municipal regime to take care of local interests.<sup>3</sup> Following the provision's enshrinement within the federal Constitution, it was made mandatory for the 14 provincial states that existed at the time to ensure that their provincial constitutions facilitated and effected the existence of this type of entity for the management of local affairs. The modality of the municipal regime was left in the hands of each province, and there is thus a variety of configurations of municipalities in the different provinces. Some provinces have a strong municipal tradition (meaning that it has traditional legal status due to being in existence for a long time, such as Córdoba and Santiago del Estero), whilst other provinces rely less on their municipalities (such as Tucumán and the province of Buenos Aires (not the autonomous City of Buenos Aires) that has 135 districts (these are municipalities that together cover the entire provincial territory)).

The institutional position of the municipality was reinforced by the 1994 reform of the federal Constitution. The reform took a step forward by requiring that: "[E]ach province dictates its own constitution, in accordance with the provisions of article 5, ensuring municipal autonomy and regulating its scope and content in the institutional, political, administrative, economic and financial order".<sup>4</sup> The federal Constitution only requires provinces to assure the perpetual and unchallengeable existence of municipalities as territorial entities within each province and provides that they must be endowed with municipal autonomy. The federal Constitution does not contain any further provisions in this regard as it is up to each provincial state to determine its institutional structure.<sup>5</sup>

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<sup>3</sup> Federal Constitution, art 5. At that time, no province had established a municipality. After 1853, the first municipalities were created in the province of Santa Fe by provincial law in 1858, in the city of Rosario in 1860 and in 1868 in the province of Tucumán. Only in 1876 was a municipal regime established in the city of Buenos Aires (see CM Gorla, "Evolución histórica del régimen municipal en Argentina" (CONICET, 2007) available [here](#)).

<sup>4</sup> Federal Constitution, art 123.

<sup>5</sup> The 1994 reform attributed the autonomous city of Buenos Aires a status analogous to that of a province. However, the autonomous city of Buenos Aires does not contain municipalities, but it does contain several "neighbourhoods" (*Comunas*) within it for administrative and organisational purposes.

The Argentine Supreme Court of Justice recently made a distinction between the content and scope of municipal autonomy and dictated that:<sup>6</sup>

“[B]y explicitly enshrining its autonomy, the Constitution of 1994 differentiated the contents and the scope of such status. The contents are exhaustive and comprise the institutional, political, administrative, economic and financial spheres; the scopes, which make up the variable perimeter corresponding to each content, were delegated to the proper regulation of provincial public law. The determination of the aforementioned “contents” prevents autonomy from being reduced to a mere grandiloquent literary formula but, in practice, empty of meaning (Fallos: 341:939, Considerando 6; Fallos 343:1389); the “scopes” corresponding to each content may have a greater or lesser extension, depending on several factors (amount of population of the municipality, regional incidence, character of provincial capital, etc.), but in no way may they be so minimalist as to frustrate the content they regulate.”

In short, the powers afforded by the federal Constitution to a municipality cannot be reduced by the provinces to such an extent as to make municipal autonomy (one of the *Wesensgehalt* of this institutional guarantee) impossible in practice. Consequently, provinces are not only responsible for modulating the scope of these contents without abolishing them, but they are further obliged to support the existence of their municipalities in cases of crisis. This study will thoroughly analyse the protection of municipalities in times of crisis.

## 2.2 Provincial constitutions

The distribution of powers between the federal and provincial governments is governed by the federal Constitution which provides that: “[T]he Provinces retain all powers not delegated to the national government”.<sup>7</sup>

In line with these federal parameters, it is the responsibility of each province to design the municipal model to be adopted as, in terms of constitutional law, it is a matter reserved for provinces. The federal Constitution does not make further provision in this regard, as all municipal issues are matters of provincial constitutional law and local (provincial) laws.

Each province is thus responsible for guaranteeing an autonomous municipal regime (that is, one that allows municipalities to manage their activities without interference from the provincial state). The principle of democratic legitimisation of the municipal authorities by popular election of the inhabitants is thus imposed.

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<sup>6</sup> *Caso Municipio de La Rioja s / Casación*, CSJ 1490/1491/\*2018, RH 1, of 17/02/2022).

<sup>7</sup> Federal Constitution, art 121. It embodies the principle introduced in 1791 by Amendment X to the Constitution of the United States.

The federal Constitution states that the provinces may dictate their constitutions with freedom of institutional configuration and elect their authorities without the intervention of the federal government.<sup>8</sup> As previously discussed the provinces are compelled to establish municipal entities for the management of local interests,<sup>9</sup> and additionally, the federal Constitution<sup>10</sup> further seeks to ensure municipal autonomy and regulate the scope and content of the institutional, political, administrative, economic, and financial powers of municipalities.<sup>11</sup>

Each province can design its own model of municipal administration, although it must guarantee municipal autonomy in its different degrees - from the simplest (political-administrative autonomy) to the most intense (institutional autonomy, when the inhabitants have the power to dictate their municipal charter).

In short, within the territorial perimeter of a province, municipalities must exist, together with a provincial government, as public entities with their own territorial scope. Their geographic delimitation is established by provincial law, although juxtaposed to the provincial space, and their competences are reduced to the management of local interests.

In Argentina, these local public entities are regulated by provincial constitutions.<sup>12</sup> Therefore, within a provincial territory, there is a separation of functions between the provincial state and the municipality. On the one hand, a provincial state has jurisdiction within the territory of that provincial state, whilst, on the other hand, a municipality is in charge of the management of the local interests of a specific geographic area assigned to it by provincial law.

All of the constitutions of the 23 provinces contain, by necessity, provisions that regulate the scope of their municipal regime, and these provisions usually occupy an extensive part

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<sup>8</sup> *Idem*, art 122 provides that: "They have their own local institutions and are governed by them. They elect their governors, their legislators and other provincial officials, without the intervention of the federal government". (This article remained unchanged by the 1994 reform.)

<sup>9</sup> *Idem*, art 5 provides that: "Each province shall dictate for itself a Constitution under the republican representative system, in accordance with the principles, declarations, and guarantees of the National Constitution and [that] ensures its administration of justice, its municipal regime, and primary education". (This text was not modified by the 1994 reform, as it was prevented from doing so. However, art 123 was amended by the 1994 reform, as set out in the footnote *infra*.)

<sup>10</sup> *Idem*, art 123 provides that: "Each province dictates its own constitution, in accordance with the provisions of Article 5, *ensuring municipal autonomy and regulating its scope and content in the institutional, political, administrative, economic and financial order*" (the addition in italics).

<sup>11</sup> The interpretation of the CSJA, which, in 1989 in *Rivademar, Ángela v Municipalidad de Rosario (Fallos 312:326)*, affirmed the nature of the municipalities and their autonomy, was taken up to a great extent.

<sup>12</sup> The autonomous city of Buenos Aires is not included, as although it is a "constitutional autonomous city" occupying a territory of 22 000 hectares of urban nature, it does not contain municipalities in its interior (like New York). However, it is internally divided into districts (called *barrios* for administrative purposes) that are not overseen by municipalities - it is a federated city without municipalities in its interior.

of the constitutional text.<sup>13</sup> Typically, several chapters are dedicated to establishing the basic points of a province's municipal regime. A constitution will generally contain provisions setting out how to establish municipalities, the urban or territorial extension of the municipalities, categories of municipalities according to the number of inhabitants, the resources allocated to the municipalities, the basic structure of a province's government, and a list of local competences allocated to the municipalities (which list is non-exhaustive).

In general, a province's governmental structure follows the presidential model of an executive department and a deliberative council directly elected by the vote of the residents. There is no local judicial power, meaning there are no municipal judicial magistrates, since the judicial function is in the hands of the provincial state. Even though some municipalities have established misdemeanour courts, these are not of a judicial nature but are administrative tribunals that review misdemeanours, restrictions, or administrative sanctions imposed by a municipal authority (the purpose of which is to guarantee a municipal resident access to an impartial body to oversee a due legal process).<sup>14</sup>

The municipality has competencies of a local nature, usually indicated in the provincial constitutional texts.<sup>15</sup>

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<sup>13</sup> The following Constitutions may be consulted: Province of Buenos Aires/1994 (arts 190-197); Province of Catamarca/1988 (arts 244-262); Province of Chaco/1994 (arts 182-206); Province of Chubut/1994 (arts 244-245); Province of Córdoba/1987-2001 (arts 190-197); Province of Corrientes/2007 (arts 216-236); Province of Entre Ríos/2008 (arts 229-256); Province of Formosa/2003 (arts 177-186); Province of Jujuy/1986 (arts 178/196); Province of La Pampa/1994 (arts 115-124); Province of La Rioja/2008 (arts 168-174); Province of Mendoza/1916 (arts 197-210); Province of Misiones/1988 (arts 161-171); Province of Neuquén/2006 (arts 270-298); Province of Río Negro (arts 225-240); Province of Salta/1986-1998 (arts 170-183); Province of San Juan/1986 (arts 239-255); Province of San Luis/2006 (arts 247-280); Province of Santa Cruz/1998 (arts 140-154); Province of Santa Fe/1962 (arts 106-108); Province of Santiago del Estero/2005 (arts 204-223); Province of Tierra del Fuego/1991 (arts 169-187); and Province of Tucumán/2006 (arts 132-143).

<sup>14</sup> The decisions of these administrative tribunals can always be reviewed before the provincial courts.

<sup>15</sup> See the Constitution of Córdoba, art 186 which lists the municipal competences: "The following are functions, attributions and purposes inherent to the municipal competence: 1. To govern and administer local public interests aimed at the common good. 2. To politically judge the municipal authorities. 3. To create, determine and collect economic-financial resources, prepare budgets, invest resources, and control them. 4. To administer and dispose of the assets that make up the municipal patrimony. 5. To appoint and remove municipal agents, guaranteeing the administrative career and stability. 6. To carry out public works and provide public services by itself or through private parties. 7. To attend to the following matters: sanitation; health and assistance centers; hygiene and public morality; old age, disability and homelessness; cemeteries and funeral services; building plans, opening and construction of streets, squares and promenades; design and aesthetics; roads, traffic and urban transportation; use of streets and subsoil; construction control; environmental protection, landscape, ecological balance and environmental pollution; To establish and foster institutions of intellectual and physical culture and educational establishments governed by ordinances in accordance with the laws on the subject; tourism; social welfare, social assistance and banking services. 8. To establish and promote policies to support and disseminate cultural, regional and national values; in general. To conserve and defend the historical and artistic heritage. 9. To regulate the administrative procedure and the system of misdemeanours. 10. To establish restrictions, easements and to qualify the cases of expropriation for public utility in accordance with the laws that govern the matter. 11. To regulate and coordinate urban and building plans. 12. To publish

Although a municipal entity is guaranteed by the federal Constitution and the scope of its competences and its most relevant features are regulated in each provincial constitution, a municipal entity's existence and organisation depend fundamentally on the enactment of two provincial laws: (i) the special law of creation of each municipality and (ii) the general law regulating the organisation and functioning of all municipalities (usually called the "organic law of municipalities"). The provincial tax and budget laws that regulate and provide financial resources to the municipalities are also of crucial importance in allowing municipalities to operate.

### **2.2.1 Special law of creation**

The creation of a municipality depends on the sanction of a special law by the provincial legislature that provides for the creation of a municipality and determines precisely the territory assigned to the municipal jurisdiction. Every municipality has an individual law creating it.<sup>16</sup>

In some provinces, an entire provincial territory is overseen by municipalities, each of which has its own territory. Other provinces only recognise urban municipalities, and provinces that do so retain provincial jurisdiction over the territory not occupied by municipalities. It is up to each provincial constitution to establish either a territorialist or urban municipality geographic model.

An Argentine municipality cannot be assimilated to the concept of "county" used in the Anglo-Saxon world (some North American counties<sup>17</sup> contain municipalities within them, whilst some cities, such as New York, are divided into counties). Although the formation of the counties in North America depends on the constitution of each state (unlike the Argentine model), many of them were pre-existing and were created by what Tocqueville terms element "community spontaneity".<sup>18</sup>

### **2.3 Organic law of municipalities**

The provincial regulatory regime contains a general law on municipalities, usually called the "organic law of municipalities", which is issued by the provincial legislative branch and develops more detailed aspects of how a province organises its municipalities. This law establishes different categories of municipalities (although sometimes the provincial constitution itself establishes categories), the structure of the various types of municipal

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periodically the state of its income and expenses and, annually, a report on the work carried out. To exercise the functions delegated by the Federal or Provincial Government, finally, an opening clause is always included as clause 14. To exercise any other function or attribution of municipal interest that is not prohibited by this Constitution and is not incompatible with the functions of the powers of the State".

<sup>16</sup> It is very rare that a provincial constitutional text refers to a pre-existing municipality (eg Tierra del Fuego: Transitory Provisions 8, 9 and 15), although all of them establish the capital city where the provincial authorities must reside, which usually also has its own municipal regime.

<sup>17</sup> See the National Association of Counties available [here](#).

<sup>18</sup> A de Tocqueville, *De la démocratie en Amérique*, 1835/1840.

government (generally with a deliberative body or council), and an executive body (mayor) elected by vote of the inhabitants.

### **2.3.1 Provincial fiscal laws (tax and budgetary)**

Provincial fiscal laws are the provincial legal provisions on tax matters that affect the resources allocated to municipalities to carry out their functions.

Provinces obtain their resources from two sources: provincial tax collection and federal co-participation (a percentage of the national tax collection).<sup>19</sup> From the amount that the provinces receive from tax collection, a percentage is provided to the municipalities as second-degree co-participation. The percentage of the secondary co-participation that each municipality receives, in many cases, depends on the category assigned to it.<sup>20</sup> For instance, a first category municipality receives a higher percentage than a lower category municipality.

The impact of provincial tax laws is indirectly relevant<sup>21</sup> to distressed municipalities as tax collection by the provincial state constitutes one of the sources of municipal revenue. According to the principle of fiscal legality, provincial taxes must be established by law.<sup>22</sup>

Consequently, the municipal treasury is fed by two main sources: the co-participation that comes from the provincial state and the fees for municipal public services that the municipality receives from its residents. Municipalities may also receive special funds from the provincial and national governments specifically earmarked for certain local public works or services. They may also receive assets through donations from individuals, commercial companies, or public good entities.

## **2.4 Municipal charter**

Some municipalities enjoy “institutional” autonomy. The residents of municipalities with “institutional” autonomy can dictate their own municipal charter. The municipal charter is equivalent to a statute dictated by the community itself through an extraordinary assembly, made up of representatives elected by popular vote where they autonomously determine

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<sup>19</sup> The provinces receive a percentage of the co-participable mass (a set of taxes collected by the Nation) whereof they must allocate a portion to the municipalities (Law 23,548 on Federal Co-participation, art 9(g)). In this sense, some provincial constitutions and laws set a percentage on such federal co-participation that must be directly distributed amongst the municipalities that they oversee.

<sup>20</sup> The category levels are established by taking into account the size of the population that a municipality oversees, territorial extension, amount of municipal services, etc.

<sup>21</sup> The usual provincial taxes are real estate tax, gross income tax, stamp tax and motor vehicle tax, and the municipal taxes are traffic tax and vehicle patents. The municipal taxes are collected by the province in exchange for a lower percentage as a commission, in order to remit most of it to the municipalities.

<sup>22</sup> A discussion on whether municipalities have the capacity to charge taxes or only fees as consideration for services falls outside the scope of this study.

the organisational form and operation of a municipality, without the provincial state intervening.<sup>23</sup>

### 3. Economic-financial regime

Municipalities provide their municipal services and public work functions with resources obtained from their own revenues (taxes for services to neighbours or on certain economic activities within their jurisdiction) and from the fiscal provision received by the provincial state that they report to that is then contributed to them (secondary co-participation). Provinces may receive fiscal provision from the state's collection of, for example, motor vehicle tax or certain percentages of provincial fiscal resources. To a lesser extent, a municipality may receive contributions from the national treasury for certain specific works or special social plans.<sup>24</sup>

This capacity to carry out its economic and financial activity corresponds to the constitutional principle of economic autonomy, which guarantees the municipality the power to contract payment commitments for services or public works without the intervention of the provincial government.

The economic-financial turnaround of a municipality - as well as the provincial and federal state - may be effected by allocating funds to it from the municipal budget, which is annually approved by the deliberative council. Like all budgets, it is an advanced estimate of the resources to be received and expenses to be incurred, calculated for the following fiscal year (from 1 January to 31 December of each year).

A municipality must calculate how much its revenues will be in the following annual period; that is, it must approximate all of the funds that it will receive during the following fiscal year. Municipalities must also make a forecast of the expenditures that will be authorised for that period. As in all budgets, resources are usually calculated on the basis of those obtained the previous year.<sup>25</sup> Expenditures, due to the principle of fiscal balance, must correspond to the revenues expected for that year.

This calculation of expenses is based on the previous year's disbursements. Some expenses cannot be easily changed (such as payroll expenses, the expenses incurred to pay currently utilised services, etcetera), whilst others are contingent (such as expenses for public works projected for that year or commitments carried over from the previous year, multi-year works, etcetera).

When expenditure forecasts exceed revenue estimates, the budget will reflect a deficit. If a municipality's budget reflects a deficit, its budget must indicate how it intends to cover

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<sup>23</sup> There are 186 municipalities with an organic charter.

<sup>24</sup> E Arraiza (eds), *Manual de Gestión Municipal* (2<sup>nd</sup> ed, Konrad Adenauer Stiftung, Buenos Aires, 2019) at 70-88.

<sup>25</sup> In inflationary times, a corrective coefficient is usually included to consider increases in both resources and expenses because of the estimated inflation for that year.



this shortfall (through borrowing, issuing securities, setting new taxes, etcetera) in accordance with the principle of fiscal responsibility.

A draft annual budget ordinance must be submitted by a municipal executive department to a deliberating council. A council will analyse, deliberate on, and approves a municipal budget, which is then published in the Official Gazette.

Because annual municipal budgets are public, municipal fiscal accounts are known and accessible by any person. Whoever contracts with a municipality or grants it a loan cannot claim that it was unaware of, or lacked knowledge about, the financial state of the municipal entity that they have contracted with.

In short, the economic commitments assumed by a municipality have budgetary support derived from the specific allocation of fiscal resources that will be received during the period of one year. Therefore, every creditor of a municipality knows in advance whether a commitment has budgetary support.

Furthermore, municipalities, similarly to any other state entity, carry out their economic activity based on a financial administration system founded on the legal principle that no expenditure may be committed without the corresponding budget reflecting that commitment. In other words, if there is no prior budgetary item or if it does not have sufficient funds, a municipality cannot assume an economic commitment. As this is a general rule that does not admit ignorance, ignorance cannot be invoked. Internal accounting services (and external, if any)<sup>26</sup> are responsible for enforcing this essential condition of validity and, correlatively, may observe the conclusion of a fiscal commitment without the corresponding budgetary allocation.

A municipality has current expenses (salaries and current services such as electricity, water, gas, etcetera) that are unavoidable, and their payment is a priority due to their essential nature. Any other financial commitment agreed with third parties for public works or for the rendering of municipal public services must be supported by the corresponding budgetary forecast that constitutes a fiscal commitment to meet such purposes. As stated above, the municipality cannot validly assume these obligations without budgetary support.

In addition, any contract that involves a commitment of public funds is regulated by an exhaustive and normatively regulated public contracting system (accounting or financial administration, contracting, public works, and public employment ordinances). Any contractor of a municipality has access to this information. In addition, if a contractor in good faith assumes that its credit has budgetary support and complies with all of the applicable legal regulations, it is not the contractor's responsibility if a counterparty municipality fails to comply with the agreed payments.

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<sup>26</sup> Some municipalities are controlled by an external body: a municipal Court of Auditors (in Córdoba, Rio Negro and Santa Fe) and the provincial Court of Auditors (province of Chaco and Buenos Aires).

## 4. Insolvency situations

Notwithstanding the foregoing, municipalities may experience moments of non-compliance with obligations or payments. These situations could be once-off and temporary, or widespread and serious. Situations of this kind could originate in an unexpected retraction of resources to cover committed expenditures, or represent a high number of cases that break the budgetary balance in a sustained manner so that there are not enough resources to meet the commitments accrued in the future. The discussion that follows will firstly analyse the normal sporadic cases and then the situations of serious anomalous insolvency.

### 4.1 Normal cases: lawsuits for debts, liens for credits

Aside from situations of general, extended, and sustained cessation of payments, municipalities may be sued by creditors should they default on their debt payments in alignment with debts of any nature (salary or other debts).

Consequential to these non-payments, a municipality may be sued by judicial action to facilitate the collection of sums of money and may have their income (such as funds in bank accounts) or assets (vehicles, real estate in the private domain, securities in their possession, or other enforceable assets) seized so that a debt can be paid by judicial foreclosure. In this case, judicial execution is no different from any other judicial process of debt collection.

In some provinces, there are laws that set limitations on judicial orders against municipalities, providing, for example, that measures may not affect the provision of essential services such as the provision of public health services. Some provincial constitutions contain provisions for the seizure of municipal assets or resources.<sup>27</sup> In some cases, the absolute prohibition of seizure of revenues and assets required to conduct public works and services is established;<sup>28</sup> a seizable percentage limit is set;<sup>29</sup> a term for the execution of judgments is set;<sup>30</sup> or there are conditions for the inactivity of the municipality.<sup>31</sup>

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<sup>27</sup> See the provincial Constitutions of Córdoba, arts 178, 179 and 189; Catamarca, arts 41 and 258; Chaco, arts 76, 83 and 199; Chubut, arts 98 and 120; Corrientes, arts 20, 211 and 230; Entre Ríos, arts 46 and 248; Formosa, arts 34 and 183; Jujuy, arts 11 and 74(7); La Rioja, art 15; Mendoza, arts 40 and 202; Neuquén, art 156; Río Negro, art 55; Salta, art 5; San Juan, art 8; San Luis, arts 12, 78 and 276; Santiago del Estero, art 11; and Tierra del Fuego, art 80.

<sup>28</sup> See the provincial Constitutions of Catamarca, art 258; Chaco, art 199; Chubut, arts 98 and 120; Corrientes, arts 211 and 230; Mendoza, art 202(9); Tierra del Fuego, art 80; and Córdoba, art 179 (only for preventive seizures).

<sup>29</sup> See the provincial Constitutions of Entre Ríos, art 248 (providing up to 20%); Formosa, art 183 (providing up to 10%); Río Negro, art 55 (providing up to 20% of revenues); and Salta, art 5 (providing up to 25%).

<sup>30</sup> See the provincial Constitutions of Córdoba, art 179; Jujuy, arts 11 and 74(7); and San Juan, art 8.

<sup>31</sup> Provincial Constitution of San Juan, art 8.

These types of immunity clauses for municipalities raised questions about the constitutionality of the provincial rule of granting provinces or the municipalities under their jurisdiction the ability to create a prohibition on the seizure of assets. This matter was analysed by the Supreme Court of Justice of the Nation in *Dearborn Chemical Co. v Municipality of Rosario*,<sup>32</sup> which determined that, except in instances where judicial attachment represented an excessive percentage of the municipal revenues to the point of making the rendering of public services impossible, the measure must be prudentially limited to establish an annual quota.

In *Compañía Luz y Fuerza Motriz v Municipalidad de Córdoba*<sup>33</sup> the court declared the unconstitutionality of article 149 of the provincial Constitution of Córdoba, which provided that “[i]n no case may execution or seizure be made on municipal revenues”. The Supreme Court of Justice of the Nation takes a restrictive position on these types of powers of the provinces. In *S.A. Liebig's Extract of Meat Company v Province of Entre Rios*, article 30 of what was then the provincial Constitution of Entre Rios was questioned, and the Court stated that:

“Any provisions contained in local laws tending to remove from the action of creditors the assets, resources and revenues of the provincial State, contrary to the rights and guarantees granted by civil law, cannot be validly invoked, since the relations between creditor and debtor are under the exclusive legislation of the National Congress.”<sup>34</sup>

Since the precedent in *Filcrosa* was set,<sup>35</sup> the Supreme Court of Justice has maintained its position; and it did so most recently in *Municipalidad de Resistencia c/ Lubricom S.R.L. s/Ejecucion Fiscal*.<sup>36</sup>

## 4.2 Abnormal cases

It is possible to have a more general and extended municipal cessation of payments. This situation could arise due to an unforeseen drop in revenues (due to economic activity retraction), due to a municipality’s general inability to comply with salary obligations for its personnel, or with its accounts to its suppliers of services and public works.

<sup>32</sup> Fallos 182:229 of 26 March 1939.

<sup>33</sup> Fallos 188:383 of 29 November 1940.

<sup>34</sup> Fallos 284:458/1972. An extension or confirmation of this position can be seen in the case of *Volkswagen de Ahorro para Fines Determinados SA v Provincia de Misiones - Dirección General de Rentas y otros / demanda contenciosa administrativa* (Fallos: 342:1903 del 05/11/2019), which was decided by the same court as *Recurso de hecho deducido por la parte actora en la causa Montamat y Asociados SRL v Provincia de Neuquén s / acción procesal administrativa* (Fallos 343:1218/2020).

<sup>35</sup> Fallos 326: 3899.

<sup>36</sup> Fallos 332:2108/2009.

The remedies to address this type of municipal insolvency or bankruptcy situation in Argentina are as follows: (i) extraordinary provincial assistance, (ii) state of municipal economic-financial emergency and (iii) provincial intervention.

#### **4.2.1 Extraordinary provincial assistance**

Should a municipality face an economic crisis, it is the responsibility of the provincial government to which it is accountable to guarantee the maintenance and continuity of municipal services (salaries of municipal employees, local public services, etcetera).

The province does not assume the municipal debt but financially assists the municipality with either reimbursable or non-reimbursable contributions so that the municipality may face and overcome its financial distress. Such financial assistance is usually accompanied by provincial controls being enforced, such as freezing the number of personnel appointments or controlling the municipal public works or services plan. Therefore, the financial or economic imbalances incurred by a municipality are dealt with by a provincial treasury allocating it extraordinary support. A provincial government, due to its greater economic power, can cover the financial deficits or losses of a municipality.

Notably, if the provision of provincial control over a municipality in crisis is prolonged, it would seriously affect municipal autonomy since provincial control would have the effect of submitting a municipality to the rule of a provincial government, taking away its constitutionally guaranteed autonomy.

#### **4.2.2 State of municipal emergency**

Should a municipality be facing a very serious and widespread insolvency, it may resort to an extraordinary and exceptional *ad hoc* procedure: declaration of an economic-financial state of emergency. This is a *sui generis* procedure: declaring an economic and financial emergency by ordinance of a deliberative council or, exceptionally, by decree of a mayor.

An economic state of emergency is an extraordinary, exceptional, and temporary legal tool. A subject of state (national, provincial or municipal) that has declared such a state will formulate a public declaration of emergency that involves expressing that it is in an anomalous and transitory situation. Whilst it is in this situation, it is declaring that, in general, it is unable to normally comply with its obligations.

In order to be legally valid, an economic and financial emergency must be implemented by a declaration issued by the highest municipal regulatory body – a city council. Furthermore, it must be temporary and must not affect the essential content of the rights of the creditors of the municipality, and its implementation must be applied in a similar

way to the application of a national state of emergency by the Supreme Court of Justice of the Nation.<sup>37</sup>

In this regard, a state of emergency involves informing all creditors in a public, general, and reliable manner that a declaring municipality is unable to meet its financial commitments. It is essential that this emergency status, in addition to being declared publicly, is not only justified and proven but also temporary. It must be accompanied by a clear determination of the general measures that will be taken to overcome the crisis situation, including, for example, freezing the filling of vacant positions, extending the terms of overdue unpaid economic obligations, the compulsory transformation of monetary debts into public securities, or altering the modalities of compliance with outstanding benefits (known as "consolidation"). In short, there is a wide variety of modalities and compulsory modifications that must be clearly established by a municipal government itself in a general way so that all of its creditors are treated equally.

This modality of declaring a state of emergency, especially in economic and financial matters, has been repeatedly applied by the national government<sup>38</sup> and imitated by provincial states and municipalities in financial crises.

The following cases should be noted:

- (a) By Ordinance of the Deliberative Council: Municipality of Regina in the province of Rio Negro in 2020,<sup>39</sup> Municipality of Colonia Caroya in the province of Córdoba in 2020,<sup>40</sup> and Municipality of San Carlos de Bariloche in the province of Rio Negro in 2015;<sup>41</sup> and
- (b) By Resolution of the Mayor: Municipality of the City of Mendoza in the province of Mendoza in 2020<sup>42</sup> and Municipality of Rojas in the province of Buenos Aires in 2020. In some cases, courts invalidated the declarations of emergency.<sup>43</sup>

In several cases, a state of financial emergency dictated by a provincial state inevitably had an impact on municipal public accounts, which is why this type of law usually allows

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<sup>37</sup> See *Peralta, Luis A y otro v Estado Nacional (Ministerio de Economía - Banco Central)*" Fallos 313:1513/1990; *Bustos, Alberto Roque y otros v Estado Nacional y otros Fallos*: 327:4495/2004; and *Massa, Juan Agustín v Poder Ejecutivo Nacional - dto 1570/01 y otros s amparo ley 16.986"* Fallos: 329:5913/2006.

<sup>38</sup> Law 23.697 of 1989; Law 23.982 of 1991; Law 25.561 of 2002; and Law 27.541 of 2019.

<sup>39</sup> Available at <https://www.rionegro.com.ar/el-deliberante-de-regina-prorrogo-la-emergencia-economica-del-municipio-1720157/>.

<sup>40</sup> Available at [https://boletinoficial.cba.gov.ar/wp-content/4p96humuzp/2020/05/5\\_Secc\\_200520.pdf](https://boletinoficial.cba.gov.ar/wp-content/4p96humuzp/2020/05/5_Secc_200520.pdf).

<sup>41</sup> Available at <https://www.concejobariloche.gov.ar/index.php/informacion-institucional/novedades-del-concejo-municipal-de-bariloche/10428-se-aprobo-la-emergencia-economica-administrativa-y-financiera-de-la-municipalidad>.

<sup>42</sup> Available at <https://www.universidad.com.ar/la-ciudad-de-mendoza-se-declaro-en-emergencia-economica-y-financiera>.

<sup>43</sup> In 2007, the Superior Court of Justice of the Province of Misiones declared the declaration of a state of emergency of the municipality of Posadas invalid.

municipalities to adhere to the guidelines and mechanisms for reorganisation proposed by the legal regulations.

#### **4.2.3 Provincial intervention**

A provincial state is a guarantor of the operation of a municipality. Therefore, in the event of a deep and insoluble cessation of payments by a municipality, an extreme constitutional measure may be utilised: a provincial intervention of the operation of the distressed municipality that involves the temporary displacement of its elected authorities (mayor, councilmen (municipal legislators) and non-permanent officials). Each provincial constitution establishes the grounds on which an intervention may be made, and the relevant body (the governor of the province and its legislative branch) assesses the suitability of an intervention. Generally, a decision to intervene is implemented by the provincial legislature passing a law that results in the termination of the elected municipal authorities (mayor and / or city council), and they are replaced by an intervener. The aim of this temporary official is to balance the municipality's finances with extraordinary help from provincial resources. Once this objective is achieved, the intervener must call the municipality's residents to vote for a new mayor and / or city council to oversee the municipality.

## **5. Conclusion**

In short, there is no pre-established court insolvency procedure to address situations where a municipality faces insolvency, bankruptcy, or is failing to make payments that are due. In contrast, private parties facing financial distress may use insolvency procedures to make an arrangement with creditors, or some type of universal judgment that brings together creditors to receive a payment proposal from the failed entity. A municipality, by its nature as a public legal entity, is governed by *ad hoc* administrative law provisions. There is no law in the provinces that regulates, in a general and set manner, a process analogous to the reorganisation or bankruptcy proceedings for municipalities.

## Local public entities in distress - a critical analysis of the Australian approach

By Elizabeth Streten\*

### 1. General context of insolvency law

The insolvency of local public entities, generally called local governments in Australia, is arguably an under-researched area. Where it is considered, it is generally assessed outside of the general insolvency field and deliberated upon within the field of public governance. This is likely because insolvency of local governments is not regulated by the same legal framework as most corporate insolvencies, and local governments are subject to a different framework under local government legislation and authority, rather than under corporate insolvency legislation *per se*.

Insolvency laws themselves are fragmented in Australia. The country has a federal government system with powers split between the Commonwealth (federal) government and the different State governments under the Australian Constitution.<sup>1</sup> Due to its unique federalisation history surrounding colonisation, the Australian Constitution has defined federal powers.<sup>2</sup> Under the Australian Constitution the federal Parliament is granted the specific power, concurrent with each of the States, to make laws with respect to bankruptcy and insolvency.<sup>3</sup>

The bankruptcy of natural persons is not relevant to this project and is addressed in its own separate suite of legislation.<sup>4</sup> The Australian Financial Services Authority (AFSA), a Commonwealth federal government body, manages the application of bankruptcy and personal properties securities law.

The Corporations Act<sup>5</sup> is the principal legislation managing the liquidation and rescue of companies. There are also supporting provisions in the Corporations Regulations,<sup>6</sup> the Australian Securities and Investments Commission Act,<sup>7</sup> and the Insolvency Practice Rules (Corporations).<sup>8</sup>

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<sup>1</sup> R Mason, "Insolvency Academics Contributing to the Review of Insolvency Laws: An Australian Perspective", *Nottingham Business and Insolvency Law e-journal* (2015) 3 263 at 265.

<sup>2</sup> Commonwealth of Australia Constitution Act 1900 (Cth). The Federal powers are set out in s 51.

<sup>3</sup> *Idem*, s 51(xvii).

<sup>4</sup> Primarily the Bankruptcy Act 1966 (Cth); Bankruptcy Regulations 2021 (Cth); and Insolvency Practice Rules (Bankruptcy) 2016 (Cth).

<sup>5</sup> Corporations Act 2001 (Cth).

<sup>6</sup> Corporations Regulations 2001 (Cth).

<sup>7</sup> Australian Securities and Investments Commission Act 2001 (Cth).

<sup>8</sup> Insolvency Practice Rules (Corporations) 2016 (Cth).

External administration is addressed in Part 5 of the Corporations Act and winding-up in the case of insolvent companies is addressed more particularly from Part 5.4 onwards. The Corporations Act provides mechanisms for the appointment of receivers, voluntary administrators and liquidators. Registered insolvency practitioners are appointed to these positions. There are detailed processes regarding the registration and appointment of practitioners as receivers, administrators and liquidators, together with detailed processes regarding court involvement, creditor involvement, and provisions regarding the various stakeholders impacted by insolvency, such as employees and debtors. The Australian Securities and Investments Commission (ASIC), a Commonwealth (federal) government body, is Australia's corporate, markets and financial services regulator. ASIC regulates, amongst other things, corporate insolvency practitioners.<sup>9</sup>

In recent decades, there have been numerous inquiries and reviews of Australian insolvency laws and the regulation of Australian insolvency practitioners.<sup>10</sup> Some of these inquiries have deliberated upon the foundation of Australian corporate insolvency laws. In particular, the 1988 Harmer Report<sup>11</sup> set out nine guiding principles of contemporary insolvency law.<sup>12</sup> The Harmer Report contemplated that the essential purpose of Australian insolvency is the provision of a fair and orderly process for dealing with the financial matters of insolvents.<sup>13</sup> The report also makes reference to the relief of insolvents from liability, the need for creditor participation and the relevance of equality and support for the community.<sup>14</sup> In addition to serving the interests of creditors, the Harmer Report raises the importance of debtors and society in the administration of Australian insolvency law. However, the later 2010 Senate Enquiry is more creditor-focused; it argues that the role of insolvency law, being derived from the United Kingdom, is to protect the interests of creditors.<sup>15</sup>

After the 2010 Senate Enquiry, there were numerous legislative reforms to Australian insolvency processes and the regulation of Australian practitioners.<sup>16</sup> This was a time of

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<sup>9</sup> See ASIC's website [here](#).

<sup>10</sup> See for example the Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988); Commonwealth, *Review of the Regulation of Corporate Insolvency Practitioners: Report of the Working Party* (Ms Veronique Ingram, Chairperson) AGPS, Canberra, June 1997; Parliamentary Joint Committee on Corporations and Financial Service, Parliament of Australia, *Corporate Insolvency Laws: A Stocktake* (2004); and Senate Economics References Committee, Parliament of Australia, *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework* (2010).

<sup>11</sup> Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988), at 2.

<sup>12</sup> R P Buckley, "Commentary: The systemic benefit of insolvency law: a lacuna in the Australian literature", *Insolvency Law Journal* (2003) 11(1) at 38.

<sup>13</sup> Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988), at 2.

<sup>14</sup> *Ibid.*

<sup>15</sup> Senate Economics References Committee, Parliament of Australia, *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework* (2010) 1.

<sup>16</sup> The Insolvency Law Reform Bill 2013 was released as an exposure draft by the Attorney-General and Parliamentary Secretary to the Treasurer on 19 December 2012 seeking submissions by 8 March 2013. Almost two years later, the Insolvency Law Reform Bill 2014 was released as an exposure draft on 7 November 2014 seeking submissions by 19 December 2014. It then became the Insolvency Law Reform



significant disruption to the industry.<sup>17</sup> A major reform was the Insolvency Law Reform Act 2016 (ILRA). The ILRA, together with associated legislation and practice rules, amended amongst other things core aspects of corporate insolvency regulation and practice. Some of the main changes pertained to practitioners' legal responsibilities as set out in Australian federal corporate insolvency legislation.<sup>18</sup> The ILRA was passed in February 2016, but it had a staggered implementation with the first stage commencing on 1 March 2017 and the second stage on 1 September 2017. Further legislative changes took place in 2017 and 2018 with the commencement of a user-pay regulation levy,<sup>19</sup> "ipso facto" regulation impacting contractual creditor protections, and the commencement of regulation regarding "safe harbour" director protections.<sup>20</sup>

Apart from Covid-19 legislative responses, there have also been some other significant recent reforms in Australia – the Corporations Amendment (Corporate Insolvency Reforms) Act<sup>21</sup> commenced on 1 January 2021. This act established a new framework for small businesses with a new formal debt restructuring process, a simplified liquidation process and further measures available to eligible small business.

Local governments are different from companies: they are established and managed pursuant to local government legislation in order to deliver State / Territory local and regional priorities. In recent years there has been debate about the recognition of local governments in the Australian (federal) Constitution. There were attempts to amend the Australian Constitution to include such recognition by way of national referendums, including in 2013 with the Constitution Alteration (Local Government) Bill on the financial recognition of local government. However, no referendum has succeeded.

As a consequence of various concerns regarding alleged corruption, unsafe workplaces and financial distress, local governments have also been the subject of numerous public inquiries and investigations.<sup>22</sup>

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Bill 2015 before passing both Chambers of the Houses of Parliament and receiving Royal Assent as the Insolvency Law Reform Act of 2016.

<sup>17</sup> E Streten, "Insolvency Practitioners: A Phenomenological Study", *Insolvency Law Journal* 29(2) at 83.

<sup>18</sup> Corporations Act 2001 (Cth); Corporations Regulations 2001 (Cth); and supporting provisions in the Australian Securities and Investments Commission Act 2001 (Cth).

<sup>19</sup> The Australian Securities and Investments user-pay regime commenced on 1 July 2017. The relevant legislation, the ASIC Supervisory Cost Recovery Levy 2017 (Cth), received Royal Assent on 19 June 2017 after passing through both houses of Parliament on 15 June 2017.

<sup>20</sup> See the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017 (Cth). Provisions colloquially known as "safe harbour" commenced on 19 September 2017. The provisions colloquially known as "ipso facto" commenced 1 July 2018.

<sup>21</sup> Corporations Amendment (Corporate Insolvency Reforms) Act 2020 (Cth).

<sup>22</sup> See for example <https://www.parliament.nsw.gov.au/tp/files/77157/Balranald%20-%20Public%20Inquiry%20-%20Dismissal%20-%20Public%20Inquiry%20Report.pdf>; [https://www.dlgsc.wa.gov.au/docs/default-source/local-government/inquiries/report-of-the-inquiry-into-city-of-cockburn.pdf?sfvrsn=c0c343fa\\_3](https://www.dlgsc.wa.gov.au/docs/default-source/local-government/inquiries/report-of-the-inquiry-into-city-of-cockburn.pdf?sfvrsn=c0c343fa_3); <https://www.parliament.qld.gov.au/work-of-committees/committees/PCCC/inquiries/current-inquiries/InquiryCCCLCC2021>; <https://www.olg.nsw.gov.au/media-releases/public-inquiry-into-central-coast-council/>; and [https://www.regional.gov.au/territories/norfolk\\_island/public-inquiry-nirc/index.aspx](https://www.regional.gov.au/territories/norfolk_island/public-inquiry-nirc/index.aspx).

## 2. Local public entities

### 2.1 General position

This study focuses on local public entities (namely local governments in Australia), which are sometimes referred to as the third tier of government in Australia. As discussed above, Australia has a federal government system (called the Commonwealth government) which could be referred to as the first tier of government that provides laws for the entirety of Australia. There is a division of powers between the federal Commonwealth government and the various second tier State governments, which retain various law-making powers under the Australian Constitution.<sup>23</sup> There are six States (New South Wales, Victoria, South Australia, Queensland, Western Australia and Tasmania), and there are also two self-governing Territories (the Northern Territory and the Australian Capital Territory).

The treatment of local governments across the States and Territories is not uniform. However, each State has taken legislative steps to recognise local government in its State constitutions and has enacted a number of legislations establishing and governing those local governments. The Northern Territory also has a governing legislation. However, as a Territory, its power is limited to the power granted by the federal Commonwealth. Legislation relevant to the government of the Territories is set out in the Northern Territory (Self-Government) Act<sup>24</sup> and the Australian Capital Territory (Self-Government) Act.<sup>25</sup> The Australian Capital Territory is unique in Australia in that it does not have a separate system of local government.<sup>26</sup>

The regulatory framework for local government in Australia involves a Department of Local Government, at second tier government, a Local Government Grants Commission and ancillary regulatory bodies together with statutes in the form of a Local Government Act and supporting legislation.<sup>27</sup> The following is a list of the relevant second tier government constitutional recognition of local governments and the main governing legislations:

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<sup>23</sup> R Mason, "Insolvency Academics Contributing to the Review of Insolvency Laws: An Australian Perspective", *Nottingham Business and Insolvency Law e-journal* (2015) 3 263 at 265. Also see a visual diagramme of the levels of Australian government, available [here](#).

<sup>24</sup> Northern Territory (Self-Government) Act 1978 (Cth).

<sup>25</sup> Australian Capital Territory (Self-Government) Act 1988 (Cth).

<sup>26</sup> In this regard, see [here](#).

<sup>27</sup> B Dollery, S O'Keefe and L Crase, "State Oversight Models for Australian Local Government", *Economic Papers* (2009) 28(4) 279 at 280.

State / Territory	Constitution	Main governing act
Queensland	Constitution of Queensland (Qld) <sup>28</sup>	Local Government Act (Qld) <sup>29</sup> (the Queensland Act)
New South Wales	Constitution Act (NSW) <sup>30</sup>	Local Government Act (NSW) <sup>31</sup> (the NSW Act)
Victoria	Constitution Act (Vic) <sup>32</sup>	Local Government Act 1989 (Vic) <sup>33</sup> has been replaced by Local Government Act 2020 (Vic) <sup>34</sup> (the Victorian Act). It has been labelled the most ambitious reform to the government sector in over 30 years. <sup>35</sup> However, parts of the earlier act remain in force at the time of writing.
South Australia	Constitution Act (SA) <sup>36</sup>	Local Government Act (SA) <sup>37</sup> (the South Australian Act)
Tasmania	Constitution Act (Tas) <sup>38</sup>	Local Government Act <sup>39</sup> (the Tasmanian Act)
Western Australia	Constitution Act (WA) <sup>40</sup>	Local Government Act <sup>41</sup> (the Western Australian Act)
Northern Territory	Not applicable	Local Government Act <sup>42</sup> (the Northern Territory Act) which commenced on 1 July 2021.

The terminology for local governments is not always consistent across each of the above States and the Northern Territory. They are generally called “local governments”, “local councils”, “local government bodies”, and sometimes “councils”, but can also be called “municipal councils”. In the Northern Territory there are nine large regional councils and

<sup>28</sup> Constitution of Queensland 2001(Qld), Ch 7.

<sup>29</sup> Local Government Act 2009 (Qld).

<sup>30</sup> Constitution Act 1902 (NSW), Part 8, s 51.

<sup>31</sup> Local Government Act 1993 (NSW).

<sup>32</sup> Constitution Act 1975 (Vic) Part IIA, ss 74A-74B.

<sup>33</sup> Local Government Act 1989 (Vic).

<sup>34</sup> Local Government Act 2020 (Vic).

<sup>35</sup> See <https://www.localgovernment.vic.gov.au/council-governance/local-government-act-2020>.

<sup>36</sup> Constitution Act 1934 (SA) Part 2A, s 64A.

<sup>37</sup> Local Government Act 1999 (SA).

<sup>38</sup> Constitution Act 1934 (Tas) Part IVA, ss 45A-45C.

<sup>39</sup> Local Government Act 1993 (Tas).

<sup>40</sup> Constitution Act 1889 (WA) Part IIIB, ss 52-53.

<sup>41</sup> Local Government Act 1995 (WA).

<sup>42</sup> Local Government Act 2019 (NT).

within these there are 63 local authorities in remote communities.<sup>43</sup> The Australian Capital Territory has seven not-for-profit community councils (which are not local governments).<sup>44</sup>

Local governments are subject to oversight by the relevant Minister of Local Government across each State and in the Northern Territory, with the assistance of their office and appointed officers. The roles of local governments are described on websites across the States and the Northern Territory as making, executing and administering local laws or making significant decisions for local communities; they exist for the good rule and local government of their area.<sup>45</sup>

## 2.2 Laws across different States and the Northern Territory

The laws that apply to local governments differ between the various States and the Northern Territory in accordance with the provisions of the applicable Local Government Acts and associated acts and regulations. By way of example, some, but not all, have the ability to form organisations to provide local governments with a more efficient mechanism to serve their communities.

In New South Wales, there is the ability to form county councils, which may have functions comprising any one or more of the functions of the local government council.<sup>46</sup> There is also the ability to form or participate in the formation of a corporation or other entity, or acquire a controlling interest in one, in the circumstances detailed below.

In Queensland and Victoria, organisations called “beneficial enterprises” may be formed. Pursuant to section 39 of the Queensland Act, a beneficial enterprise is “an enterprise that a local government considers is directed to benefiting, and can reasonably be expected to benefit, the whole or part of its local government area”. In conducting a beneficial enterprise in Queensland, the local government may, amongst other things, “participate with an association”, which includes forming or taking part in forming an association (such as certain companies).<sup>47</sup> However, there are several provisions limiting the liability of the local government.<sup>48</sup>

Pursuant to section 110 of the Victorian Act, for the purpose of performing its role, a council may participate in any of the following beneficial enterprises: (i) become a member

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<sup>43</sup> In this regard, see [here](#).

<sup>44</sup> In this regard, see [here](#).

<sup>45</sup> See <http://www.dlgrma.qld.gov.au/local-government/local-government-ilgp.html>, <https://www.olg.nsw.gov.au/public/about-councils/>, <https://knowyourcouncil.vic.gov.au/guide-to-councils/what-councils-do>, <https://walga.asn.au/About-Local-Government.aspx>, <https://www.lga.sa.gov.au/sa-councils/local-government-in-sa>, [http://www.dpac.tas.gov.au/divisions/local\\_government](http://www.dpac.tas.gov.au/divisions/local_government) and <https://www.edo.org.au/publication/role-of-northern-territory-commonwealth-and-local-government/>.

<sup>46</sup> NSW Act, s 394.

<sup>47</sup> Queensland Act, s 40.

<sup>48</sup> *Idem*, s 40(2)(c). Also, under the Statutory Bodies Financial Arrangements Act 1982, a local government may need the Treasurer’s approval before entering into particular financial arrangements.

of a corporation, (ii) participate in the formation of a corporation, trust or other body, (iii) acquire shares in a corporation, trust or other body, and (iv) enter into a partnership or joint venture with any other person or body. There are however various requirements, including an assessment of risk.<sup>49</sup>

Western Australia is very limited in what can be formed,<sup>50</sup> and the Northern Territory cannot form anything beyond local government subsidiaries.<sup>51</sup>

### 2.3 A deeper consideration - New South Wales

The laws of New South Wales (NSW) will be detailed as an example of the application of law pertaining to local governments in Australia. A council in NSW has the functions conferred or imposed on it by or under the NSW Act or by another act or law.<sup>52</sup> These functions include things supplemental, incidental or consequential to, such functions.<sup>53</sup> A summary of local government roles compared with State and national roles is set out on the NSW Parliamentary website.<sup>54</sup> As shown on that website, local governments have a relatively narrow range of functions; some major responsibilities of the State are hospitals and schools whereas local governments are “concerned with matters close to our homes, such as building regulations and development, public health, local roads and footpaths, parks and playing fields, libraries, local environmental issues, waste disposal, and many community services”.<sup>55</sup> In general, Australian local governments are responsible for the provision of local infrastructure such as roads and waste collection.<sup>56</sup> There are some differences among the various States, for example Queensland and regional NSW local

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<sup>49</sup> Victorian Act, s 111.

<sup>50</sup> Western Australian Act, 3.60; and Local Government (Functions and General) Regulations 1996 (WA), r 32, provides that (1) a local government may form or take part in forming an association that is to be incorporated under the Associations Incorporation Act 2015 and may do things for the purpose of the incorporation of the association under that Act, and (2) a local government may form or take part in forming a body corporate established under the Strata Titles Act 1985 section 14(1) or the Community Titles Act 2018 section 17(1). These incorporations relate to strata (property) schemes and associations.

<sup>51</sup> Northern Territories Act, s 67 provides that the Minister for Local Government may approve a local government subsidiary to come into existence on a specific date as a body corporate that has the powers and functions conferred or assigned by its constitution in order to carry out functions related to local government on behalf of its consistent council or councils. The constitution must be approved by the Minister under s 69 of the Northern Territories Act. The Minister has approved the constitution of CouncilBiz (described [here](#) as a local government subsidiary established to manage the information technology support of regional councils) and Latitude 12 - East Arnhem Regional Council (which was a local government subsidiary established to carry out functions in relation to local government on behalf of the East Arnhem Regional Council, but as per the discussion [here](#) it has since been abolished).

<sup>52</sup> NSW Act, ss 21 and 22.

<sup>53</sup> *Idem*, s 23.

<sup>54</sup> See <https://www.parliament.nsw.gov.au/about/Pages/The-Roles-and-Responsibilities-of-Federal-State-a.aspx>.

<sup>55</sup> *Ibid*.

<sup>56</sup> S Jones and R G Walker, “Local government distress in Australia: A latent class regression analysis” in S Jones and D A Hensher (eds), *Advances in Credit Risk Modelling and Corporate Bankruptcy* (1<sup>st</sup> ed, Cambridge University Press, Cambridge, 2008) ch 9, 242-268, at 247-248.

governments bear the responsibility for water and sewerage whereas many others do not.<sup>57</sup>

Local governments in NSW cannot form or participate in the formation of a corporation or other entity or acquire a controlling interest in one unless it is in accordance with the NSW Act or with Minister consent.<sup>58</sup> An entity means any partnership, trust, joint venture, syndicate or other body (whether or not incorporated). It does not include any such entity that is of a class prescribed as not being within this definition but, at the time of writing, the regulation has not prescribed such a class. This restriction on formation of companies does not prevent a local government from being a member of a co-operative society or company limited by guarantee.

To obtain aforementioned Minister consent, the Minister needs to be satisfied of the public interest in undertaking the relevant participation or formation. Online information assists in understanding the criteria for formation of a corporation.<sup>59</sup> The financial viability of the council is a listed consideration, based upon financial information routinely required from the council.

## 2.4 Revenue sources

Local governments across the States and the Northern Territory receive funding from a number of sources. The main source of income for local government councils is the payment of rates. However, notwithstanding that rates are the only tax collected by local government, rates make up only some 3.4% of all of the taxes raised by all three tiers of government.<sup>60</sup> There is also federal government assistance provided under the Financial Assistance Grant programme and the Local Government (Financial Assistance) Act.<sup>61</sup> The Australian Government provided almost AUD 64 billion under the Financial Assistance Grant programme to local government since 1974-1975 (including 2022-2023).<sup>62</sup>

It has been estimated that local councils are responsible, on average, for raising 80% of their own revenue, with rates being approximately 38% of that revenue.<sup>63</sup> However, these figures are not necessarily consistent across the States. Australian academics Dollery, Byrnes and Crase have noted that "Australian local councils survive on a relatively narrow revenue base...within this narrow range, most revenue raising has important 'non-

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<sup>57</sup> This is discussed in B Dollery, S O'Keefe and L Crase, "State Oversight Models for Australian Local Government", *Economic Papers* (2009) 28(4) 279 at 280.

<sup>58</sup> NSW Act, s 358.

<sup>59</sup> See <https://www.olg.nsw.gov.au/council-circulars/07-49-criteria-for-applications-under-section-358-of-the-local-government-act-1993-formation-of-corporations-or-other-entities/>.

<sup>60</sup> See <https://alga.asn.au/facts-and-figures/>.

<sup>61</sup> Local Government (Financial Assistance) Act 1995 (Cth).

<sup>62</sup> See <https://www.infrastructure.gov.au/territories-regions-cities/local-government/financial-assistance-grant-local-government>.

<sup>63</sup> See <https://alga.asn.au/facts-and-figures/>.

discretionary' elements".<sup>64</sup> In this respect, "individual councils have differing abilities to raise revenue, based on location, population size, rate base and the ability to levy user charges".<sup>65</sup> The website of the Office of Local Government in South Australia reports that some 70% of its funding is from rates, the other 30% is from statutory charges (3%), user charges (9%), grants and subsidies (14%), investment income (1%), and reimbursements and other (3%).<sup>66</sup> The 2017 published NSW councillor handbook reports that on average NSW councils receive 21% of their regular income from ordinary land rates.<sup>67</sup>

There are only two States in Australia that have a cap on the amount of rates that they can collect, namely NSW and Victoria.<sup>68</sup> The South Australian State government attempted to introduce legislation seeking to implement rate-capping into South Australia in 2018, however it was not passed. The Independent Pricing and Regulatory Tribunal NSW sets the maximum amount that NSW councils can collect in general revenue through an annual rate peg and considers councils' requests to set higher charges with special variations (the 2022-2023 rate peg for each NSW council ranges from 0.7% to 5.0% depending upon the level of population growth).<sup>69</sup> This is the maximum percentage amount by which a local government in NSW may increase its general income for the year.<sup>70</sup>

While investment is permitted,<sup>71</sup> it may only be done in legislated circumstances. In NSW it must be in a permitted form, as notified by the Minister via Gazette, a copy of which is obtainable together with NSW investment policy guidelines from the NSW Office of Local Government website.<sup>72</sup> Under Chapter 15, Part 12 of the NSW Act, a NSW local government may also borrow and provide security for borrowings for a purpose allowed, but the Minister may from time to time impose limitations or restrictions upon particular council(s) or councils generally.<sup>73</sup> The borrowing may be in the form of an overdraft or loan or by other means approved by the Minister.<sup>74</sup> The Minister has issued a revised borrowing order - councils may only borrow Australian currency in Australia. Councils must not delegate the borrowing function, must exercise the reasonable care and diligence that a prudent person would exercise when borrowing funds, and are expected to have a full understanding of the terms and conditions of borrowing arrangements before entering into any contract.<sup>75</sup> Tcorp is a facility that offers borrowing facilities to NSW local governments.<sup>76</sup>

<sup>64</sup> B Dollery, J Byrnes and L Crase, "A typology of the Sources of Council Sustainability", *Working Paper Series University of New England* (2007) 4 1 at 15.

<sup>65</sup> See <https://alga.asn.au/facts-and-figures/>.

<sup>66</sup> See this breakdown at <https://www.lga.sa.gov.au/sa-councils/local-government-in-sa>.

<sup>67</sup> See <https://www.olg.nsw.gov.au/wp-content/uploads/Councillor-Handbook-2017.pdf> at 11.

<sup>68</sup> See <https://www.lga.sa.gov.au/sa-councils/local-government-in-sa/rate-capping>.

<sup>69</sup> See <https://www.ipart.nsw.gov.au/Home/Industries/Local-Government/For-Ratepayers/The-rate-peg>.

<sup>70</sup> *Ibid.*

<sup>71</sup> See for example NSW Act, s 625.

<sup>72</sup> See <https://www.olg.nsw.gov.au/councils/council-finances/financial-guidance-for-councils/investments/>.

<sup>73</sup> NSW Act, ss 621-624.

<sup>74</sup> *Idem*, s 622.

<sup>75</sup> See <https://www.olg.nsw.gov.au/council-circulars/09-21-revised-borrowing-order/>.

<sup>76</sup> The website is available at <https://www.tcorp.nsw.gov.au/html/localcouncils.cfm>.

The approach to borrowing is not uniform across all States and the Northern Territory. By way of example, in Queensland a local government is required to obtain the Treasurer's approval to undertake particular financial arrangements / borrowings.<sup>77</sup> Under a General Approval dated 23 May 2003 issued by the Queensland Treasurer, the Department of Local Government, Racing and Multicultural Affairs may grant approval for local governments to borrow from, or establish working capital facility with, Queensland Treasury Corporation (QTC). Separate approval of the Treasurer is, however, still required for borrowings and facilities not sourced from QTC. Further, in Victoria, a local government cannot borrow unless the proposed borrowings were included in its budget or revised budget.<sup>78</sup>

## 2.5 Oversight

Local governments in Australia arguably have very limited autonomy, due to their State government oversight and due to "the non-discretionary nature of the environment in which they operate, through largely exogenously determined demographic factors, council revenue, municipal expenditure, etc".<sup>79</sup> All the governments of the States and the Northern Territory have oversight of their local governments and there is strict financial accountability: for example in Chapter 13, Part 3, Division 1 and 2 onwards of the NSW Act, a local government is required to keep strict accounting records, and they must be referred to audit by the local government as soon as practicable at the end of each year. The audits are made public. Following a financial audit, the Audit Office issues a variety of reports to entities and reports periodically to Parliament. These reports give opinions on the truth and fairness of financial statements, and comment on entity compliance with certain laws, regulations and government directives. They may comment on financial prudence, probity and waste, and recommend operational improvements.<sup>80</sup> Pursuant to section 426 of the NSW Act, the Auditor-General is to communicate with the Minister on all matters arising under the NSW Act or the regulations and which, in the opinion of the Auditor-General, are sufficiently significant to be brought to the Minister's attention. An inquiry may be instigated by the Department Chief Executive<sup>81</sup> and reported back to the Minister.<sup>82</sup> The Minister has broad powers, including ordering provision of information / documents,<sup>83</sup> requesting an inquiry,<sup>84</sup> and / or ordering the council to do or refrain from doing things as recommended as a result of an inquiry.<sup>85</sup> Where considered necessary, the Governor of NSW has the power to appoint administrator(s) to a council under the

<sup>77</sup> *Statutory Bodies Financial Arrangements Act 1982* (Qld), Part 5, Division 2.

<sup>78</sup> Victorian Act, s 104.

<sup>79</sup> B Dollery, S O'Keefe and L Crase, "State Oversight Models for Australian Local Government", *Economic Papers* (2009) 28(4) 279 at 289.

<sup>80</sup> See <https://www.audit.nsw.gov.au/sites/default/files/documents/FINAL%20WEB%20-%20Report%20on%20Local%20Government%202019.pdf>.

<sup>81</sup> NSW Act, s 430.

<sup>82</sup> *Idem*, s 433.

<sup>83</sup> *Idem*, s 429.

<sup>84</sup> *Idem*, s 430.

<sup>85</sup> *Idem*, s 434.



NSW Act.<sup>86</sup> This process, and the process to dissolve a council, are discussed in further detail below.

### 3. Dealing with local public entities in distress

Australian academics have raised concerns that Australian local government councils face various challenges in maintaining fiscal sustainability, as they face escalating demands on resources while simultaneously having a diminishing financial capacity.<sup>87</sup> Some academics have concluded that government failure is more pronounced among local governments.<sup>88</sup> Dollery has gone so far as to declare in 2009 that the “dawn of the new millennium has given rise to the emergence of acute financial distress in all Australian local government state and territory jurisdictions as repeatedly demonstrated by numerous national and state-based inquiries into the financial sustainability of local government councils”.<sup>89</sup> These inquiries were undertaken in particular throughout the first decade of the 21<sup>st</sup> century and raised concerns with respect to the financial sustainability of Australian local governments.<sup>90</sup>

Local government councils have also featured in the media in recent years because of, amongst other things, alleged corruption,<sup>91</sup> concerns regarding workplace culture and / or failing to provide a safe workplace,<sup>92</sup> as well as concerns regarding financial distress and / or financial management.<sup>93</sup> The Australian Broadcasting Corporation recently

<sup>86</sup> *Idem*, s 256.

<sup>87</sup> See for example J Byrnes and B Dollery “Local Government Failure in Australia: An Empirical Analysis of New South Wales”, *Australian Journal of Public Administration* (2002) 61(3) 54 at 54.

<sup>88</sup> *Idem*, at 62.

<sup>89</sup> B Dollery, “Financial Sustainability in Australian Local Government: Problems and Solutions”, *Working Paper Series University of New England School of Business, Economics and Public Policy* (2009) 3 1 at 2.

<sup>90</sup> *Ibid*. See for example the Commonwealth Grants Commission Report (2001); the Local Government National Report (2004-05); the Commonwealth House of Representatives Standing Committee on Economics, Finance and Public Administration’s Rates and Taxes: A Fair Share for Responsible Local Government Report (Hawker Report) (2004); the South Australian Financial Sustainability Review Board’s Rising to the Challenge Report (2005); the report entitled “Are Council’s Sustainable” undertaken in New South Wales (2006); the report entitled “Size, Shape and Sustainability Report” (2006); the Western Australian Local Government Association’s “Systemic Sustainability Study, the PriceWaterhouse Coopers” National Financial Sustainability Study of Local Government Report (2006); and the Local Government Association of Tasmania’s “Review of the Financial Sustainability of Local Government in Tasmania” (2007). There was also a 2013 review by Ernst & Young on behalf of the Department of Regional Australia, Local Government, Arts and Sports entitled “National financing authority for local government” which was undertaken to review options for aggregate local government debt in Australia.

<sup>91</sup> See for example, <https://www.brisbanetimes.com.au/national/queensland/explainer-what-happened-at-logan-city-council-20200107-p53pl8.html>, <https://www.redlandcitybulletin.com.au/story/7035198/former-qld-councillors-in-court-over-fraud/> and <https://www.abc.net.au/news/2021-04-14/fraud-charges-logan-councillors-dropped/100067622>.

<sup>92</sup> See for example, <https://www.governmentnews.com.au/council-sacked-after-report-finds-safe-workplace-not-provided/>, <https://heraldonlinejournal.com/2020/07/10/cockburn-fesses-up-to-inquiry/> and <https://thewest.com.au/politics/local-government/department-of-local-government-launch-inquiry-into-city-of-cockburn-months-after-stephen-cains-departure-ng-b881600843z>.

<sup>93</sup> See for example, <https://www.abc.net.au/news/2019-10-04/central-darling-shire-faces-decade-with-no-elected-councillors/11574000>, <https://www.abc.net.au/news/2020-12-02/central-coast-council-runs-up->

reported that a local government council was financially distressed due to floods, bushfire and / or the Covid-19 pandemic.<sup>94</sup>

### 3.1 Laws pertaining to local public entities in distress

When local governments are in distress, they are managed under the aforementioned Local Government Acts in each relevant State and the Northern Territory. These statutes provide processes for the oversight, administration and dissolution of local governments in a range of circumstances, including circumstances of insolvency and / or corruption.

As established above, there are strict auditing and financial accounting processes. Ministers / Governors have broad powers in the oversight of local government councils and can involve various prescribed authorities or individuals in investigating them. Ministers or similar are also generally responsible for dissolving councils. An investigation / inquiry is generally the first step in the process. While there are community complaint mechanisms and general community reporting such as to ombudsmans,<sup>95</sup> and while local councillors are subject to voters at election time, it is ultimately the politicians who action concerns pertaining to financial distress of local governments.

The following is a summary of the laws pertaining to the different States and the Northern Territory.

### 3.2 New South Wales

The Governor of New South Wales (NSW) has the power to dismiss all civic offices in relation to a council where a public inquiry has been held concerning the council and where the Minister has recommended that the Governor make such a declaration.<sup>96</sup> The Governor may also appoint an administrator or more than one administrator.<sup>97</sup> The appointment of such is generally after public inquiry, but there are limited legislated circumstances where an administrator may be appointed without an inquiry.<sup>98</sup> The administrators take over the role of the elected councillors, who cease to hold office, and have all the functions of the council until their appointment ceases.<sup>99</sup> The administrators are paid a salary from the local government council's funds determined by the Governor,<sup>100</sup> and the Governor may terminate the administrators appointment at any

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[565-million-in-debt/12944496](https://coastcommunitynews.com.au/central-coast/news/2021/08/sale-of-water-and-sewer-catastrophic-says-union/), <https://coastcommunitynews.com.au/central-coast/news/2021/08/sale-of-water-and-sewer-catastrophic-says-union/> and <https://www.sbs.com.au/news/residents-of-a-tiny-australian-island-are-calling-for-a-return-to-self-rule-to-save-their-culture>.

<sup>94</sup> See for example, <https://www.abc.net.au/news/2020-06-19/lismore-council-budget-on-brink-of-collapse/12374152>.

<sup>95</sup> See for example, <https://www.olg.nsw.gov.au/public/complaints-against-councils/>.

<sup>96</sup> NSW Act, s 255(1).

<sup>97</sup> *Idem*, s 256.

<sup>98</sup> *Idem*, s 257.

<sup>99</sup> *Idem*, s 258(1).

<sup>100</sup> *Idem*, s 258(2).

time.<sup>101</sup> If not terminated by the Governor, the appointment ends immediately before the first meeting of council held after a fresh election.<sup>102</sup> There are also legislative provisions for the appointment of others to assist, such as temporary advisers,<sup>103</sup> financial controllers,<sup>104</sup> and interim administrators.<sup>105</sup>

In NSW a council is constituted for each “area” as determined under the NSW Act.<sup>106</sup> The Governor may, by proclamation, dissolve all or part of an area and the Minister may recommend such a proclamation after an inquiry has been held and the inquiry report has been considered.<sup>107</sup> The proclamation may deal with, amongst other things, transfer of assets.<sup>108</sup> The Governor may also amalgamate areas and, in such cases, the councillors of former areas generally cease to hold office.<sup>109</sup> There have been numerous amalgamations of council areas in NSW, some of which have been disputed by councils, and court action has proceeded in State court.<sup>110</sup>

The NSW Act also allows a proposal to be made to the Minister to establish or dissolve or amend the constitution of a county council pursuant to provisions set out in Chapter 12, Part 5 of that Act. With respect to dissolution, the Minister makes a recommendation to the Governor of NSW and, pursuant to section 397, the Governor may by proclamation revoke an earlier proclamation in force under section 387 for the purpose of dissolving a county council.

Cudgegong (Abattoir) County Council trading as Mudgee Regional Abattoir is a case example of a NSW county council being wound-up due to insolvency. The matter was political and legislation was passed to address the situation - schedule 9 of the NSW Act was added to provide for the winding-up of Cudgegong (Abattoir) County Council. In the second reading speech for the amending legislation, the following was stated in summary of the case:

“The bill will ... amend the Local Government Act 1993 to ensure accountability for the financial failure of the county council. The amendments will allow some or all creditors to be paid out after the winding-up of the abattoir operation. Most importantly, the bill will ensure that the former employees of the county council immediately qualify for financial assistance....As separate corporate and legal entities, county

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<sup>101</sup> *Idem*, s 258(3).

<sup>102</sup> *Idem*, s 258(4).

<sup>103</sup> *Idem*, s 438G.

<sup>104</sup> *Idem*, s 438HB.

<sup>105</sup> *Idem*, s 438M.

<sup>106</sup> *Idem*, s 219.

<sup>107</sup> *Idem*, s 212.

<sup>108</sup> *Idem*, s 213.

<sup>109</sup> *Idem*, s 218A.

<sup>110</sup> See <https://www.abc.net.au/news/2016-09-20/nsw-councils-win-appeal-to-have-forced-mergers-set-aside/7863126>, <https://nswcourts.com.au/articles/nsw-supreme-court-rejects-council-merger-plans/> and <https://auspublaw.org/2017/11/council-amalgamations-in-nsw/>.

councils, like local councils, are responsible for managing their own affairs on a daily basis and must be guided by their own legal and financial advice. While subject to the Local Government Act, it is not the Minister's or the Department of Local Government's role to oversee or endorse a local or county council's business transactions and decisions. However, as part of the Department of Local Government's brief to monitor the financial health of local government, the county council was placed on the financial monitoring list as one of 30 councils in financial difficulty. Throughout this financial monitoring, the county council's management expressed optimism that despite its difficult trading situation the abattoir could pull through. Nevertheless, on 3 September this year the county council became insolvent and its board members resigned. Mr Stephen Parbery was appointed as administrator of the county council under the Local Government Act. Mr Parbery met with Mudgee Shire Council on 8 September 2003, seeking \$2.1 million in financial assistance to keep the abattoir operating for the following six weeks. Mudgee council declined to provide the amount sought. It did agree to provide \$100,000 to cover immediate unpaid abattoir wages. Mr Parbery indicated to the Minister that without the required financial assistance there was no legal or financial alternative other than closure of the abattoir operation. On 9 September this year all of the abattoir employees were stood down. Rabo Bank, the major creditor of the county council, is owed approximately \$5 million, and employee entitlements are estimated at \$2.5 million excluding any redundancy payments that may be payable. There are other significant creditors, including local businesses. It is quite clear that the assets of the county council will not meet its debts. Mr Parbery advised the Minister that due to the hopelessly insolvent state of the county council he intended to seek appointment as a receiver and manager of the county council under the Supreme Court Act 1970. Mr Parbery believed that with the dual powers of administrator and court-appointed receiver and manager he would be able to develop a strategy to maximise the return to creditors, including unpaid employees. Mr Parbery was appointed by the Supreme Court of New South Wales as receiver and manager of the county council on 11 September...."<sup>111</sup>

Essentially, the insolvency provisions of the Corporations Act were applied to the winding-up of this county council as if it were a company, subject to specified alterations under that Schedule 9.<sup>112</sup> Mr Parbery was appointed as liquidator on 1 November 2003 pursuant to Schedule 9.<sup>113</sup> This Schedule facilitated transference of liabilities from the county council

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<sup>111</sup> See <https://www.parliament.nsw.gov.au/bill/files/3122/A5603.pdf>.

<sup>112</sup> NSW Act, Sch 9, cl 1(2).

<sup>113</sup> See [https://download.asic.gov.au/media/1320871/ASIC\\_B48\\_03.pdf](https://download.asic.gov.au/media/1320871/ASIC_B48_03.pdf) at 4.

to two councils to the extent, or in the proportions, specified in or determined in accordance with the proclamation.<sup>114</sup>

### 3.3 Queensland

Chapter 5 of the Queensland Act deals with monitoring and compliance and provides for remedial action by the department's chief executive, including recommending matters to the Minister for remedy.<sup>115</sup> The department's chief executive also has the power to appoint advisor(s) or financial controllers.<sup>116</sup> The chief executive may also direct a local government to pay the Minister the salary, allowances, costs and expenses of advisors and financial controllers.<sup>117</sup> The Minister can recommend that the Governor in Council take action, including removing councillors, appointing an interim administrator to act in place of the councillors of a local government, or suspending or dissolving a local council.<sup>118</sup> The fees, allowances and expenses of interim administrators are decided by the Governor in Council.<sup>119</sup>

An interesting case is Ipswich City Council (ICC) which was subject to the Local Government (Dissolution of Ipswich City Council) Act,<sup>120</sup> where the council was dissolved and an interim administrator was appointed to act in place of the councillors. This action was taken not due to insolvency *per se* but rather due to an investigation by the Crime and Corruption Commission and its findings in the report "Culture and Corruption Risks in Local Government: Lessons from an investigation into Ipswich City Council".<sup>121</sup> The above Act was introduced to "resolve those concerns promptly and to provide the Ipswich community with certainty by dissolving the ICC and providing for the appointment of an interim administrator to act in place of the ICC councillors for an interim period ending at the conclusion of the quadrennial election for the Ipswich Local Government area held in 2020".<sup>122</sup> It is reported that former Ipswich council chief executive officer, Carl Wulff, was sentenced to five years in prison with respect to accepting bribes worth more than AUD 240,000.<sup>123</sup>

In relation to beneficial enterprises, the establishment, acquisition, monitoring, sale or winding-up of a beneficial enterprise must be made by resolution of council.<sup>124</sup> In the case of ICC, after implementation of an interim administrator, resolutions were made to wind-up a number of beneficial enterprises, including Ipswich City Developments Pty Ltd.

<sup>114</sup> NSW Act, Sch 9, Part 2.

<sup>115</sup> Queensland Act, s 116.

<sup>116</sup> *Idem*, ss 117-118.

<sup>117</sup> *Idem*, s 119.

<sup>118</sup> *Idem*, ss 122-124.

<sup>119</sup> *Idem*, s 206(1).

<sup>120</sup> Local Government (Dissolution of Ipswich City Council) Act 2018 (Qld).

<sup>121</sup> See <https://www.legislation.qld.gov.au/view/pdf/bill.first.exp/bill-2018-082>.

<sup>122</sup> *Ibid*.

<sup>123</sup> See <https://www.abc.net.au/news/2019-02-15/ipswich-city-council-ceo-carl-wulff-sentenced-for-corruption/10814924>.

<sup>124</sup> This is summarised by the Logan City Council in its "Beneficial Enterprise Policy", available [here](#), at 2.

Following a members' resolution on 30 August 2018, Ipswich City Developments Pty Ltd entered into a members voluntary liquidation process and was deregistered on 20 June 2019. A copy of the Council Report for 2018-2019 providing an update regarding these various winding-ups is publicly available online.<sup>125</sup> In the process of winding-up, Ipswich City Developments Pty Ltd sold and transferred the majority of its remaining property and assets to council, including a dividend payment of AUD 2.5 million on 20 August 2018.<sup>126</sup> In the winding-up the liquidator attached standard creditor rights information,<sup>127</sup> and the deregistration was completed under the Corporations Act.

### 3.4 Other States

Pursuant to the Victorian Act, the Governor in Council may, amongst other things, on recommendation from the Minister, suspend a council, appoint an administrator or appoint a temporary administrator.<sup>128</sup> An administrator assumes the functions of the council, subject to any conditions on appointment, and is entitled to be paid remuneration and allowances and is employed on the conditions fixed by the Minister with remuneration paid by the council.<sup>129</sup> The Governor in Council has broad powers, including the power to abolish a council.<sup>130</sup>

Pursuant to section 9 of the South Australian Act, the Governor of South Australia may by proclamation, amongst other things, constitute a new council or abolish a council. Chapter 13 provides for review of local councils or subsidiaries. This includes internal reviews or reviews by the Minister or referral of matters by the Minister to the ombudsman for investigation. The Minister has broad powers, including power to require information,<sup>131</sup> or to take action based on information from the Independent Commissioner Against Corruption, Auditor-General, or Ombudsman.<sup>132</sup> A "suitable person" or "suitable persons" may also be appointed as administrator(s) to a defaulting council by the Governor upon recommendation by the Minister.<sup>133</sup> The remuneration of an administrator (which is determined by the Governor) and any liability incurred by an administrator in the course of the administration is paid or satisfied out of the funds of the defaulting council.<sup>134</sup> The administrator(s) appointed must report to the Minister on the administration of the affairs of the defaulting council at intervals of not more than three months.<sup>135</sup> There are also

<sup>125</sup> See [https://www.ipswich.qld.gov.au/\\_data/assets/pdf\\_file/0018/120870/Ipswich-City-Council-Annual-Report-2018-2019.pdf](https://www.ipswich.qld.gov.au/_data/assets/pdf_file/0018/120870/Ipswich-City-Council-Annual-Report-2018-2019.pdf). A copy of the official liquidator reports are also publicly available [here](#) and [here](#).

<sup>126</sup> See <https://www.ipswichfirst.com.au/ipswich-city-developments-being-wound-up-assets-transferred-to-council/>.

<sup>127</sup> See <https://www.mcgrathnicol.com/app/uploads/D18-180913-InitialCredInfo-SJW.pdf>.

<sup>128</sup> Victorian Act, s 230.

<sup>129</sup> *Idem*, s 231.

<sup>130</sup> *Idem*, s 235.

<sup>131</sup> South Australian Act, s 271A.

<sup>132</sup> *Idem*, s 273.

<sup>133</sup> *Idem*, s 273(2) and (5).

<sup>134</sup> *Idem*, s 273(11).

<sup>135</sup> *Idem*, s 273(13).

avenues to investigate a subsidiary and the Minister can require steps be taken to have it wound-up.<sup>136</sup>

There are also broad powers under the Western Australian Act and Tasmanian Act. By way of example, the Western Australia Act at 2.1 and 2.2 provides that the Governor of Western Australia, on the recommendation of the Minister, may make an order declaring amongst other things, an area of the State to be a district or ward, or abolishing a district or ward. Under the Tasmanian Act, municipal areas are specified in a list in Schedule 3 of that Act, and the Governor of Tasmania on recommendation of the Minister is given the power to adjust, amend or substitute the list.<sup>137</sup>

### 3.5 Northern Territory

Pursuant to section 16 the Northern Territory Act the power to, amongst other things, constitute or abolish local government may be exercised by the "Administrator" by Gazette. The terminology is different and the administrator of the Northern Territory is an official appointed by the Governor-General of Australia to represent the government of the Commonwealth in the Northern Territory. There is a process of "official management" of councils if the Minister is satisfied there are serious deficiencies in the conduct of council affairs.<sup>138</sup> In this process council members are suspended from office and a suitable person is appointed by the Minister to manage the affairs of the council (an official manager) together with the appointment of a suitable person (who may or may not be the official manager) to investigate and report back to the Minister on the conduct of the councillors suspended and on the financial position of the council.<sup>139</sup> The remuneration of the official manager is determined by the Minister and payable from the funds of the relevant council.<sup>140</sup> The official manager has full power to transact any business of the council and to do anything else the council could have done, but for the suspension or dismissal of its members.<sup>141</sup>

The Minister may approve councils to form a body council (a local government subsidiary) to carry out functions related to local government.<sup>142</sup> Pursuant to section 74, the Minister may, by Gazette notice, abolish a local government subsidiary. In relation to the local government subsidiary CouncilBiz, its constitution provides that, in the event the Minister abolishes the subsidiary or it otherwise becomes dissolved, the amount that remains after dissolution and satisfaction of debts and liabilities will be transferred in equal shares to all members excluding the Local Government Association of the Northern Territory or as

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<sup>136</sup> *Idem*, ss 274-275.

<sup>137</sup> Tasmanian Act, s 16.

<sup>138</sup> Northern Territory Act, s 318(1).

<sup>139</sup> *Idem*, s 318(2).

<sup>140</sup> *Idem*, s 321(3) and (4).

<sup>141</sup> *Idem*, s 321(1).

<sup>142</sup> *Idem*, Chap 4, Part 4.4.

otherwise on the basis of a formula agreed by special resolution.<sup>143</sup> In relation to the local government subsidiary Latitude 12, its constitution provided that in the event of abolition by the Minister, all property, rights, and liabilities were to be transferred to the East Arnhem Regional Council of the Northern Territory.<sup>144</sup> However, irrespective of the constitution of a local government subsidiary, the Minister may make directions in relation to the transfer or vesting of a local government subsidiary's property, rights and liabilities upon its abolishment.<sup>145</sup>

### 3.6 The purpose of these laws

Local governments are creatures of statute and their function, management and powers derive from the relevant Local Government Acts discussed above. The NSW Act describes its overall purpose as:

- (a) providing the legal framework for the system of local government for New South Wales;
- (b) setting out the responsibilities and powers of councils, councillors and other persons and bodies that constitute the system of local government;
- (c) providing for governing bodies of councils that are democratically elected;
- (d) facilitating engagement with the local community by councils, councillors and other persons and bodies that constitute the system of local government; and
- (e) providing for a system of local government that is accountable to the community and that is sustainable, flexible and effective.<sup>146</sup>

The Office of Local Government in New South Wales describes its local governments as follows:

"The State's 128 local councils employ over 48,000 staff and spend more than \$12 billion annually on providing key infrastructure, facilities and services to local communities. They also manage community assets worth nearly \$178 billion. Local councils play an important role in improving the lifestyle and amenity of local communities across NSW."<sup>147</sup>

Although the avoidance of insolvency is not mentioned specifically and the management of financially distressed local councils is different from the framework to manage personal

<sup>143</sup> See <https://centraldesert.nt.gov.au/documents/council-documents/council-partners/constitution-of-councilbiz>, at cl 8. The members are listed in the constitution, sch 1.

<sup>144</sup> See <https://static1.squarespace.com/static/569308c7dc5cb46e49dc9ee5/t/5a010c358165f56ac4a03add/1510018109459/Latitude+12+Constitution.pdf> at cl 8.

<sup>145</sup> Northern Territory Act, s 74(2).

<sup>146</sup> NSW Act, s 7.

<sup>147</sup> See <https://www.olg.nsw.gov.au/public/>.



and corporate insolvency more generally, it is clear that continuity of public service is a part of providing a sustainable, flexible and effective system of local government that delivers to local communities.

There is no general description of the winding-up framework for local government nor of its role. However, it is relevant to look, by way of example, to the Local Government Amendment (Cudgegong (Abattoir) County Council Dissolution) Act<sup>148</sup> which introduced Schedule 9 to the NSW Act to deal with the winding-up of Cudgegong (Abattoir) County Council. The Second Reading speech by Burton (Parliamentary Secretary) noted that the schedule was introduced “to ensure accountability for the financial failure of the county council...[to] allow some or all creditors to be paid out ...” and to “ensure that the former employees of the county council immediately qualify for financial assistance”.<sup>149</sup>

### 3.7 Repercussions for councillors

Councillors are of course subject to public opinion at election time. They are also subject to codes of conduct, such as the Model Code of Conduct for Local Councils in NSW,<sup>150</sup> which is prescribed by regulation and sets the minimum standards of conduct for council officials.<sup>151</sup> If a councillor fails to comply with the standards of conduct prescribed, then that constitutes misconduct under the NSW Act, and there is a range of penalties that may be imposed on councillors, including suspension or disqualification from civic office.<sup>152</sup> Many of these prescribed standards pertain to disclosure of interests, concerns regarding misuse of position / corruption and general conduct obligations. There are Codes of Conduct in other states which can similarly lead to disciplinary action.<sup>153</sup>

## 4. Dealing with local public entities in distress - law in practice

A relevant example, and the first example, of local government financial failure in Australia is the case of Central Darling Shire Council in New South Wales. From January 2011 onwards, there were a number of adverse financial reports regarding this council and a number of requests by the council for financial assistance.<sup>154</sup> In December of 2013, the NSW Minister for Local Government suspended the Central Darling Shire Council for three months (which was later extended by another three months until June 2014) and appointed an interim administrator due to a liquidity crisis.<sup>155</sup> During the period of

<sup>148</sup> Local Government Amendment (Cudgegong (Abattoir) County Council Dissolution) Act 2003 No 56.

<sup>149</sup> See <https://www.parliament.nsw.gov.au/bill/files/3122/A5603.pdf> and <https://www.parliament.nsw.gov.au/bill/files/3122/C5603.pdf>.

<sup>150</sup> See <https://www.olg.nsw.gov.au/councils/governance/model-code-of-conduct/>.

<sup>151</sup> They are prescribed in NSW under the NSW Act, s 440 and the Local Government (General) Regulation 2021 (NSW). A copy is available [here](#).

<sup>152</sup> See <https://www.olg.nsw.gov.au/wp-content/uploads/2020/08/Model-Code-of-Conduct-2020.pdf> at 5.

<sup>153</sup> See for example, that of Queensland available [here](#). There have been, and continue to be, a number of changes to these Codes such as in Western Australia (see [here](#)) and Victoria (see [here](#)).

<sup>154</sup> A historical summary is provided in J Drew, “Autopsy of Municipal Failure: The Case of Central Darling Shire”, *Australasian Journal of Regional Studies* (2016) 22(1) 79 at 89.

<sup>155</sup> *Idem*, at 79.

suspension, the appointed interim administrator took steps to address the financial and structural issues of the council and delivered an administrator's report and prepared a "recovery plan".<sup>156</sup> On 19 June 2014, the Minister for Local Government also appointed a Commissioner to hold a public inquiry into the Central Darling Shire Council and to have particular regard to "whether the Council had properly carried out its functions of financial management, asset management, legislative compliance and community leadership", and to consider whether the elected council had the capacity to "resolve the outstanding issues, including establishing a sound foundation for the Council's future sustainability".<sup>157</sup>

On 22 October 2014 the final report of that inquiry was handed down recommending, amongst other things, that the civic offices of the Council be declared vacant, that there be extension of the administration period until September 2020 and that the administrator(s) address the financial and structural issues facing the council and ensure "completion of the recovery plan".<sup>158</sup> The administration period was later again extended by the Minister until 2024 so that "a comprehensive long-term plan [can] be developed and implemented to ensure a stronger future for the council and its communities".<sup>159</sup> This saw the Central Darling Shire Council enter its eighth year of administration in October 2021, which raises a number of concerns regarding the absence of democratically elected councillors over a lengthy period of time.

In relation to this concern, on 3 August 2021, the administrator published a release noting:

"Our limited rate base means that we rely heavily on government funding to ensure essential services are provided to the community, including roads, water and sewerage services and waste management... We are also unique in that we have gone through a long period of administration, and while many residents feel that they are not democratically represented, I can assure all residents they are being heard. This has been shown through the extensive consultations we have undertaken for the development of our Community Strategic Plan, with the addition of targeted town and village plans. Almost 300 people participated in consultations. With a total population of just over 1800, this is an outstanding effort by staff, our consultants and - more importantly - our communities."<sup>160</sup>

In its 2019-2020 annual report, the mission of Central Darling Shire Council was stated to be "[r]ealising quality opportunities for all in the Central Darling Shire through: Effective leadership, Community development through involvement, participation, partnership, ownership and collaborative approach, Facilitation of services, Community ownership,

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<sup>156</sup> *Ibid.* Also see <https://www.olg.nsw.gov.au/wp-content/uploads/Central-Darling-Public-Inquiry-Report.pdf> at 4.

<sup>157</sup> See <https://www.olg.nsw.gov.au/wp-content/uploads/Central-Darling-Public-Inquiry-Report.pdf> at 3.

<sup>158</sup> *Idem*, at 5.

<sup>159</sup> See <https://www.olg.nsw.gov.au/media-releases/central-darling-administration-extended/>.

<sup>160</sup> See <https://www.centraldarling.nsw.gov.au/News-articles/LG-WEEK>.

Delivery of consistent, affordable and achievable services and facilities”.<sup>161</sup> However, the administrator communicated that:

“The 2019/20-Financial Year has been one of many challenges of drought, floods, fire and COVID19. All have contributed to the challenges of maintaining services and governance which has demanded considerable organisational capacity at the expense of day to day issues. The Minister for Local Government’s decision not to hold elections in 2020 and continue under administration for another four years until 2024. This continues to cause concern for some residents in the community, regarding the loss of local democracy and community advocacy to other levels of government. We continue to address the many outstanding legacy issues that face Central Darling Shire, such as the sale of land for unpaid rates was a big step forward. I do not underestimate the challenges in this area particularly, the ongoing issue of attracting staff with the necessary skills and experience to live and work in a rural and remote community.”<sup>162</sup>

The report noted that the council was “now in a positive financial position, however there is still much work to be done with our financial and governance systems to ensure our sustainability in the long term”.<sup>163</sup>

This case example shows the Minister determining a long gestation of administration of Central Darling Shire Council, even past the council being in a “positive financial position” in order to enable longer-term sustainability. The elected councillors were removed from office, essentially from December 2013, and there is no intention to hold democratic elections now until 2024. The current appointed administrator, Mr Robert Stewart, was appointed by the NSW Minister for Local Government on 25 January 2019. He performs all the functions of an elected council, with support from a general manager and two directors, with his experience of more than 40 years in local government.<sup>164</sup>

It is clear that Australian local governments are not impervious to financial distress. To the contrary, a number of Australian academics have raised deep concerns for the fiscal sustainability of Australian local government,<sup>165</sup> and there are clear examples of financial distress occurring amongst local governments. The narrow financial avenues available for revenue raising, together with adverse costs pertaining to managing the recent Covid-19

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<sup>161</sup> See <https://www.centraldarling.nsw.gov.au/files/assets/public/public-documents/annual-reports/cdsc-2019-20-annual-report-final.pdf> at 2.

<sup>162</sup> *Idem*, at 7.

<sup>163</sup> *Idem*, at 9.

<sup>164</sup> See <https://www.centraldarling.nsw.gov.au/Council/Organisation/Administrator>.

<sup>165</sup> See for example J Byrnes and B Dollery, “Local Government Failure in Australia: An Empirical Analysis of New South Wales”, *Australian Journal of Public Administration* (2002) 61(3) at 54, and B Dollery, “Financial Sustainability in Australian Local Government: Problems and Solutions”, *Working Paper Series University of New England School of Business, Economics and Public Policy* (2009) 3 1 at 2.

pandemic, raise further questions about the long term durability of Australian local governments.

## Local public entities in distress - a critical analysis of the Bangladeshi approach

By Morshed Mannan\* and Borhan Uddin Khan\*\*

### 1. The general context of insolvency law

#### 1.1 Legislative framework for corporate insolvency law

Bangladesh has a fragmented legislative approach to dealing with corporate insolvency, as the relevant laws concerning corporate insolvency are contained in multiple pieces of legislation. The two major laws dealing with liquidation and corporate rescues are the: (i) Companies Act 1994 (Act Number XVIII of 1994), which came into force on 1 December 1994, and (ii) Bankruptcy Act 1997 (Act Number X of 1997), which came into force on 1 August 1997. Apart from these primary laws, the Bankruptcy Rules 1997 (which came into force on 1 August 1997), which is a piece of secondary legislation under the Bankruptcy Act 1997, also governs the procedural aspects of insolvency proceedings under the Bankruptcy Act 1997. The Code of Civil Procedure 1908 is also a salient part of this legislative framework as it, *inter alia*, governs the appointment of receivers<sup>1</sup> and the continuation / abatement of lawsuits initiated by insolvent plaintiffs.<sup>2</sup>

As noted by Mannan, Rahman and Khan,<sup>3</sup> there are five formal, court-supervised insolvency procedures:

- (a) reorganisation<sup>4</sup> prior to an order of adjudication of bankruptcy;<sup>5</sup>
- (b) composition<sup>6</sup> or a scheme of arrangement<sup>7</sup> after an order of adjudication of bankruptcy;<sup>8</sup>

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<sup>1</sup> The Code of Civil Procedure, Order XL.

<sup>2</sup> *Idem*, Order XXII, Rules 8-9.

<sup>3</sup> M Mannan, M M Rahman and B U Khan, "National Report for Bangladesh", in J Chuah and E Vaccari (eds), *Treatment of Executory Contracts in Insolvency Law: A Global Guide* (Edward Elgar, Cheltenham, 2019) paras 26.20-26.22

<sup>4</sup> This is a process where the company applies to the court for approval of a plan for the reorganisation of its debts.

<sup>5</sup> Bankruptcy Act 1997, s 46.

<sup>6</sup> A composition involves a company making a proposal to pay its creditors less than what is owed to them and the creditors agreeing to it. This agreement, to be effective, needs to be approved by a court.

<sup>7</sup> Schemes of arrangement involve a company and its creditors agreeing to a scheme by which debts are gradually liquidated. To be effective, this arrangement needs to be approved by a court.

<sup>8</sup> Bankruptcy Act 1997, ss 43-45, read with Bankruptcy Rules 1997, rules 42-45.

- (c) compromise or arrangement<sup>9</sup> prior to or pursuant to winding-up;<sup>10</sup>
- (d) liquidation following a creditor-initiated, voluntary winding-up<sup>11</sup> or involuntary winding up by a court.<sup>12</sup> A creditors' voluntary winding-up may, in certain circumstances, be ordered to continue under the supervision of a court;<sup>13</sup> and
- (e) bankruptcy adjudication.<sup>14</sup> The Bankruptcy Act 1997 provides the process of obtaining an order of adjudication and its effects.<sup>15</sup>

As far as the Companies Act 1994 is concerned, the corporate liquidation procedure specified in the act is sometimes used in practice, but its provisions on compromise and arrangement have rarely been used for pre-insolvency rescue. On the other hand, the Bankruptcy Act 1997, which applies to both companies and natural persons, is hardly used in practice for corporate liquidation or rescue. Whilst not a formal part of Bangladesh's corporate insolvency law framework, an important tool for creditors to realise non-performing loans from defaulters, including those who are ostensibly in financial distress, is the Money Loans Court Act 2003 (Act Number VIII of 2003, which came into force on 10 March 2003). However, it is not possible to simultaneously file a case under the Money Loans Court Act 2003 and the Bankruptcy Act 1997, stymying the use of the latter legal instrument.

Special rules apply for insolvencies of companies within certain commercial sectors. In the case of the insolvency of banking companies, the Banking Companies Act 1991 (Act Number XIV of 1991, which came into force on 14 February 1991) provides for Government-led rescue arrangements<sup>16</sup> and liquidation through involuntary winding-up by the High Court Division of the Supreme Court of Bangladesh.<sup>17</sup> In the case of insurance companies, the Insurance Act 2010 (Act Number XIII of 2010, which came into force on 18 March 2010) provides for rescue arrangements<sup>18</sup> and liquidation,<sup>19</sup> in addition to the applicable provisions of the Companies Act 1994. Similarly, special rules apply to legal entities that are not companies but are, for example, co-operative societies. Co-operative societies are wound-up and dissolved at the order of the Registrar of co-operative societies under the Co-operative Societies Act 2001 (Act Number XLVII of 2001, which

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<sup>9</sup> Although compromise and arrangement under the Bankruptcy Act are not insolvency processes, they may sometimes be used prior to or pursuant to insolvency.

<sup>10</sup> Companies Act 1994, ss 228-230.

<sup>11</sup> *Idem*, ss 234(1) and 297-314.

<sup>12</sup> *Idem*, ss 234(1) and 241-277.

<sup>13</sup> *Idem*, s 316.

<sup>14</sup> Bankruptcy Act 1997, s 31.

<sup>15</sup> *Idem*, ss 9-42 and the Bankruptcy Rules 1997, rules 35-38.

<sup>16</sup> Banking Companies Act 1991, ss 58-63.

<sup>17</sup> *Idem*, ss 64-108.

<sup>18</sup> Insurance Act 2010, ss 95-99.

<sup>19</sup> *Idem*, s 103.

came into force on 15 July 2001, as amended in 2013).<sup>20</sup> The Registrar is also the authority who appoints a liquidator for winding-up.<sup>21</sup>

As is apparent from the discussion above, courts play an important role in corporate insolvency procedures. When a company becomes unable to pay its debts (that is, it becomes insolvent), the High Court Division of the Supreme Court of Bangladesh may order the involuntary winding-up of that company<sup>22</sup> and appoint an official liquidator other than the official receiver appointed by the Government.<sup>23</sup> The court also has the power to grant injunctions, hear petitions, and stay winding-up proceedings.<sup>24</sup> To facilitate winding-up proceedings, the court has certain “ordinary” powers to, *inter alia*, settle a list of contributories to the estate of the company, require the transfer of property, order the payment of debts by contributories, exclude creditors who do not prove their debts within a fixed time period, and order the payment of costs.<sup>25</sup> Furthermore, the court has certain “extraordinary” powers to summon and examine the officers of a company and any other person who may have information about its assets; to publicly examine promoters, officers and directors of the company who are charged with fraud by an official liquidator; and to arrest potential contributories who may abscond from the proceedings.<sup>26</sup> Whilst the main responsibilities for a creditors’ voluntary winding-up rest with the creditors and a liquidator they appoint, the court continues to have a residual function to appoint or remove a liquidator; to vary arrangements that are binding on creditors or contributories; to determine questions arising from the winding-up brought by the liquidator, creditor, or contributory; and to adapt the proceedings to accommodate unforeseen circumstances.<sup>27</sup> Moreover, the court has the power to order that the creditors’ voluntary winding-up proceedings be continued under the court’s supervision.<sup>28</sup> Beyond involuntary winding-up procedures; compositions, schemes of arrangement, and reorganisation plans under the Bankruptcy Act 1997 are only effective with the approval of the court.<sup>29</sup>

Similarly, insolvency office holders such as liquidators serve an important function. During a winding-up, the official liquidator may replace the directors of a company<sup>30</sup> and act in furtherance of beneficial winding-up and liquidation.<sup>31</sup> Where insolvency adjudication orders under the Bankruptcy Act 1997 are utilised, a receiver will also displace the

<sup>20</sup> Co-operative Societies Act 2001, s 53.

<sup>21</sup> *Idem*, s 54.

<sup>22</sup> Companies Act 1994, s 241(v).

<sup>23</sup> *Idem*, s 255. Companies Act 1994, s 255(6) clarifies that “[a] receiver shall not be appointed of assets in the hands of an official liquidator”, thereby clearly delineating the functions of the two insolvency professionals.

<sup>24</sup> Companies Act 1994, ss 248, 249 and 253.

<sup>25</sup> *Idem*, ss 267-276.

<sup>26</sup> *Idem*, ss 278-280.

<sup>27</sup> *Idem*, ss 309, 311(2), 312 and 315.

<sup>28</sup> *Idem*, ss 316-321.

<sup>29</sup> Bankruptcy Act 1997, ss 43(2)-(7) and 46(5).

<sup>30</sup> Companies Act 1994, ss 262 and 301(2). This sub-section indicates that there may be circumstances in which creditors or the committee of inspection sanctions the continuance of some or all of the powers of directors.

<sup>31</sup> *Idem*, ss 255-266.

directors of a company. This is in contrast to cases of compromises and arrangements under the Companies Act 1994, in which the directors of a debtor company remain in office.

In certain circumstances, creditors also have a direct influence on insolvency procedures. In cases of creditors' voluntary winding-up, the entire process is subject to the control and oversight of a meeting of creditors, an appointed creditors' committee of inspection, and the liquidator they appoint for carrying out the winding-up proceedings and the distribution of assets.<sup>32</sup> In cases of winding-up under the supervision of a court, the supervising court may have regard to the wishes of the creditors and contributories as adduced through any sufficient evidence.

A court may consider the wishes of creditors and contributories with respect to deciding between a winding-up by the court or a winding-up subject to court supervision, the appointment of liquidators, and any other matter related to a court-supervised winding-up.<sup>33</sup> Creditors also have the right to participate in and vote on whether to use rescue mechanisms available under the Bankruptcy Act 1997 and the Companies Act 1994. Similarly, when managing and distributing an insolvent company's estate, a receiver is obliged to consider the desires of creditors, potentially via a creditors' committee.<sup>34</sup>

The low recovery rate of these procedures, alongside the amount of time needed to complete them, are the principal reasons why Bangladesh is considered to be a debtor-friendly jurisdiction. A recent comparative analysis of the legal frameworks for corporate insolvency in 18 major jurisdictions across the Asia-Pacific region found that three jurisdictions, including Bangladesh, were "most debtor-friendly".<sup>35</sup> The World Bank's latest Doing Business report illuminates the recovery rate and time involved. Its resolving insolvency metric, which only assesses the relatively expeditious foreclosure proceedings initiated under the Money Loans Court Act 2003, found that it took four years to complete a procedure and only 29.1 cents on the dollar would be recovered.<sup>36</sup> Corporate insolvency procedures under the other legislation often take longer, with a local daily newspaper recently reporting that of the 11 cases filed under the Bankruptcy Act 1997 between January 2016 and December 2020, only two have been disposed of.<sup>37</sup>

## 1.2 Ongoing corporate insolvency law reforms

In view of the discussed shortcomings of the current corporate insolvency procedures and due to a desire to improve Bangladesh's standing in the (recently scrapped) Doing Business rankings, a number of reform proposals have been discussed in the media and

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<sup>32</sup> *Idem*, ss 298-299.

<sup>33</sup> Companies Act 1994, s 318.

<sup>34</sup> Bankruptcy Act 1997, s 36 read with s 68(3).

<sup>35</sup> See <https://www.herbertsmithfreehills.com/latest-thinking/guide-to-restructuring-turnaround-and-insolvency-in-asia-pacific-october-2018>.

<sup>36</sup> See <https://www.doingbusiness.org/en/data/exploreconomies/bangladesh#>.

<sup>37</sup> R Karim, "Cases drag at bankruptcy courts", *The Business Standard* (5 June 2021), available [here](#).



academic circles. There has long been an intent to substantially amend the Companies Act 1994, which, amongst other things, would affect the winding-up of companies. The proposed draft Companies Act 2013 would extinguish the distinction between members' voluntary winding-up proceedings and creditors' voluntary winding-up proceedings. In contrast to the current situation, it will not be possible to commence a creditors' voluntary winding-up proceeding without furnishing a declaration of solvency.<sup>38</sup> However, at present, it appears that the Government of Bangladesh is focused on amending the Companies Act 1994 instead of entirely overhauling the legislation. This is illustrated by the recent passing of the Companies (First Amendment) Act 2020 (Act Number 7 of 2020, which came into force on 25 February 2020) and Companies (Second Amendment) Act 2020 (Act Number 24 of 2020, which came into force on 26 November 2020). These amendments, *inter alia*, abolished mandatory common seal requirements and introduced the one-person company as a new entity form. With relevance to corporate insolvency, the Companies (Second Amendment) Act 2020 inserted two new provisions into the Companies Act 1994 concerning fraudulent transfers in the lead-up to liquidation proceedings.<sup>39</sup> If a company, in the six months prior to the application for liquidation makes any monetary payments, supplies goods, or transfers authority over immovable or movable property for the purposes of taking action against or by a company, a court can, if it deems fit, order the transaction to be deemed illegal and rescinded.<sup>40</sup> Moreover, if a company transfers any assets or supplies any goods in the year preceding a liquidation application or voluntary winding-up application, those transactions will be void unless they were carried out in the ordinary course of business, in good faith, or the buyer had to pay a reasonable price. The liquidator can recover these assets or goods from the company or person to whom they were transferred or supplied.<sup>41</sup>

More recently, policymakers have turned their attention to the Bankruptcy Act 1997, having noted the shortcomings of the current framework in resolving insolvency. On 6 February 2019, the Bangladesh Bank, along with the Law Commission of Bangladesh and the Bangladesh International Arbitration Centre (BIAC), convened a meeting to discuss far-reaching amendments to the Bankruptcy Act 1997 so as to make it more effective in punishing habitual defaulters.<sup>42</sup> Afterwards, the Bangladesh Bank sent a report to the Finance Ministry on the need to reform the Bankruptcy Act 1997, as it was not as effective as the Money Loans Court Act 2003.<sup>43</sup> In 2021, a draft amendment to the Bankruptcy Act 1997 was prepared by the Bangladesh Bank, which, *inter alia*, addressed the time needed to dispose of a suit / action and set out a new procedure for financial creditors to take

<sup>38</sup> Companies Act 2013, ss 455-456.

<sup>39</sup> Companies (Second Amendment) Act 2020, s 8.

<sup>40</sup> Companies Act 1994, s 327(4).

<sup>41</sup> *Idem*, s 327(5).

<sup>42</sup> A Uddin, "BB moves to amend bankruptcy act", The Daily Star (6 February 2019), available [here](#).

<sup>43</sup> R Anjan, "When will the Bankruptcy Act be amended? [কবে সংশোধন হবে দেউলিয়া আইন]", *Bangladesh Pratidin* (27 October 2020), available [here](#) (in Bangla).

action against corporate debtors (including the restructuring of debts).<sup>44</sup> However, a bill to this effect has yet to be placed before the Parliament.

At present, the emergency regulations introduced by the Government of Bangladesh in response to the Covid-19 pandemic have not affected Bangladesh's insolvency framework. However, it is worth noting that the creation of a virtual court system facilitates the virtual filing of civil suits.<sup>45</sup> This system could possibly be used, for example, by creditors in filing bankruptcy claims, as they have a one-year time limit in which to submit a claim.<sup>46</sup> Covid-19 related measures have been limited to subsidising certain key industries, such as the commercial ready-made garments sector, so as to shield them from financial distress.<sup>47</sup>

Furthermore, and of particular relevance, is that the United Nations Capital Development Fund (UNCDF) has been working together with the Government of Bangladesh to develop a municipal investment financing programme. Its creation is motivated by a desire to enable municipalities to issue municipal bonds in order to finance public infrastructure and other public works such as the construction of recreation centres. So far, nine municipalities have been rated between BBB+ and BBB. However, for these bonds to be issued, there must be legal reforms to facilitate borrowing by local government bodies and, concomitantly, the creation of mechanisms to rescue those municipalities that may face financial distress.<sup>48</sup>

## **2. Local public entities**

### **2.1 Defining local public entities**

Legal reforms are required as neither the Companies Act 1994 nor the Bankruptcy Act 1997 applies to "basic" local public entities, which are public authorities or entities that are funded by taxes and provide essential services to local communities. Whilst generic terms such as "public entity" and "local entity" are not used in existing laws, the legal framework does reference and regulate statutory public authorities such as municipalities, city corporations and fully state-owned enterprises.<sup>49</sup> A "statutory public authority" is a term defined in the Constitution of the People's Republic of Bangladesh. Article 152 of the Constitution states that a "statutory public authority means any authority, corporation or

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<sup>44</sup> Financial Institutions Division, Draft Law: Bankruptcy Act 2021 (last updated 16 February 2021), available [here](#) (in Bangla).

<sup>45</sup> See the practice direction of the High Court Division of the Supreme Court of Bangladesh, Notice No 3, dated 7 June 2020. Also see the Use of Information Technology by Courts Ordinance 2020.

<sup>46</sup> Bankruptcy Act 1997, s 12(1)(c).

<sup>47</sup> This has also extended to include certain time-bounded relief on the payment of interest / profits on loans (Bangladesh Bank BRPD Circular No 23, dated 4 May 2020), as well as relaxing rules concerning foreign-owned or foreign-controlled companies obtaining working capital loans from their parent companies or shareholders (Bangladesh Bank FE Circular No 19, dated 3 May 2020).

<sup>48</sup> J U Haroon, "UNCDF-developed Municipal Bond to hit Bangladesh Capital Market", *The Financial Express BD* (16 October 2017), available [here](#).

<sup>49</sup> The term "public sector undertaking" is also used.

body the activities or the principal activities of which are authorised by any act, ordinance, order or instrument having the force of law in Bangladesh". There are many corporate entities that are created by law that fulfil this criterion, including municipalities and city corporations.

A municipality is a body corporate that is composed of elected officials (a mayor and councillors) who are entrusted with local government control in an administrative unit of the Republic.<sup>50</sup> The Government of Bangladesh can declare a municipal area and grant municipality status after analysing a rural area's population, its density, its economic importance, local income sources, and the percentage of non-agricultural professional residents in the area.<sup>51</sup> As statutory bodies, municipalities enjoy perpetual succession and have a common seal. They have the power to sue and be sued in their own name, as well as to acquire, hold, and transfer moveable and immoveable property, subject to the provisions of the Local Government (Municipality) Act 2009 and its Rules.<sup>52</sup> At present, there are three categories of municipalities: Class A, Class B, and Class C. Class A municipalities are those that have at least BDT 10 million (Bangladeshi Taka) in their own revenue resources (excluding government grants), Class B municipalities are those with BDT 6 million or above in revenue, and Class C municipalities are those with a minimum of BDT 2 million in revenue.

A city corporation is also a body corporate that is composed of elected officials (a mayor and councillors) who are entrusted with local government in an administrative unit of the Republic.<sup>53</sup> The Government of Bangladesh can upgrade a municipal area into a city corporation after analysing the population size and density of the municipal area, its local sources of income, its economic importance, its existing infrastructure, the potential for its expansion, the municipality's current annual revenue, and the public's opinion on a potential upgrade.<sup>54</sup> As statutory bodies, city corporations enjoy perpetual succession and have a common seal. They have the power to sue and be sued in their own name, as well as to acquire, hold, and transfer moveable and immoveable property, subject to the provisions of the Local Government (City Corporation) Act 2009 and its Rules.<sup>55</sup> The case of *Shamima Sultana Seem*<sup>56</sup> clarified that city corporations enjoy separate legal personality from government departments and that the central Government cannot interfere in their functions through the issuance of standing orders.

Other statutory public authorities include the Dhaka Transport Coordination Authority, the Water Supply and Sewerage authorities, medical universities that serve as both hospitals

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<sup>50</sup> Constitution of the People's Republic of Bangladesh, art 59(1) read with Local Government (Municipality) Act 2009, s 5. In Bengali, a municipality is known as a *pourashava*.

<sup>51</sup> Local Government (Municipality) Act 2009, s 2(43) read with ss 3-4 and 6.

<sup>52</sup> *Idem*, s 4(3).

<sup>53</sup> Constitution of the People's Republic of Bangladesh, art 59(1), read with Local Government (City Corporation) Act 2009, ss 3(7) and 5.

<sup>54</sup> Local Government (City Corporation) Act 2009, ss 2(14) and 3(4).

<sup>55</sup> *Idem*, s 3(6).

<sup>56</sup> *Shamima Sultana Seema and 9 Others v Govt. of Bangladesh* 57 DLR (HCD) (2005) 201.

and educational institutions in cities throughout Bangladesh, and seaport authorities, all of which were created by acts of Parliament. These institutions can also only be dissolved through either an act of Parliament<sup>57</sup> or an order of the Government.<sup>58</sup>

In addition, there are many private companies in which the Government holds a majority shareholding. Some of these companies may be deemed “hybrid” local public entities since they carry out fundamental services or distribute essential goods at a local level. One such example is the Dhaka Mass Transit Company Limited, which was established in 2013 as a fully government-owned company to implement the metro rail project in the capital city. Another earlier example is the Dhaka Power Distribution Company Limited, which is fully owned by the Government.

## 2.2 Scope of activities and powers

The missions of statutory public authorities, but not government-majority companies, are generally stated in the respective laws creating these authorities. For example, the Grameen Bank, which is regulated by the Grameen Bank Act 2013, is responsible for the extension of micro-credit to landless persons.<sup>59</sup> Municipalities and city corporations also have specific missions stated in their respective laws. Municipalities’ main responsibilities are to provide services to citizens within their municipal area, co-ordinate the activities of the municipal administration and government officials, develop infrastructure, and maintain the security and discipline of citizens.<sup>60</sup> To fulfil this mandate, a municipality has several explicit functions and responsibilities. In particular, they must supply water and sanitation, manage the disposal of waste, issue plans to ensure economic and social justice, construct transport infrastructure, administer birth and death registration, conserve public health and the environment, manage markets and slaughterhouses, oversee beautification, and fulfil any other responsibilities delegated to them by the Government.<sup>61</sup> Similarly, the main functions of a city corporation are specified in the third schedule of the Local Government (City Corporation) Act 2009. They broadly concern the enforcement of regulation and efforts to further public health, public welfare, public safety, public works, and development activities.

The Constitution empowers both municipalities and city corporations to “impose taxes for local purposes, prepare their budgets” and maintain funds.<sup>62</sup> The taxes that a municipality and city corporation can levy are listed in the third schedule of the Local Government (Municipality) Act 2009 and the fourth schedule of the Local Government (City Corporation) Act 2009. In addition, city corporations can, with the approval of the Government, obtain loans from any financial institution.<sup>63</sup> This follows from The Local

<sup>57</sup> Bangabandhu Sheikh Mujib Medical University Act 1998 (Act No 1 of 1998), s 57.

<sup>58</sup> The Chittagong Port Authority Ordinance 1976 (Ordinance No 52 of 1976), s 50.

<sup>59</sup> Grameen Bank Act 2013, ss 4(2) and 19.

<sup>60</sup> Local Government (Municipality) Act 2009, s 50(1).

<sup>61</sup> *Idem*, s 50(2).

<sup>62</sup> Constitution of the People’s Republic of Bangladesh, art 60.

<sup>63</sup> Local Government (City Corporation) Act 2009, s 79(1).

Authorities Loans Act 1914, which also applies to municipalities and city corporations and allows them to borrow on the security of (part of) their funds to carry out works they are legally authorised to carry out, give relief during famines and times of scarcity, prevent the outbreak of dangerous epidemic diseases, and take other ancillary measures.<sup>64</sup> Importantly, should the local authority default, the Government will assume the security and only a Government officer can deal with the amounts owed in alignment with that security to, for example, repay the loan and interest.<sup>65</sup> Furthermore, local authorities can seek to borrow money through the issuance of short-term promissory notes.<sup>66</sup>

Municipalities can also enter into private partnership agreements for water supply, drainage and sewerage, waste management, and road construction in the interest of their citizens.<sup>67</sup>

Other statutory public authorities are typically permitted to borrow money; however, the terms on which they may borrow vary. The Water Supply and Sewerage authorities, for instance, can take up loans from the Government, commercial banks and financial institutions, but they cannot accept an interest rate that is lower than the prevailing rate offered by commercial banks from the latter two.<sup>68</sup> In contrast, the Chittagong Port Authority Ordinance simply requires approval from the Government to borrow money for the purpose of carrying out its objectives.<sup>69</sup> Government-majority companies can take up loans within Bangladesh and abroad on the same terms as ordinary companies and report on these liabilities and expenses (for example, interest repayments) in the same manner as ordinary companies in their annual financial statements. Thus, their restrictions in terms of investments during periods of financial distress (for example, owing to the unfair preference and fraudulent transfer offences) are identical to those of privately-owned companies.

The capacity of statutory public authorities to enter associations and form subsidiaries is governed by the respective laws giving birth to these authorities and, in most of the cases, the relevant laws are enabling rather than restrictive.<sup>70</sup> As a matter of fact, since the Government dominates the governing bodies of both government-majority companies and statutory public authorities, the Government decides the issue of association on an *ad hoc* basis. For instance, the Dhaka Transport Coordination Authority has the power to form companies that will help implement a local public transport system with prior approval,<sup>71</sup> which they exercised by incorporating the aforementioned Dhaka Mass Transit Company

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<sup>64</sup> The Local Authorities Loans Act 1914 (Act No 9 of 1914, which came into force on 28 February 1914), s 3(1).

<sup>65</sup> *Idem*, s 5.

<sup>66</sup> *Idem*, s 6(1).

<sup>67</sup> Local Government (Municipality) Act 2009, ss 96 and 97(B).

<sup>68</sup> Water Supply and Sewerage Authority Act 1996 (Act No 6 of 1996), s 32(1).

<sup>69</sup> The Chittagong Port Authority Ordinance 1976, s 36.

<sup>70</sup> See, for example, The Chittagong Port Authority Ordinance 1976, s 106, which permits municipalities to form joint committees with other municipalities and local authorities to deal with matters of common interest.

<sup>71</sup> Dhaka Transport Coordination Authority Act 2012 (Act No 8 of 2012), s 19.

Limited. The association and company formation decisions are overseen by, amongst others, a board of directors that is typically exclusively comprised of public servants and technocrats. In contrast, government-majority companies, like any other ordinary company, are governed by the Companies Act 1994. In general, they are not restricted in the activities that they pursue. However, their activities are scrutinised by the Government because they have Government representatives on their board.

It is relevant to mention that, under the Bangladesh Public-Private Partnership Act 2015 (Act Number 18 of 2015, which came into force on 16 September 2015) and its applicable rules and regulations, contractual arrangements between, *inter alia*, statutory public authorities (including local government bodies) and private partners for the purpose of the latter carrying out public works or services are actively encouraged.<sup>72</sup>

### 2.3 Applicability of corporate insolvency and accounting laws

A private university, hospital, or transport provider is subject to another regulatory regime, including different corporate insolvency laws, than a statutory public authority. These basic local public entities also have different, specific rules concerning the reporting of their financial results. The Government prescribes the appropriate methods for municipalities to account for their income and expenditure, as well as the authority responsible for auditing these accounts.<sup>73</sup> Any produced audit report is subsequently shared with the Government.<sup>74</sup> The same terms apply to city corporations in the preparation of their audited accounts.<sup>75</sup> A municipality may take action against any parties who are responsible for a failure to maintain accounts as prescribed or other account or auditing irregularities.<sup>76</sup> For instance, if an offender is an employee or officer, a municipality may suspend or dismiss them.<sup>77</sup> With respect to both municipalities and city corporations; employees, officials, or elected persons can be held personally liable if their negligence or misconduct directly resulted in a loss, waste, or misuse of money or property belonging to these basic local public entities.<sup>78</sup> In relation to the Water Supply and Sewerage authorities of Dhaka city and Chattogram city (previously Chittagong city), the Government has a special responsibility to ensure that they meet their corporate plans, programmes and performance agreements.<sup>79</sup> To aid the Government in fulfilling this responsibility, Water Supply and Sewerage authorities must maintain accounts in a manner akin to that of a commercial enterprise and present a summary of these accounts to the board of the authorities and the Government for review.<sup>80</sup> These accounts should be externally audited and supplemented by an annual report that has already been reviewed by the

<sup>72</sup> The Bangladesh Public-Private Partnership Act 2015, s 2(27).

<sup>73</sup> Local Government (Municipality) Act 2009, ss 93-94.

<sup>74</sup> *Idem*, s 94(5).

<sup>75</sup> Local Government (City Corporation) Act 2009, ss 77-78.

<sup>76</sup> Local Government (Municipality) Act 2009, s 94(6).

<sup>77</sup> *Idem*, s 73(4).

<sup>78</sup> *Idem*, ss 47 and 81.

<sup>79</sup> Water Supply and Sewerage Authority Act 1996, s 41.

<sup>80</sup> *Idem*, ss 36-37.

Government for compliance with the Water Supply and Sewerage authorities' performance agreements.<sup>81</sup>

In contrast, hybrid local public entities, such as state-owned enterprises formed under the Companies Act 1994, follow the accounting and auditing rules contained in this act. For example, these rules apply to hybrid local public entities such as the Dhaka Power Distribution Company Limited (a public limited liability company under the control of the Ministry of Power, Energy and Mineral Resources)<sup>82</sup> and Titas Gas Transmission and Distribution Company Limited (a public limited liability company with 75% of its shares held by Petrobangla, a statutory public authority).<sup>83</sup> The different treatments of basic and hybrid local public entities is discussed in more detail below.

### **3. Dealing with local public entities in distress - the legal framework**

#### **3.1 Principles and framework**

As mentioned above, the legal framework for basic local public entities, namely statutory public authorities in the Bangladesh context, differs from that for companies formed under the Companies Act 1994, including companies that the Government has a majority shareholding in. The laws establishing statutory public authorities do not disclose the reasons behind this variance.

The application of the Bankruptcy Act 1997 against statutory public authorities that do not primarily seek to make profits is categorically barred.<sup>84</sup> However, the Companies Act 1994 does not contain any such provision. Nevertheless, the liquidation and rescue mechanism of this act are not applicable against statutory public authorities for reasons stated below. In fact, every statutory public authority has been created by statute. All of the statutes establishing statutory public authorities typically provide that the authorities established by them can only be wound-up by the Government or through the enactment of a new law. These provisions typically prevent courts from applying the winding-up or liquidation provisions of the Companies Act 1994. Moreover, the rescue mechanisms provided by the Companies Act 1994, such as compromises and arrangements, will not apply against statutory public authorities, as these provisions are only applicable to companies liable to be wound up under the Act.<sup>85</sup> Similarly, the Local Government (Municipalities) Act 2009 provides for the abolition of existing municipalities or the merger or division of municipalities.<sup>86</sup> Municipalities can be dissolved, for example, for failing to collect 75% of their imposed annual tax, rates, tolls, fees and other charges without reasonable grounds.<sup>87</sup> The Local Government (City Corporation) Act 2009 also states that a city

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<sup>81</sup> *Idem*, ss 38 and 40.

<sup>82</sup> Dhaka Power Distribution Company Ltd Annual Report 2020, at 100 and 106.

<sup>83</sup> Titas Gas Transmission and Distribution Company Ltd Annual Report 2020, at 6.

<sup>84</sup> Bankruptcy Act 1997, s 11(2).

<sup>85</sup> Companies Act 1994, s 228(6).

<sup>86</sup> Local Government (Municipality) Act 2009, ss 4(4)(d)-(e) and 11.

<sup>87</sup> *Idem*, s 49.

corporation can be dissolved for failing to fulfil its financial obligations.<sup>88</sup> The central Government has traditionally retained the power to dissolve basic local public entities. The case of *Tahera Begum*<sup>89</sup> outlines how the Bangladesh Local Councils and Municipal Committees (Dissolution and Administration) Order 1972 (PO Number 7 of 1972) and the Bangladesh Local Government (Union Parishad and Pourashava) Order 1973 (PO Number 22 of 1973) were used to dissolve existing local government units and create new ones.

In theory, the dissolution of local public entities could be due to debts owed on loans from both public and private financial institutions, as municipalities and city corporations have the authority to obtain such loans. In practice, municipalities and city corporations receive financial assistance through block and special grants from the central Government.<sup>90</sup> Those municipalities and city corporations that lack sufficient local revenue and struggle to meet their debts and expenses, and as such are financially distressed, tend to rely heavily on these grants. They also rely on funds from international development partners, particularly when they are financially distressed.<sup>91</sup>

Therefore, a statutory public authority in distress can only be liquidated upon Government order (after a proposal for doing so has been considered by the Cabinet)<sup>92</sup> or if required by new legislation, as the case may be. To provide a concrete example: the jute, textile, sugar and food, steel and engineering, and chemical scheduling enterprises that are under the control of the state corporations of these respective industries, are not subject to the winding-up provisions of the general insolvency law framework (even if they were once under private ownership).<sup>93</sup> Instead, these particular enterprises are wound-up and liquidated in a manner directed by the Government through a notification in the official Gazette.<sup>94</sup> The liquidation cell (which is a small department) of a responsible Ministry is responsible for overseeing the liquidation process rather than the management of the concerned enterprise. As indicated by the examples of statutory public authority legislation above, the repealing legislation typically establishes a new authority to immediately take over the employees, officials, assets and liabilities of the dissolved entity. This will especially be the case where the distressed authority was dispensing an essential service. Evidently, there is an intention to ensure the continuity of public services in practice, even if this intention is not explicitly stated in the legislation creating an entity. Laws establishing statutory public authorities do not contain any provisions on rescue; instead, a statutory public authority's rescue depends on whether they receive financial support from the central Government, or not.

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<sup>88</sup> Local Government (City Corporation) Act 2009, s 108(1)(b).

<sup>89</sup> *Tahera Begum v Farukh Meah*, 35 DLR (AD) (1983) 170, para 4.

<sup>90</sup> Local Government (Municipality) Act 2009, s 89(2)(g) and Local Government (City Corporation) Act 2009, s 70(2)(c).

<sup>91</sup> A K M Pramanik, A F M Khan and Q Haque, *Presentation on the Municipal Public Finance Scenario in Bangladesh* (2018), available [here](#); and P K Panday, *Reforming Urban Governance in Bangladesh: The City Corporation* (Palgrave Macmillan, Cham, 2017) at 95.

<sup>92</sup> Rules of Business 1996, as amended in July 2012, rule 16(ix)(c).

<sup>93</sup> Bangladesh Industrial Enterprises Nationalisation Act 2018, ss 3(1) and 22(1).

<sup>94</sup> *Idem*, s 22(2).



Rescue arrangements of private banking companies involve Government oversight and thus bear a resemblance to how local public entities in financial distress are addressed. The Government, following a consultation with the Bangladesh Bank, may acquire the undertaking of a banking company, should the bank be managed in a manner detrimental to the interests of its depositors, contrary to the country's banking, or the provision of credit policies.<sup>95</sup> Alternatively, the Government, in consultation with the Bangladesh Bank, can prepare a scheme for the rescue of the undertaking of a bank, which can lead to its transfer to another bank.<sup>96</sup>

### 3.2 Parties involved

For the reasons stated above, the general rules on the role of directors or insolvency office holders in insolvency procedures are inapplicable to statutory public authorities but apply, without any exceptions, to government-majority companies. Municipalities and city corporations – which constitute statutory public authorities – have government-nominated and appointed officials as directors or elected persons in key decision-making and oversight roles. As such, the role of directors and liquidators is decided on an *ad hoc* basis depending on the nature and needs of a given statutory public authority, and the Ministry responsible for it.

The position is different for companies formed under the Companies Act 1994, as well as for some of the hybrid local public entities discussed previously. The remainder of this section elaborates on the role of concerned parties in potential insolvency proceedings involving hybrid local public entities formed under company legislation. Rescue mechanisms under the Companies Act 1994, such as compromise and arrangements, are debtor-in-possession processes, which are procedures during the operation of which a company's directors retain their powers, albeit they are subjected to the supervision of the High Court Division of the Supreme Court of Bangladesh.<sup>97</sup> The court may, at its discretion, grant a stay on enforcement actions during the time a compromise or arrangement is being negotiated.<sup>98</sup> Importantly, company law dictates that "if a majority in number representing three-fourth[s] in value of creditors...agree to any compromise or arrangement, the compromise or arrangement will be binding on all the creditors or the class of creditors".<sup>99</sup>

When a company is subject to an involuntary winding-up procedure initiated by a court under the Companies Act 1994, its directors are replaced by an official receiver appointed by the Government who acts as the company's official liquidator.<sup>100</sup> Additionally, a court

<sup>95</sup> Bank Companies Act 1991, s 58(1)(b).

<sup>96</sup> *Idem*, s 59.

<sup>97</sup> Companies Act 1994, s 3(1) read with ss 228-230.

<sup>98</sup> *Idem*, s 228(5).

<sup>99</sup> *Idem*, s 228(3).

<sup>100</sup> Companies Act 1994, s 251(2). An official receiver is appointed by the Government in accordance with the Official Receiver's Act 1938 (Bengal Act No VII of 1938). This Act, however, does not require official receivers to have any particular qualifications.

may appoint one or more persons as official liquidators.<sup>101</sup> Although no qualification is statutorily set for such an appointment – beyond giving security as may be set by the court – lawyers or accountants are generally appointed to these roles.<sup>102</sup> An official receiver or liquidator must charge fees by way of percentage or otherwise as a court may direct.<sup>103</sup>

Whilst a company is subject to a creditors' voluntary winding-up procedure under the Companies Act 1994, the company and its creditors may nominate a person to be its liquidator. If a company and its creditors nominate different persons, the person nominated by the creditors is preferred. However, a company can apply to a court to have its nominee appointed in place of, or in addition to, the creditors' nominee.<sup>104</sup> The committee of inspection or, if there is no such committee, the creditors, will determine the liquidator's remuneration. Where a liquidator's remuneration is not fixed by either body, it is determined by the court.<sup>105</sup> During a creditors' voluntary winding-up, a liquidator's remuneration is payable out of the assets of the company to which the liquidator is appointed in priority to all other claims except for those of secured creditors.<sup>106</sup> Following the appointment of a liquidator, a company's directors are stripped of all of their powers except for those possessed in conjunction with their role as members of a committee of inspection. If there is no such committee, the directors will enjoy the powers that the creditors authorise them to have.<sup>107</sup> Moreover, there is an automatic stay of enforcement actions during the winding-up process.<sup>108</sup>

To have a composition, scheme of arrangement, or reorganisation plan passed under the Bankruptcy Act 1997, two-thirds in value of all creditors<sup>109</sup> must accept it, and the Bankruptcy Court must subsequently approve the plan or procedure.<sup>110</sup> Upon receiving judicial approval, an arrangement crams-down on all creditors.<sup>111</sup> Conversely, a court may refuse to approve compositions or schemes of arrangement if they appear to be unreasonable or not beneficial for a company's general body of creditors.<sup>112</sup> Similarly, whilst deciding whether to approve a reorganisation plan, a court takes several factors into account, such as national interest, the interests of creditors and the interests of the debtor.<sup>113</sup> In such cases, the court may also make necessary modifications and impose

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<sup>101</sup> Companies Act 1994, s 255.

<sup>102</sup> *Idem*, s 255(4).

<sup>103</sup> *Idem*, s 256(3), and Official Receiver's Act 1938, s 7(1).

<sup>104</sup> Companies Act 1994, s 299.

<sup>105</sup> *Idem*, s 301(1).

<sup>106</sup> *Idem*, s 313.

<sup>107</sup> *Idem*, s 301(2).

<sup>108</sup> *Idem*, s 324.

<sup>109</sup> Bankruptcy Act 1997, ss 43(2) and 46(5).

<sup>110</sup> *Idem*, s 4 read with ss 43(6), 44 and 46(5). This court is presided over by a District Judge or by an Additional District Judge (if authorised by the District Judge).

<sup>111</sup> *Idem*, ss 43(2), 44 and 46(6).

<sup>112</sup> *Idem*, s 43(4).

<sup>113</sup> *Idem*, s 46(5).

conditions for protecting the interests of (i) dissenting creditors, (ii) various classes of creditors, and (iii) the general body of creditors.<sup>114</sup>

When a company becomes subject to bankruptcy adjudication proceedings brought under the Bankruptcy Act 1997, the administration of that company's affairs, on the making of an order of adjudication, stands vested in the appointed receiver.<sup>115</sup> A court may also appoint an interim receiver with the same powers prior to the said adjudication.<sup>116</sup> An automatic stay on enforcement actions is allowed whilst bankruptcy proceedings are pending.<sup>117</sup> However, this stay does not apply to secured creditors as they are entitled to claim in relation to their fixed security before the date of the order of adjudication for insolvency.<sup>118</sup> If they do not do so, they can, before distributions are made to general creditors, realise their security through the intervention of an appointed receiver.<sup>119</sup>

### 3.3 Technical rules / procedures

Having discussed the role of various parties within different types of insolvency proceedings, it is worthwhile to consider the technical rules that apply to these parties concerned.

The general rules regarding the appointment, powers, duties, and remuneration of insolvency practitioners such as (official) liquidators, receivers, and special managers, apply to government-majority companies in the same manner as private companies.<sup>120</sup> There is no specific law, rule, or licensing system for insolvency practitioners in Bangladesh.

The technical rules and procedures contained in the Bankruptcy Act 1997 are of particular interest. Receivers are chosen from the approved list of receivers maintained by the Government.<sup>121</sup> As to the qualification of receivers, the statute only requires that such persons (including individuals, firms and companies) are of good reputation with regard to honesty and are sufficiently competent to serve the public's interests as receivers.<sup>122</sup> An individual must be a citizen of Bangladesh and hold a graduate degree.<sup>123</sup> An appointed receiver may, subject to a court order, carry on the business of a debtor company if doing so would be beneficial for winding-up the estate.<sup>124</sup> A receiver is entitled to fees realisable

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<sup>114</sup> *Ibid.*

<sup>115</sup> *Idem*, s 31(2).

<sup>116</sup> *Idem*, s 23(1).

<sup>117</sup> *Idem*, 31(3).

<sup>118</sup> *Idem*, s 31(4).

<sup>119</sup> *Idem*, s 54(3).

<sup>120</sup> See, for example, Bankruptcy Act 1997, ss 64-69 and 71-74; and Companies Act 1994, ss 251 and 255-266. These provisions provide the general rules applicable to receivers under the Bankruptcy Act 1997 and liquidators under the Companies Act 1994, respectively.

<sup>121</sup> Bankruptcy Act 1997, s 64(1).

<sup>122</sup> *Idem*, s 106.

<sup>123</sup> Bankruptcy Rules 1997, rule 46(2)(b).

<sup>124</sup> Bankruptcy Act 1997, s 71(2)(a).

from the sale proceeds of an estate at the following rate: (i) 10% of the amount up to the first BDT 1,000,000; (ii) 5% of the amount up to the next BDT 19,000,000; and (iii) 1% of sale proceeds realised above BDT 19,000,000.<sup>125</sup> A receiver is also entitled to reimbursement of all the expenses incurred in realising and distributing the assets of the estate.<sup>126</sup> A court may also appoint officers and employees to assist the receiver.<sup>127</sup> Their remuneration is paid out of the receiver's fees.<sup>128</sup>

Under the Bankruptcy Act 1997, when distributing the proceeds received from selling an estate's assets, payments are first made to meet administrative expenses and receiver's fees. Thereafter, payments must be made to cover the following, in this order:

- (a) all taxes and debts due to the Government;
- (b) employee wages in respect of services rendered to the debtor company during the six months before filing;
- (c) bank debts;
- (d) unsecured claims; and
- (e) subordinated claims.<sup>129</sup>

Only once the claims in each category has been paid in full may the claims in the following category be paid.

If whilst allocating proceeds it appears that these funds are not sufficient to meet all bank debts, these claims for bank debts shall proportionately abate in order to ensure that at least 50% of all payments to be made in respect of unsecured claims are possible.<sup>130</sup> The preferential treatment of a creditor can also be nullified by courts where fraudulent transfers have occurred.<sup>131</sup>

If a company is being wound-up, the liquidation-related rules will apply in the winding-up of that company, which include the respective rights of secured and unsecured creditors under these rules.<sup>132</sup> Legislation sets out<sup>133</sup> the priority ranking of companies undergoing involuntary winding-up or creditors' voluntary winding-up:

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<sup>125</sup> *Idem*, s 66(1).

<sup>126</sup> *Idem*, s 66(2).

<sup>127</sup> *Idem*, s 64(3)(a).

<sup>128</sup> *Idem*, s 64(3)(b).

<sup>129</sup> Bankruptcy Act 1997, s 75(1).

<sup>130</sup> *Idem*, s 75(2).

<sup>131</sup> *Idem*, s 61.

<sup>132</sup> Companies Act 1994, s 324.

<sup>133</sup> *Idem*, s 325(1).

- (a) all revenue, taxes, cesses, and rates payable to the Government or a local authority;
- (b) all wages / salaries of clerks / servants with respect to their service to a company in the two months prior to the winding-up;
- (c) all wages of labourers / workmen with respect to their services rendered within the two months prior to the winding-up;<sup>134</sup>
- (d) compensation payable under the Workmen's Compensation Act 1923 (Act Number 8 of 1923) with respect to the death or disablement of any officer or employee of the company;
- (e) sums due to any employee from a provident fund, pension fund, gratuity fund or any other fund for the welfare of employees; and
- (f) expenses for any investigation made in accordance with section 195(c) of the Companies Act 1994.

These debts will "rank equally among themselves and be paid in full, unless the assets of the company are insufficient to meet all of them, in which case they shall abate in equal proportion".<sup>135</sup>

#### **4. Dealing with local public entities in distress - law in practice**

The formal liquidation or rescue of a local public entity hardly ever reaches the court system in Bangladesh. Instead, local government units, including city corporations, are typically dissolved through acts of Parliament or an amendment to an existing act.<sup>136</sup> For instance, the Dhaka City Corporation was dissolved in 2011, and its employees, assets, and liabilities were divided amongst a Dhaka North City Corporation and a Dhaka South City Corporation through an amendment of the Local Government (City Corporation) Act 2009 (Act Number 60 of 2009).<sup>137</sup> Similarly, a Dhaka Transport Coordination Authority was created in 2012 to streamline, plan, integrate and modernise the transport system of the Dhaka metropolitan area (which includes the capital city Dhaka, as well as certain adjoining districts). This authority abolished the earlier Dhaka Vehicle Coordination Board, which had been formed by the Dhaka Vehicle Coordination Board Act 2001 (Act Number 19 of 2001), and inherited its officers, employees, debts, liabilities, and assets.<sup>138</sup> However, the

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<sup>134</sup> Subject to a maximum of BDT 500 (USD 5.89) per person.

<sup>135</sup> Companies Act 1994, s 323(2)(a).

<sup>136</sup> BRAC Institute of Governance and Development, *Institutional Enabling Environment Report: Narayanganj, Bangladesh* (Cities Alliance, Brussels, 2017) at 10.

<sup>137</sup> Local Government (City Corporation) (Amendment) Act 2011 (Act No 22 of 2011), s 3 introduced a new s 3A to the Local Government (City Corporation) Act 2009.

<sup>138</sup> Dhaka Transport Coordination Authority Act 2012 (Act No 8 of 2012), s 23.

Government generally takes one of two approaches in dealing with basic and hybrid local public entities.

Firstly, it recapitalises the local public entity through a budgetary allocation. To address financial distress faced by statutory public authorities (including municipalities and city corporations), the national budget allocates funds out of taxpayers' money either to meet the capital shortfall or as cash incentives to these entities on a regular basis.<sup>139</sup> Municipalities and city corporations are able to access multiple financing sources ranging from loans from government-owned banks<sup>140</sup> to extraordinary grants from the Government.<sup>141</sup> As government allocations are regularly made through national budgets, and both local revenue collection and local government expenditure are very low, the financial burden falls on the national exchequer.<sup>142</sup> However, there is no systematic study available to determine the extent of its impact. That being said, there is a good number of statutory public authorities that are quite strong in terms of financial health. Recently, a new law named the Surplus Fund Act 2020 (Act Number IV of 2020) was passed by Parliament. This law requires 61 state-owned enterprises to deposit their surplus funds / idle money with the national exchequer so that the Government can utilise the funds for development works.

Secondly, in the case of statutory public authorities that deliver essential services or utilities (hybrid local public entities), the Government often (i) restructures statutory public authorities into government-majority companies or (ii) privatises statutory public authorities or government-majority companies. Many statutory public authorities facing financial distress have been restructured as government-majority companies on the assumption that corporate governance will improve and that this transformation will ultimately save these entities. In this process, the liabilities of these entities to other government bodies have sometimes been declared as equity by the Government.<sup>143</sup> The Rules of Business permit the Government to provide share capital to any government-majority companies.<sup>144</sup> Moreover, many hybrid local public entities in distress have been privatised through a transfer to the private sector or to employees / workers. Although privatisation started in Bangladesh in the 1970s, it was institutionalised through the

<sup>139</sup> Bangladesh Petroleum Corporation Act 2016, s 4; Bangladesh House Building Finance Corporation Order 1973, s 4; and Bangladesh Telecommunications Regulations Act 2001, s 4.

<sup>140</sup> P K Panday, *Reforming Urban Governance in Bangladesh: The City Corporation* (Palgrave Macmillan, Cham, 2017) at 90.

<sup>141</sup> Local Government (Municipality) Act 2009, s 89(2)(g); and Local Government (City Corporation) Act 2009, s 70(2)(c).

<sup>142</sup> P K Panday, *Reforming Urban Governance in Bangladesh: The City Corporation* (Palgrave Macmillan, Cham, 2017) at 95 provides that whilst the payment of holding tax is a lucrative source of income for both municipalities and city corporations, "only 2 percent of total local government revenue is collected at [the] local level", with the major tax bases being controlled by the national Government; and M Rahman, T I Khan and M A Sabbih, *Policy Note: Introducing a 'Universal Pension Scheme' in Bangladesh In Search of a Framework* (Centre for Policy Dialogue, Dhaka, 2019), available [here](#) provides that Bangladesh does not have a universal pension system. The formal pension system at national level only covers employees in government service.

<sup>143</sup> K Nahar, "Biman now at financial risk", *The Financial Express* (16 May 2018), available [here](#).

<sup>144</sup> Rules of Business 1996, rule 16(ix)(b).

establishment of the Privatization Board in 1993. Later, this board was transformed into the Privatization Commission under the provision of a newly enacted law – the Privatization Act 2000. In 2016, this Act was replaced by the Bangladesh Investment Development Authority Act 2016 (Act Number 36 of 2016). Consequently, the Privatization Commission was replaced by the Bangladesh Investment Development Authority, a new statutory body tasked with dealing with investment-related issues, including privatisation of state-owned enterprises. The Bangladesh Investment Development Authority regulates the process of privatising state-owned enterprises in various sectors.<sup>145</sup> Since 1993, a total of 74 state-owned enterprises have been privatised, of which 54 were privatised through an outright sale and 20 through the offloading of government shares.

The cotton and jute mill industries are of particular significance in countries like Bangladesh, as these two industries were nationalised at the time of independence, were major employers in local communities, and produced essential commodities. Indeed, cotton and jute were, for a long time, two of the most consumed fibres in the world, with the latter largely being grown by rural smallholders in the Bengal delta during much of the 20<sup>th</sup> and 21<sup>st</sup> centuries.<sup>146</sup> As such, for much of Bangladesh’s history, the mills have not experienced market competition with private competitors on an even playing field.<sup>147</sup> However, local publicly-owned factories in these two industrial sectors frequently experienced financial distress, resulting in worker<sup>148</sup> and investor buyouts.

The history of Dhakeswari Cotton Mills provides an illustrative example hereof. The company had textile mills in Naryanganj, which became part of East Pakistan after India’s partition in 1947. Following the Indo-Pakistan War of 1965, these mills were declared to be enemy property and were handed over, along with their management, to the Government of East Pakistan. Subsequently, following Bangladesh’s Liberation War of 1971, the Government of Bangladesh nationalised the jute and cotton industries through the Bangladesh Industrial Enterprises (Nationalisation) Order 1972 (PO Number 27 of 1972), with the Dhakeswari Cotton Mill becoming a scheduled industrial enterprise under the Bangladesh Textile Mills Corporation. Following decades of financial turmoil, the Dhakeswari Cotton Mill was liquidated by an order dated 25 January 1982 of the Ministry of Jute and Textiles (Textile Division). Court cases concerning the mill’s winding-up and liquidation continued for decades after the liquidation and are useful in showing how the winding-up of a local public entity can be clearly distinct from winding-up under the Companies Act 1994 or the Bankruptcy Act 1994. This distinction is stated explicitly in the case of *Abdul Hamid v Dhakeshwari Cotton Mills Ltd and ors.*<sup>149</sup> Judge Mustafa Kamal (as

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<sup>145</sup> Bangladesh Investment Development Authority Act 2016, ss 8(13)-(14) and 23-27.

<sup>146</sup> See T O Ali, *A Local History of Global Capital: Jute and Peasant Life in the Bengal Delta* (Princeton University Press, Princeton, 2018); and S Beckert, *Empire of Cotton: A Global History* (Penguin, London, 2015).

<sup>147</sup> See, for instance, C E Humphrey, *Privatization in Bangladesh: Economic Transition in a Poor Country* (Routledge, New York and Abingdon, 1990) at 126-127; and SA Mahmood, “Private jute mills in Bangladesh: A story of death and rebirth”, *Dhaka Tribune* (13 September 2021), available [here](#).

<sup>148</sup> See the discussion of the difficulties in the transfer process in *New Luxmi Narayan Cotton Mills Limited and Another v The Government of Bangladesh and Others*, 2 LCLR (2013) 81.

<sup>149</sup> 36 DLR (1984) 257.

he then was) held that “the Legislature has made it more than clear that no provision of law relating to the winding up of companies shall apply to any scheduled industrial enterprise”.<sup>150</sup> As suits are stayed upon the winding-up of a company, this judgment made it clear that suits or legal proceedings can be brought against scheduled industrial enterprises that are being wound-up.<sup>151</sup>

Just such a suit challenging, *inter alia*, the sale of units by the official liquidator in these same winding-up proceedings was the subject of a later case, namely *The Official Liquidator, The Dhakeswari Cotton Mills, Ltd. v The Dhakeswari Cotton Mills, Ltd. And Others*.<sup>152</sup> In this case, the highest court in Bangladesh, the Appellate Division of the Supreme Court of Bangladesh, held that an amendment to PO Number 27 of 1972, brought by Ordinance Number LXXIII of 1984 on 13 December 1984, which bars suits against scheduled industrial enterprises after a winding-up order has been made, has retrospective effect.<sup>153</sup> However, as the suit involved defendants other than a scheduled industrial enterprise, the suit was not abated in that case.<sup>154</sup> This line of reasoning was later affirmed in the unreported case of *Shakawatullah v Liquidator, Liquidation Call Dhakeswari Cotton Mills and Ors*.<sup>155</sup> This case concerned the deposit of rent by a retired employee of Dhakeswari Cotton Mill who lived in a property that was originally owned by the mill but had been undergoing liquidation since 23 January 1982. The Appellate Division held in a judgment that no suit or other legal proceeding shall be commenced against a scheduled industrial enterprise, or any industrial enterprise placed under a statutory corporation. Similarly, all suits or legal proceedings pending against such an enterprise on the date of a winding-up order are voided.<sup>156</sup> In short, both scheduled industrial enterprises and insolvent companies benefit from the stay of suits following the commencement of winding-up proceedings, albeit under separate legal regimes.

Whilst the decisions stemming from Dhakeswari Cotton Mill’s liquidation provide some clarity, the recent Bangladesh Industrial Enterprises (Nationalisation) Act 2018 has complicated matters. Whilst section 22(1) clearly states that the winding-up provisions of the Companies Act 1994 are inapplicable to corporations and scheduled industrial enterprises mentioned in section 3 of this Act (for example, textile mills under the Bangladesh Textile Mills Corporation), it omits provisions regarding the possibility of commencing suits or other legal proceedings against such legal entities after a winding-up process has begun. It also does not mention whether suits filed prior to a winding-up order are voided once the order is made. This may add to the confusion surrounding the *ad hoc* winding-up of multiple state-owned enterprises in the cotton or jute industries in Bangladesh.

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<sup>150</sup> *Idem*, para 15.

<sup>151</sup> *Idem*, para 17.

<sup>152</sup> 16 BLD (AD) (1996) 295, para 4.

<sup>153</sup> PO No 27 of 1972, s 23(4).

<sup>154</sup> 16 BLD (AD) (1996) 295, para 17.

<sup>155</sup> Civil Petition for Leave to Appeal No 1087 of 2005, decided on 15 January 2006.

<sup>156</sup> *Idem*, para 4.



## 5. Conclusion

This chapter provided an overview and analysis of how the financial distress of local public entities is resolved in Bangladesh. Whilst there is a wide variety of “basic” and “hybrid” local public entities in Bangladesh, there is a paucity of case law concerning the distress of basic local public entities. This may be, tentatively, attributed to two main reasons. Firstly, basic local public entities, such as city corporations and municipalities, were initially introduced as a means of strengthening local governments and democracy. Their role as significant financial players within local communities is a more recent development. Consequently, we see many more reported judgments concerning disputes over the elections of officials than the financial management of these entities.<sup>157</sup> Secondly, the distress of basic local public entities is often addressed through executive decisions and central Government orders, which are deliberated (largely) behind closed doors. Whilst the host of corporate insolvency procedures outlined in this chapter are applicable to government-majority companies, the fact that the Government is the majority or sole shareholder of these entities and, quite often, an important creditor has meant that courts are rarely required to deal with matters stemming from the financial distress of hybrid local public entities.

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<sup>157</sup> For a complete review of all of the reported decisions regarding the financial distress of local governments in two leading Bangladeshi reports, see M N Bhuiyan, *Review of Local Government Laws: Towards Prospect of a Local Government Uniform Framework Legislation* (Government of Bangladesh, Dhaka, 2015).

# Local public entities in distress - a critical analysis of the Belgian approach

By Steven Van Garsse\* and Ellen Wouters\*\*

## 1. General context of insolvency law

### 1.1 General

Belgian insolvency law has been the focus of the legislator on various occasions over the past decades.<sup>1</sup> With the Law of 11 August 2017,<sup>2</sup> the Belgian legislator added new Book XX to the Code of Economic Law (Book XX CEL) and since then Belgian insolvency law has been contained in this Code of Economic Law. Book XX CEL merged the previously existing Law of 31 January 2009 on the continuity of businesses<sup>3</sup> and the Bankruptcy Law of 8 August 1997<sup>4</sup> into one coherent whole, which is incorporated into the Code of Economic Law.<sup>5</sup> The former Law of 31 January 2009 aimed to preserve the continuity of businesses by making extrajudicial or judicial arrangements with the creditors of a company in distress. On the other hand, the Bankruptcy Law laid down the relevant procedure in the event that a reorganisation failed, or the company was in such bad shape that a reorganisation was no longer possible. With the introduction of Book XX CEL, the Belgian legislator has therefore opted for a uniform approach. The legislator did not limit itself to incorporating these laws only, and insolvency law was also thoroughly overhauled in a number of respects. With these amendments, the Belgian legislator aimed to comprehensively modernise existing insolvency law and adapt it to European regulations.<sup>6</sup>

Book XX CEL came into force on 1 May 2018. This book applies to insolvency proceedings initiated as of the entry into force of the law.<sup>7</sup>

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<sup>1</sup> A Van Hoe, S Brijs and J Cardinaels, "Het nieuwe insolventierecht: op zoek naar nieuwe evenwichten", in B Tilleman and M E Storme (eds), *Curatoren en vereffenaars: actuele ontwikkelingen V* (Intersentia, Antwerp, 2020) at 2.

<sup>2</sup> Law of 11 August 2017 introduced Book XX "Insolvency of Businesses" into the Code of Economic Law, and introduced the definitions specific to Book XX and the law enforcement provisions specific to Book XX into Book I of the Code of Economic Law, *Belgian Official Gazette* 11 September 2017.

<sup>3</sup> Law of 31 January 2009 on the continuity of businesses, *Belgian Official Gazette*, 9 February 2009.

<sup>4</sup> Bankruptcy Law, *Belgian Official Gazette*, 28 October 1997.

<sup>5</sup> D De Marez and C Stragier, *Boek XX. Een commentaar bij het nieuwe insolventierecht* (die Keure, Bruges, 2018) at 3.

<sup>6</sup> Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (OJ 30 June 2000), reference and Regulation (EU) No 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (OJ 5 June 2015). Also see Title VII "Cross-border insolvency" in Book XX CEL and M Vanmeenen, "When the wind of change blows: Europa zet in op harmonisering van herstructurering en tweede kansbeleid", *RDC-TBH* (2019) 466 at 468.

<sup>7</sup> Book XX CEL, art XX.76.

## 1.2 Insolvency proceedings in Belgian law

Belgian law has two insolvency procedures: firstly, the judicial reorganisation procedure (by amicable agreement and by collective agreement or by transfer under judicial supervision) with a view to the complete or partial rescue of the company;<sup>8</sup> and secondly, the bankruptcy procedure with a view to the liquidation of the company when there is no longer any hope of rescuing it.<sup>9</sup>

## 1.3 Balance between debtors and creditors

With this legal framework, the Belgian legislator attempted to find a balance between debtors and creditors. Belgian insolvency law has undergone a remarkable change over the past decades. Belgian insolvency law has evolved towards a more efficient and value-maximising approach. The Belgian insolvency law attempts to restore the normal functioning of the economic market as fast as possible by ensuring a quick and efficient liquidation, and by giving a fresh start to the bankrupt who survives this liquidation.<sup>10</sup>

## 1.4 The role of the different actors in Belgian insolvency law

The insolvency judge plays the key role in Belgian insolvency law and has significant control over the course of the insolvency proceedings. For example, it is stipulated that the court must *ex officio* examine all circumstances relevant to the insolvency proceedings and may *ex officio* order any useful investigative measure.<sup>11</sup> The insolvency judge has almost total control over the timing. Under the Belgian legal system, the commercial court only has jurisdiction for claims and disputes arising directly from insolvency proceedings.<sup>12</sup>

Furthermore, the insolvency official is an important role player in Belgian insolvency law. The insolvency official is appointed by the court to carry out one or more of the following tasks: verify and accept the claims submitted in the course of insolvency proceedings, defend the collective interests of creditors, manage all or part of the assets of which the debtor has been deprived, liquidate these assets and, if appropriate, distribute the proceeds to creditors, and oversee the management of the debtor's business.<sup>13</sup>

An insolvency official may be a court-appointed administrator, provisional administrator or trustee and must always be independent and impartial.<sup>14</sup>

<sup>8</sup> Title V – Judicial reorganisation.

<sup>9</sup> Title VI – Bankruptcy.

<sup>10</sup> A Van Hoe, S Brijns and J Cardinaels, "Het nieuwe insolventierecht: op zoek naar nieuwe evenwichten", in B Tilleman and M E Storme (eds), *Curatoren en vereffenaars: actuele ontwikkelingen V* (Intersentia, Antwerp, 2020) at 2, no. 2; and H Cousy, "Naar een nieuwe visie op het insolventierecht? Enkele theoretische beschouwingen ter inleiding" in H Braeckmans (ed), *Curatoren en vereffenaars: actuele ontwikkelingen II* (Intersentia, Antwerpen, 2010) 3 at 16, no 14.

<sup>11</sup> Book XX CEL, art XX.7.

<sup>12</sup> Judicial Code, art 574, 2°.

<sup>13</sup> Book XX CEL, art XX.2. 7°.

<sup>14</sup> *Idem*, art XX.20.

At the debtor's request, the court may also appoint a company mediator to facilitate the reorganisation of all or part of its assets or operations.<sup>15</sup> The company mediator takes a neutral stance and does not intervene in the management of the company, nor does the company mediator act as an advisor to the debtor or creditors.<sup>16</sup>

Under Belgian insolvency law, the principle of equality between creditors (*par condicio creditorum*), as set out in articles 7 and 8 of the Mortgage Act applies, except in cases of preferential treatment of some creditors.<sup>17</sup>

## 1.5 Reforms

As indicated above, Belgian insolvency law was comprehensively reformed with the introduction of Book XX CEL. The European directive on preventive restructuring mechanisms is expected to be implemented by 17 July 2022.<sup>18</sup> With this directive, the European legislator has aimed to achieve a minimum harmonisation of so-called preventive restructuring frameworks. In addition, this directive lays down basic rules to harmonise the fresh start for natural persons within Europe. The directive also highlights the importance of expert insolvency practitioners.<sup>19</sup> It is clear that certain aspects of Belgian insolvency law will need to be re-examined in light of the transposition of this directive. For example, the current judicial reorganisation under Belgian law is clearly more formally organised than the European so-called preventive restructuring frameworks.<sup>20</sup>

The amendments resulting from the transposition of this directive will probably not have any direct or indirect impact on the limited framework provided for local administrations in distress under Belgian insolvency law (see the discussion in paragraph 3 below).

In response to the Covid-19 pandemic, the federal government introduced the Corona Law on 21 March 2021.<sup>21</sup> This law provides, amongst other things, for a relaxation of the formalities for access to judicial reorganisation. The federal government has extended the flexible insolvency rules introduced by the Law of 21 March 2021 until 16 July 2022.<sup>22</sup> This date was not chosen at random. In principle, the transposition of the aforementioned

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<sup>15</sup> *Idem*, art XX.36.

<sup>16</sup> D De Marez and C Stragier, *Boek XX. Een commentaar bij het nieuwe insolventierecht* (die Keure, Bruges, 2018) at 140.

<sup>17</sup> Mortgage Act, *Belgian Official Gazette*, 22 December 1851.

<sup>18</sup> Directive (EU) 2019/1023 of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132.

<sup>19</sup> M Vanmeenen, "When the wind of change blows: Europa zet in op harmonisering van herstructureren en tweede kansbeleid", *RDC-TBH* (2019) 466 at 466.

<sup>20</sup> *Idem*, at 476.

<sup>21</sup> Law of 21 March 2021 amending Book XX CEL and the Income Tax Code 1992, *Belgian Official Gazette*, 26 March 2021.

<sup>22</sup> Royal Decree implementing the extension of arts 2 and 4 to 12 of the Law of 21 March 2021 amending Book XX CEL and the Income Tax Code 1992, *Belgian Official Gazette* 29 June 2021, 66017.

directive on restructuring and insolvency enters into force the following day. This extension is intended to avoid a spike in bankruptcies following the Covid-19 crisis.

## 2. Local public entities

### 2.1 The Belgian administrative landscape

#### 2.1.1 General

Belgium is a federal state made up of regions and communities. The complexity of the administrative organisation in Belgium has grown considerably with the expansion of the government's remit, regionalisation and "Europeanisation". Today, the government has many different branches and levels. Partly under the impetus of European law, the government is increasingly relying on the private sector or public-private partnerships to achieve the general purposes established under the law.<sup>23</sup>

The term "government" is no longer an unambiguous one in Belgian law. The main structures – for instance the federal public administration, the regional public administration (regions and communities) and the provinces and municipalities – today still form an important basis of the Belgian public administration. However, in addition to these main structures, there are a range of other legal entities responsible for public service missions.<sup>24</sup> Nonetheless, the term (administrative) government is an evolving one that has been subject to changes in recent years.<sup>25</sup> The concept of a public law entity will be primarily used hereinafter. Public law entities are legal persons that are given shape by specific rules of public law or that are governed by public law to a significant extent. They are entities with a certain legal autonomy. They can be branches of the state (regions, provinces, municipalities, etcetera), or they may be created by one of these government levels and entrusted with tasks of general interest. They are, therefore, usually vested with a share of governmental authority.

In order to somewhat clarify the landscape, a brief overview of the various local entities is given below by way of example, with a focus on Flanders. However, similar structures and arrangements can be found in the other regions and communities of Belgium. In particular, the rules on co-operation, administrative supervision, reporting and financing applicable to the above-mentioned local entities are discussed below.

As regards financing, provinces and municipalities can derive revenues from the levy of taxes, or enjoy a share of taxes levied at a higher level. They also receive revenues from fees for services that they provide and from endowments or grants. Municipalities also generate significant revenues from dividends received from inter-municipal partnerships

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<sup>23</sup> S Van Garsse (ed), *Handboek bestuursrecht* (Politeia, Brussels, 2020) at 139.

<sup>24</sup> *Ibid.*

<sup>25</sup> *Idem*, at 31-33; and S De Somer, "Het begrip 'administratieve overheid' en zijn Vlaamse aanverwanten", in S Somer (ed), *Bestuursorganisatierecht* (Die Keure, Bruges, 2020) 379 at 420.

and other companies in which they participate. Other local entities derive their revenues from sales, services, participations and grants. They can also sometimes benefit from inheritances or donations. As the case may be, municipalities have final financial responsibility for these local structures or co-operation structures directly or indirectly with regard to other local entities (see the discussion in paragraph 3 below)<sup>26</sup>.

## **2.1.2 The local level**

### **2.1.2.1 Provinces**

Belgium currently has ten provinces.<sup>27</sup> The provincial level is, in a sense, an intermediary level between municipalities and the regional government. Provinces are responsible for all matters that are of provincial importance.<sup>28</sup> The Flemish Provincial Decree<sup>29</sup> demarcates these matters for Flanders. In particular, it concerns the representation of supra-local interests, supporting tasks at the request of other administrations and taking initiatives for region-specific co-operation between administrations.<sup>30</sup> The administration of the province is in the hands of the provincial council, the deputation and the governor. They are supported by the provincial administration which is headed by the provincial governor.<sup>31</sup>

The regulations relating to provinces can be found in the Provincial Decree. In recent years, the provincial administration has been considerably rationalised.<sup>32</sup>

### **2.1.2.2 Municipalities and Public Centres for Social Welfare**

The municipality is the administrative body which is closest to the public and it is best placed to respond to the interests of the local population. Today, Flanders has approximately 300 towns and municipalities.<sup>33</sup>

The Decree on Local Administration<sup>34</sup> governs the organisation and functioning of the municipality. The municipality is governed by the municipal council, the college of mayor and aldermen, and the mayor. The municipal council represents the population of the municipality and takes care of municipal interests. The college of mayor and aldermen is

<sup>26</sup> In general, see the Constitution, arts 170 ff.

<sup>27</sup> The Constitution, art 5: Antwerp, Limburg, East Flanders, Flemish Brabant, West Flanders, Hainaut, Liège, Luxembourg, Namur and Walloon Brabant.

<sup>28</sup> The Constitution, arts 41 and 162.

<sup>29</sup> Provincial Decree 9 December 2005, *Belgian Official Gazette* 29 December 2005, 56891.

<sup>30</sup> *Idem*, art 2.

<sup>31</sup> *Idem*, title II.

<sup>32</sup> S Van Garsse (ed), *Handboek bestuursrecht* (Politeia, Brussels, 2020) at 151.

<sup>33</sup> When Belgium was created, there were 2,739 municipalities. Following some mergers in the 1970s, there were only 589 municipalities, out of which 308 were Flemish. As a result of recent mergers, there are still 300 Flemish towns and municipalities today. This number is expected to decline further through voluntary mergers.

<sup>34</sup> Decree of 22 December 2017 on local administration, *Belgian Official Gazette*, 15 February 2018.

responsible for the day-to-day management of the municipality. The mayor is the head of the municipality and at the same time the representative of the Flemish Government. These bodies are supported by the municipal administration.<sup>35</sup>

The municipalities have a dual competence: on the one hand, they defend the municipal interest, for which they can take all necessary initiatives.<sup>36</sup> On the other hand, the municipalities also perform tasks with higher levels of government (*medebewind*). These are obligations for municipal authorities to co-operate in implementing the rules and decisions of higher levels of government.<sup>37</sup>

There are also Public Centres for Social Welfare. Public Centres for Social Welfare ensure the provision of social services in the municipality. The legislative framework for Public Centres for Social Welfare can also be found in the Decree on Local Administration, which contains provisions on the autonomisation of activities and co-operation between Public Centres for Social Welfare, specifically in the form of a welfare association, autonomous care institution, hospital association, social services association / company and residential care association / company.<sup>38</sup>

Finally, each municipality has its own police district or is a member of a police district with other municipalities. Police districts with multiple municipalities have their own legal personality and should therefore be considered as separate public law entities. The same applies for the fire service. Municipalities are part of assistance zones that can also be considered as public law entities.

### 2.1.2.3 *Internal and external autonomisation*

Internal and external autonomous private or public agencies may be set up by local administrations. Given that the promotion of the public interest is still a main pillar of Belgian administrative law, if the local administration wishes to autonomise a task of municipal or provincial importance, it will have to provide sufficient justification.<sup>39</sup>

### 2.1.2.4 *Inter-municipal co-operation*

At municipal level, there are also specific regulations for partnerships between municipalities.<sup>40</sup> These partnerships are inter-municipal in nature. The Decree on Local Administration mentions partnerships with and without legal personality: the inter-local

<sup>35</sup> S Van Garsse (ed), *Handboek bestuursrecht* (Politeia, Brussels, 2020) at 152.

<sup>36</sup> See the Constitution, arts 41 and 162.

<sup>37</sup> S Van Garsse (ed), *Handboek bestuursrecht* (Politeia, Brussels, 2020) at 152.

<sup>38</sup> F Vandendriessche and J Vranckx, "Gemeentelijke verzelfstandiging en samenwerking onder het Decreet Lokaal Bestuur", *T Gem* (2018) (3-4) 222 at 240.

<sup>39</sup> One example of this is a public law external autonomisation in the autonomous municipal company (AGB). This is a service in public law form with legal personality set up by the municipality. See S Van Garsse (ed), *Handboek bestuursrecht* (Politeia, Brussels, 2020) at 152.

<sup>40</sup> See Decree on Local Administration, title III.

association (if applicable, the inter-administrative association),<sup>41</sup> the project association,<sup>42</sup> the service association,<sup>43</sup> the association with a mandate,<sup>44</sup> and the association with a private participation.<sup>45</sup>

The following Public Centres for Social Welfare also have partnerships and possibilities for autonomisation:

- the welfare association is a partnership in the form of a public law entity that can carry out certain tasks entrusted to a Public Centre for Social Welfare including executive, staff, expert and management positions;
- the autonomous care institution is a public law entity set up with the aim of operating a hospital or part of a hospital;
- the hospital association is an association under private law for the purpose of operating all or part of a hospital or hospital-related activities (non-profit association);
- the social service association or the social service company is a legal person governed by private law (non-profit association or association with a social purpose) that serves to fulfil social objectives (excluding the full or partial operation of a hospital or hospital-related activities); and
- the residential care association or the residential care company is an association or company governed by private law relating to residential and care homes, excluding the full or partial operation of a hospital or hospital-related activities.

At provincial level, there is no similar regulation that allows provinces to form associations.

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<sup>41</sup> *Idem*, art 392. This is a form of co-operation without legal personality. The association is focused on a specific project of municipal interest. It is a very “soft” form of co-operation. For example, it would include the launch of an inter-municipal football competition or the organisation of a procession.

<sup>42</sup> It is a partnership without transfer of management and with legal personality, aimed at the realisation of a specific project. For example, it will include the creation of a local multi-functional centre.

<sup>43</sup> The service association also has legal personality and is a partnership without transfer of management. For example, CIPAL, that is an inter-municipal organisation active in the field of information and communication technology services to municipalities.

<sup>44</sup> This association has legal personality and is differentiated from the previous three on account of the transfer of management. For example, Limburg.Net. is responsible for collecting and processing waste within the participating Limburg municipalities.

<sup>45</sup> This is an association with a mandate in which private persons may participate. It can only be set up under specific conditions and in the energy and waste sectors. See S Van Garsse and M Decock, “Hoofdstuk 9. Intergemeentelijke samenwerking”, in S Hennau, S Keunen and S Van Garsse (eds), *Het Decreet lokaal bestuur* (Uitgeverij Vanden Broele, Bruges, 2018), 207 at 218-240 for a general discussion on this category.



#### 2.1.2.5 *Voluntary mergers of municipalities*

In Belgium, municipalities can voluntarily merge.<sup>46</sup> The Flemish Government encourages the voluntary merger of municipalities, in order to create strong local administrations. It supports municipalities that make the decisions and guides them in the implementation.

On 16 July 2021, the Flemish Government ratified the Decree on the strengthening of local democracy. The decree aims to facilitate the voluntary merging of municipalities.<sup>47</sup>

Municipalities that jointly propose a merger can, in principle, enjoy a reduction in their debts. The Flemish Government will take over part of their debts, if there are any. The amount depends on the number of inhabitants.

#### 2.1.2.6 *Participation in companies and co-operation*

The Decree on Local Administration provides that local governments can set up associations, foundations and social enterprises, participate in them or have themselves represented in them, provided that the participation or incorporation is not made with a view to entrusting a public task.

Under the same conditions, local administrations can also set up a company, participate or be represented in it, to the extent that the sole objective of this company is to realise local public-private partnership (PPP) projects.<sup>48</sup>

#### 2.1.2.7 *Administrative oversight*

The autonomy of the local administrations does not mean that they can act and decide in complete autonomy and independence. The supervisory authority has the power to control local administrations by having oversight over them. Administrative oversight is the collective name for all means at the disposal of the supervisory authority, either to oblige the local administrations to comply with the law and respect the general interest, or to overrule their unwillingness to act. The supervisory authority has the necessary means to prevent or nullify decisions that are unlawful or contrary to the general interest.<sup>49</sup>

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<sup>46</sup> Decree on Local Administration, arts 342-384.

<sup>47</sup> Decree of 16 July 2021 amending various decrees, with regard to strengthening local democracy, *Belgian Official Gazette*, 4 August 2021.

<sup>48</sup> Decree on Local Administration, art 386, para 1; and Provincial Decree, art 188, para 1.

<sup>49</sup> Decree on Local Administration, art 327; Provincial Decree, art 242; A Mast *et al*, *Overzicht van het Belgische administratief recht* (Wolters Kluwer, Mechelen, 2014) at 121; and S Van Garsse (ed), *Handboek bestuursrecht* (Politeia, Brussels, 2020) at 131.

The supervisory authority is either the Flemish Government or the provincial governor for municipalities and Public Centres for Social Welfare, acting in accordance with the instructions of the Flemish Government.<sup>50</sup>

A distinction must be made between general oversight and special oversight. General oversight allows the supervisory authority to act, within a specified period, against decisions by the administration under supervision.<sup>51</sup> This form of oversight does not give the supervisory authority the power to substitute itself for the administration under supervision.<sup>52</sup> Administrative oversight is optional and discretionary in nature.<sup>53</sup> Local administrations, therefore, retain the actual power of decision.<sup>54</sup>

In addition to general oversight, there is also special oversight. This form of oversight applies to a limited number of decisions that are so important that they require a formal position from the supervisory authority. In a number of cases, the administration is even obliged to seek the opinion of the supervisory authority. In principle, the opinion is non-binding.<sup>55</sup>

There is, however, an exception to the principle that the supervisory authority cannot take the place of the administrations under supervisions, namely coercive supervision. In the exercise of coercive supervision, the supervisory authority may, following a letter of formal notice, appoint one or more commissioners to go on-site and collect the information or observations requested from the local administration or to carry out measures prescribed by law.<sup>56</sup> However, the substitution must remain an exceptional procedure and can only be used in the event of a manifest unwillingness or negligence on the part of a local administration to comply with its legal obligations, as this constitutes a strong limitation of municipal or provincial autonomy.<sup>57</sup>

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<sup>50</sup> Decree on Local Administration, art 326, 3°; Provincial Decree, art 241, 2°; and *Explanatory memorandum to draft decree on local administration*, *Parl. St.* VI. Parl. 2017-2018, no. 1353/1, at 22.

<sup>51</sup> Decree on Local Administration, art 332; and Provincial Decree, art 248.

<sup>52</sup> Except in the cases expressly provided for by law, decree or ordinance. S Van Garsse (ed), *Handboek bestuursrecht* (Politeia, Brussels, 2020) at 68; and S Keunen and S Verbist, "Hoofdstuk 2. Het bestuurlijk toezicht onder het Decreet lokaal bestuur", in S Hennau, S Keunen and S Van Garsse (eds), *Het Decreet lokaal bestuur* (Uitgeverij Vanden Broele, Bruges, 2018) 19 at 23.

<sup>53</sup> S Keunen and S Verbist, "Hoofdstuk 2. Het bestuurlijk toezicht onder het Decreet lokaal bestuur", in S Hennau, S Keunen and S Van Garsse (eds), *Het Decreet lokaal bestuur* (Uitgeverij Vanden Broele, Bruges, 2018) 19 at 26.

<sup>54</sup> S Van Garsse (ed), *Handboek bestuursrecht* (Politeia, Brussels, 2020) at 131.

<sup>55</sup> *Idem*, at 134.

<sup>56</sup> Decree on Local Administration, art 335; and Provincial Decree, art 253.

<sup>57</sup> S Keunen and S Verbist, "Hoofdstuk 2. Het bestuurlijk toezicht onder het Decreet lokaal bestuur", in S Hennau, S Keunen and S Van Garsse (eds), *Het Decreet lokaal bestuur* (Uitgeverij Vanden Broele, Bruges, 2018) 19 at 38; A Mast *et al*, *Overzicht van het Belgisch Administratief Recht* (Wolters Kluwer, Mechelen, 2017) at 117; and I Opdebeek, "Het dwangtoezicht, het ultieme wapen tegen een onwillig bestuur (note under Council of State 20 september 2004, no. 135.081)" *T Gem* (2005) 194 at 195.

### 2.1.2.8 Reporting and budget rules

Local administrations in Flanders are subject to a reporting obligation. They must demonstrate financial and structural balance.<sup>58</sup> For example, in order for their budgets to be approved, local administrations must demonstrate financial equilibrium on an annual basis. In addition, local administrations also need to draw up a multi-year plan showing that they will be able to repay their debts in the long term. The operation of local administrations is, therefore, largely governed by budget rules. Indeed, in principle, no expenditure may be made outside or in excess of the budget appropriations provided for.

In order to meet their reporting obligations, local governments make use of the policy-management cycle.<sup>59</sup> This is the instrument used by the Flemish local administrations for their planning (the multi-annual plan, which contains the objectives and actions to be achieved), implementation (the accounts) and evaluation (the annual accounts).

## 3. Dealing with local public entities in distress - legal framework

### 3.1 General exclusion of all public law entities

Under Belgian law, local administrations cannot, in principle, be liquidated. Under the Belgian legal system, all public law entities are expressly excluded from the scope *ratione personae* of Book XX CEL.<sup>60</sup> There is, therefore, no special legal framework in Belgium for local administrations in distress. Indeed, they cannot become insolvent.

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<sup>58</sup> See <https://lokaalbestuur.vlaanderen.be/node/29179> and <https://lokaalbestuur.vlaanderen.be/bbc-strategisch-en-financieel-beleid/bbc-ondersteuning/financieel-evenwicht>. Municipalities / Public Centres for Social Welfare (PCSWs) must meet certain balancing standards in their multi-year plans. The estimated available budget result must be greater than, or equal to, zero for each financial year (the balance). The estimated self-financing margin must be greater than, or equal to, zero in the last financial year of the period of the multi-annual plan (the structural balance). Both standards have since been supplemented by two indicators which must be included in the policy reports: the corrected self-financing margin, which reflects the structural balance without taking into account the method of financing opted for by the administration; and the consolidated self-financing margin, which supplements the self-financing margin of the municipality / PCSW with the self-financing margin of the autonomous municipal companies (and, where appropriate, of the districts). The financial balance determines the financial health of an administration and is viewed from three perspectives: the available budget result, the self-financing margin, and the adjusted self-financing margin. The consolidated financial balance includes these elements not only for the municipality and its PCSW (province), but also for its autonomous municipal companies (autonomous provincial companies) and districts. This shows the total available budget result, the total self-financing margin and the total adjusted self-financing margin for the whole group. It is a consolidation at the level of the direct partners of the municipality and the PCSW (province). The consolidated financial balance includes the available budget result, the self-financing margin and the adjusted self-financing margin of the municipality and the PCSW (province) and, where appropriate, the autonomous municipal companies (autonomous provincial companies) and the districts, together with the total.

<sup>59</sup> Decree on Local Administration, arts 249-275; and Provincial Decree, arts 141-164.

<sup>60</sup> Book XX CEL, art I.1. 1°, second para b) in conjunction with the definition of debtor in Book XX CEL, art I.22. 8°. The activity of the public law entity is not relevant to the exclusion from the scope of Book XX CEL. See in this regard M Vanmeenen and I Van De Plas, "Het toepassingsgebied van Boek XX WER: hoe meer

In the parliamentary preparations, this exclusion is justified as follows: on the one hand, by the guarantees offered by public law with regard to public law entities, and on the other hand, the insolvency rules would disrupt the functioning of the government disproportionately.<sup>61</sup> Moreover, it is also assumed that legal certainty could be compromised if a court were to declare the insolvency of a public law entity or admit a public law entity to a judicial reorganisation procedure.<sup>62</sup>

The underlying rationale for excluding all public law entities from the scope of Belgian insolvency law is the principle of “continuity of public services”, as a general principle of Belgian administrative law.<sup>63</sup>

### 3.2 Budgetary supervision of local administrations

The relatively healthy financial situation of local administrations in Belgium has been helped by strict budget rules and the administrative supervision of local administrations by the supervisory authority – and budgetary supervision in particular. The hypothesis that the supervisory authority would allow a local entity to reach the point of insolvency seems rather theoretical.<sup>64</sup>

In this respect, reference can be made to what is explained regarding administrative supervision, in particular coercive supervision, under “Administrative oversight” above. The supervisory authority may exercise coercive supervision in the event of a manifest unwillingness or negligence on the part of a local administration to comply with its legal obligations, including budget rules.<sup>65</sup>

De Rynck points to another reason: “Relative to other European municipalities, Belgian municipalities obtain a significant part of their revenue from taxes (approximately 40% while for Dutch municipalities, for example, this is only 17%) (Vereniging Nederlandse Gemeenten, 2012). This is not insignificant: voters elect local politicians and transfer some

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zielen, hoe meer vreugd”, *TBH* (2018) 207 at 220; and J Vananroye, “Het personeel toepassingsgebied van de insolventieprocedures in Boek XX WER”, in B Tilleman and ME Storme (eds), *Curatoren en vereffenaars: actuele ontwikkelingen V* (Intersentia, Antwerp, 2020) 28 at 37 and 42-43. For criticism on the general exclusion of all public law entities regardless of their activity, see D De Marez and C Stragier, *Boek XX. Een commentaar bij het nieuwe insolventierecht* (die Keure, Bruges, 2018) at 41-45.

<sup>61</sup> *Explanatory memorandum*, at 28.

<sup>62</sup> *Idem*, at 29. See D De Marez and C Stragier, *Boek XX. Een commentaar bij het nieuwe insolventierecht* (die Keure, Bruges, 2018) at 43.

<sup>63</sup> M Vanmeenen and I Van De Plas, “Het toepassingsgebied van Boek XX WER: hoe meer zielen, hoe meer vreugd”, *TBH* (2018) 207 at 220; and B Peeters, *De continuïteit van het overheidsondernemen: een begrippenanalyse en een kritiek op de uitvoeringsimmunititeit* (Maklu, Antwerp, 1989) at 223 and 335-336.

<sup>64</sup> B Peeters, *De continuïteit van het overheidsondernemen: een begrippenanalyse en een kritiek op de uitvoeringsimmunititeit* (Maklu, Antwerp, 1989) at 223 and 335.

<sup>65</sup> S Keunen and S Verbist, “Hoofdstuk 2. Het bestuurlijk toezicht onder het Decreet lokaal bestuur”, in S Hennau, S Keunen and S Van Garsse (eds), *Het Decreet lokaal bestuur* (Uitgeverij Vanden Broele, Bruges, 2018) 19 at 38; A Mast et al, *Overzicht van het Belgisch Administratief Recht* (Wolters Kluwer, Mechelen, 2017) at 117; and I Opdebeek, “Het dwangtoezicht, het ultieme wapen tegen een onwillig bestuur (note under Council of State 20 september 2004, no. 135.081)” *T Gem* (2005) 194 at 195.

of their financial resources to them through municipal taxes. There is a direct correlation between the services provided to local communities, and the ability of the politicians to provide value for money for the entity's revenues. This system encourages responsible behaviour and obliges politicians to be frugal" (free translation).<sup>66</sup> This is reinforced by the considerable transparency implemented by the Flemish Government. For example, a tool was developed that provides online insight into the expenditures and revenues, but also into the financial balance and debts of local administrations.<sup>67</sup>

Given that local entities other than municipalities or provinces usually depend on subsidies from municipalities or provinces, or are dominated by administrations of municipalities, this caution seems to extend to other local entities. If there are financial hiccups, in most cases the municipality or a higher level of government will (have to) intervene and local administrations will be called to account politically.

This is certainly not to say that local entities have no debt. They clearly take on debts. However, similar to what happens at the level of central government (federal government, regions and communities), these debts will normally not have a major impact on the continuity of the functioning of local administrations. If the debt-to-revenue ratio becomes too high, the entities will have budget problems and, what is more, in practice will have difficulty obtaining loans for investment.<sup>68</sup> Cuts will then have to be made, services will have to be scaled back, investments will have to be postponed, local taxes will have to rise, attempts will have to be made to secure more subsidies from higher levels of government or the price of given services will have to rise. As mentioned above, this will obviously have an impact on the voting intentions of the electorate in local elections.

### 3.3 Specific legislation on debts of local administrations

Although there is no legal framework in Belgium for local governments in difficulty, attention should be drawn to specific legal provisions regarding the debts of certain local administrations. Reference can be made to article 125 of the co-ordinated law on hospitals and other care institutions, which addresses the financing of deficits of public hospitals.<sup>69</sup> In respect of deficits at public hospitals, the municipality whose Public Centre for Social Welfare manages the hospital bears the deficit. If the hospital is dependent on an inter-municipal or a Public Centre for Social Welfare association, the deficit is in principle borne by the local administrations that are part of the association, according to the mutual ratio of their share in the association.<sup>70</sup>

<sup>66</sup> A Hondeghem and F De Rynck (eds), *Handboek bestuurskunde* (Vanden Broele, Bruges, 2017) at 261.

<sup>67</sup> See the discussion on reporting and budget rules above; and further see <https://lokaalbestuur.vlaanderen.be/bbc/data>.

<sup>68</sup> Financial institutions will indeed be reticent. See the discussion below.

<sup>69</sup> Co-ordinated Law of 10 July 2008 on hospitals and other care institutions, *Belgian Official Gazette*, 7 November 2008.

<sup>70</sup> F Dewallens, "Hoofdstuk III: De gezondheidszorg voorzieningen", in F Dewallens and T Vansweevelt (eds), *Handboek gezondheidsrecht Volume 1* (Intersentia, Mortsels, 2014) 97 at 179.

### 3.4 Miscellaneous

In the event of non-repayment of debts of a natural or legal person and following a court order, the assets of this person or legal person may be seized (and possibly subsequently sold at public auction). However, it is important to note that article 1412 *bis* of the Judicial Code provides that the assets of the state, regions and communities, provinces and municipalities, institutions of public utility and, in general, all public law entities are in principle exempt from seizure.<sup>71</sup> However, local authorities are required to draw-up lists, in which they identify the assets that can be seized by the creditors in satisfaction of their claims. In the absence of such a list, or if the monetisation of the assets on the list is insufficient to satisfy the creditors, the assets that are manifestly not useful to these legal persons for the performance of their duties or for the continuity of the public service may be seized. Public law entities whose assets are seized as a result of the above may lodge an objection to the competent court. They may offer the seizing creditor other assets for seizure. The offer is binding on the seizing creditor if the asset is located within Belgian territory and the monetisation is sufficient to satisfy the claim of the creditor.<sup>72</sup>

The continuity of the functioning of local administrations is thus assured. Creditors are therefore not always guaranteed that a seizure will provide a solution in all cases, as the continuity of the public service takes priority.

Finally, for the sake of completeness, it is appropriate to discuss the role of special accounting officers. Some local entities, such as assistance zones and police districts, have a special accounting officer. The special accounting officer manages the financial resources of, for instance, a police district, the revenues of the police district, ensures the payment of the salaries of the staff of the police district, and the payment of the invoices for the goods and services supplied. The special accounting officer ensures the regularity and legality of the payments. This person is also tasked with keeping the accounts of the police district, drawing-up the budget together with the chief of police and at the end of the financial year, and preparing the annual accounts. The special accounting officer reports to the police board and gives advice on all aspects relating to the finances of the police district. Special accounting officers will sometimes have to provide a guarantee in order to ensure the proper performance of their duties and may in certain cases be held personally liable if they make a mistake in the performance of their duties. It goes without saying that this calls for careful management and exercising prudence.

## 4. Dealing with local public entities in distress - law in practice

In view of what has been explained above, there are no cases of local administrations in distress in Belgium. However, the financial-economic crisis of 2008 and the Covid-19 pandemic have placed the budgets of the local administrations under pressure. The consequences are felt on the ground: higher debts and temporarily reduced revenues

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<sup>71</sup> Judicial Code, *Belgian Official Gazette*, 31 October 1967.

<sup>72</sup> *Idem*, art 1412 *bis*, para 3.

from fees and dividends. It is, therefore, expected that tax rises, cuts in the offer and higher prices for public services, and similar measures will take place in the forthcoming years.

It follows that, from a Belgian insolvency law perspective, there is no need for new laws tailored to local public entities in distress.

## Local public entities in distress - A critical analysis of the Brazilian approach

By Catarina Ferraz\*

### 1. General context of insolvency law

#### 1.1 Legal basis

Law 11.101/2005, the Brazilian Bankruptcy and Reorganisation Law, is the piece of legislation that regulates judicial and extra-judicial restructurings and bankruptcy proceedings in Brazil. It is applicable solely to private entities. In order to deal with corporate crises, this statute regulates economic imbalances - providing a market solution to illiquid companies. The purpose of Law 11.101/2005 is to maintain jobs, allow creditors' interests to be met, and achieve economic sustainability. The most important benefit of Law 11.101/2005 is the recognition of the difference between illiquidity and insolvency. This benefit is gained through the law providing different remedies for insolvent private businesses and illiquid private businesses. Many of the provisions and concepts contained in Law 11.101/2005 came from, and were inspired by, Chapter 11 of the Bankruptcy Code of the United States.

It must be noted that there is no particular insolvency regulator nor governmental agency devoted to insolvency concerns in Brazil. Rather, provisions and legal frameworks concerning insolvency laws are subject to the same legislative process as most laws before they are passed:<sup>1</sup> elaboration by the Congress or other legislative houses and approval by the President.<sup>2</sup>

Before 2005, Brazilian bankruptcy proceedings were regulated by Law 7.661/1945.<sup>3</sup> This law had to be modified because, besides being extremely outdated when compared to the country's legal system as a whole, it had several procedural flaws. Notably, it permitted a series of fraudulent actions during bankruptcy procedures and the length of a proceeding could be extended indefinitely due to bureaucracy. In addition, the legislation had several jurisprudential conflicts, with different courts disagreeing on most matters and thereby producing contradictory precedents and legal uncertainty. There was no concern for the social roles and continuity of companies; instead, the law only sought to satisfy creditors' interests. Reform was important from the perspective of pursuing business principles, and reform efforts represented the country moving towards gaining economic stability. The restructuring procedure, inserted by Law 11.101/2005, plays a fundamental role in the proper functioning of the economy insofar as it allows companies facing

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<sup>1</sup> Brazilian Federal Constitution of 1998 (the Constitution), art 59.

<sup>2</sup> *Idem*, art 66.

<sup>3</sup> *Decreto* 7.661 de 1945.



illiquidity to reorganise and continue their business. Prior to 2005, Brazilian legislation was strictly punitive as it offered ineffective reorganisation provisions that only served to postpone bankruptcy.

With the promulgation of Law 11.101/2005, a legal system concerned with the maintenance of viable companies in the market was established. Notably, this shift was demonstrated by the ascendancy of provisions in article 47 that allow companies to overcome illiquidity and be sold to another group. The preservation of companies is a basic principle of the bankruptcy law, and this principle guides the interpretation of all legal provisions within this realm. Not only is the perspective of creditors contemplated, but all of the social interests that may be affected by the dissolution of a company are taken into consideration.

The preservationist nature of the Law 11.101/2005, along with the possibility of allocating productive assets of an illiquid company to others interested in purchasing and paying off existing debts, is in contrast with the traditional idea that a company that experiences a financial crisis should always be dissolved. Complementing the purposes of corporate restructuring, Law 11.101/2005 also provides for active participation of creditors in conducting an entire reorganisation proceeding since creditors, and not the courts, are entitled to decide on a company's viability, except in cases legally recognised as cram down cases.<sup>4</sup> For a reorganisation plan to be passed, a financial economic report must be presented together with an assessment of an applicant debtor's assets, from which creditors will be able to analyse the debtor company's true financial situation and its economic viability. An analysis will allow creditors to make an informed decision on whether they should approve a proposed plan. Evidently, the goal of Law 11.101/2005 is to allow viable companies to overcome economic crises through a market solution when the conditions for a recovery exist. At their core, the reorganisation provisions seek to allow financially distressed companies to renegotiate the debt between them and their creditors, whilst allowing debtor companies to maintain their productive assets.

In conclusion, the Brazilian Bankruptcy and Reorganisation Law acts as a means of facilitating positive economic behaviours and it seeks to allow viable companies to continue operations. It operates as an instrument that allows corporations to overcome temporary crises, preserve jobs, meet creditors' interests, and regain economic and financial sustainability. However, as already elucidated, this legal framework is limited to

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<sup>4</sup> Law No 11,101, De 9 De Fevereiro De 2005, art 58, s 1° provides that "[t]he judge may grant judicial recovery based on a plan that was not approved pursuant to art. 45 of this Law provided that, at the same meeting, it has cumulatively obtained: I - the favourable vote of creditors representing more than half of the value of all creditors present at the meeting, regardless of their class; II - the approval of two (2) creditors classes pursuant to art. 45 of this Law or, if there are only 2 (two) classes with voting creditors, the approval of at least 1 (one) of them; III - in the class that has rejected it, the favourable vote of more than 1/3 (one-third) of the creditors, computed in accordance with paragraphs 1 and 2 of art. 45 of this Law. § 2 The judicial recovery can only be granted on the basis of § 1 of this article if the plan does not imply different treatment between creditors of the class that has rejected it" (author's translation).

legal persons in private law and excludes illiquid public entities from benefitting from its provisions.

## 1.2 Reform

In 2020, Law 11.101/2005 was amended by Law 14.112/2020 (the Amendment), which provided several substantial modifications to Law 11.101/2005 in light of the economic effects of the pandemic.

Supporting the goal of Law 11.101/2005 of active participation of creditors, the Amendment allows creditors to present a judicial recovery plan whenever there is a rejection of a debtor's proposed plan, or when the voting timeframe lapses.<sup>5</sup>

Another important change is the encouragement of alternative dispute resolution mechanisms throughout different phases of a proceeding, including in the Courts of Appeal, which expands the possibility of settlements. Seeking to prevent a company's partners from benefitting at the expense of creditors, the distribution of profits or dividends is also now prohibited. Moreover, the Amendment also prohibits the debtor's assets lien and the possibility of special financing to companies.

## 2. Local public entities legal framework

The provisions applicable to public entities in Brazil are constitutionally established and do not vary according to different legal spheres. In Brazil, the Constitution is the most important legal framework and guides all other laws. Title III (The Organisation of the State) of the Constitution is the section that regulates public entities, and one chapter of its content is dedicated to each type of entity that belongs to the direct public administration (that is, the Federal Union, the states, the municipalities, the Federal District, and the territories). Article 18 of the Constitution illuminates this structure:<sup>6</sup>

"Article 18. The political and administrative organization of the Federative Republic of Brazil comprises the Federal Union, the states, the Federal District and the municipalities, all of them autonomous, as this Constitution provides. (CA No. 15, 1996)

Paragraph 1. Brasília is the federal capital.

Paragraph 2. The federal territories are part of the Federal Union and their establishment, transformation into states or reintegration into the state of origin shall be regulated by a supplementary law.

Paragraph 3. The states may merge into each other, subdivide or dismember to be annexed to others or form new states or federal territories, subject to the approval of the population directly concerned,

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<sup>5</sup> Law 11.101/2005, s 4º-A.

<sup>6</sup> Constitution, art 18, Title III.

by means of a plebiscite, and of the National Congress, by means of a supplementary law.

Paragraph 4. The establishment, merger, fusion and dismemberment of municipalities shall be effected through state law, within the period set forth by supplementary federal law, and shall depend on prior consultation, by means of a plebiscite, of the population of the municipalities concerned, after the publication of Municipal Feasibility Studies, presented and published as set forth by law."

According to article 48 of the Constitution, the jurisdiction to define the limits of the national territory belongs to the Federal Union and is held throughout Congress. The National Decree 311/1938 provides the concept of municipalities, and this Decree was incorporated and maintained in 1988 with the new Constitution. Accordingly, the definition of municipalities given by this Decree provides:

"Art. 2 The municipalities comprise one or more districts, forming a continuous area. When necessary, districts will be subdivided into zones with an ordinal ranking.

These areas may also have special names.

Art. 3 The seat of the municipality has the category of city and gives it its name.

Art. 4 The district will be designated by the name of the respective headquarters, which, until it is erected in a city, will have the category of village.

In the same district, there will be no more than one village."

## 2.1 Mission of local public entities

The mission of local public entities (LPEs) in Brazil is provided by Chapter IV of the Constitution. As mentioned, concepts relating to direct public administration are strict, and therefore, there are no other similar concepts mentioned in the law or case precedents. Essentially, a municipality is a legal entity of public law that has its political territorial space within a state or federative unit and is managed by a city hall.

Under the terms of article 30 of the Constitution, municipalities are to:

- I - legislate on matters of local interest;
- II - supplement federal and state legislation where applicable;
- III - institute and collect the taxes within its competence, as well as apply its income, without prejudice to the obligation to render accounts and publish balance sheets within the deadlines established by law;
- IV - create, organize and suppress districts, observing the state legislation;
- V - organize and provide, directly or under a concession or permission regime, public services of local interest, including public transport, which is essential;

VI - maintain, with the technical and financial cooperation of the Federal Union and the State, early childhood and elementary education programmes; (Wording given by Constitutional Amendment No. 53, 2006)

VII - provide, with the technical and financial cooperation of the Federal Union and the State, health care services for the population;

VIII - promote, where appropriate, adequate territorial ordering through planning and controlling the use, parceling, and occupation of urban land;

IX - promote the protection of the local historical-cultural heritage, in compliance with federal and state legislation and inspection action.”

With regard to association, the Constitution<sup>7</sup> allows public entities to form consortia with each other to achieve common goals . Law 11.107/2005 gives general guidance on this matter.<sup>8</sup>

Decree 6.017/2007 regulates and brings specific provisions to the public consortia, complementing Law 11.107/2005. According to both legal frameworks, it is up to public entities to determine the objectives of public consortia, which are always intended to provide public services of common interest. Naturally, they must respect limits laid down by the Constitution.

## 2.2 Local public entities and financial distress

Until 2017, there was no specific legal framework to support states and municipalities facing financial difficulties. This led public managers to seek a generic solution that could serve this purpose. With the financial imbalance of several states in the last decade, which persisted for years without foreseeable improvement, the solution that the public entities sought when facing a serious financial crisis was to utilise the decree of public calamity. Previously, Rio de Janeiro, Minas Gerais, and Rio Grande do Sul have taken advantage of this decree.

The state of public calamity is defined in Decree 7.257/2010 as an “abnormal situation, caused by disasters, causing damages and losses that imply the substantial commitment of the responsiveness of the public power of the entity reached”. The procedure in this regard was laid down in Law 12.340/2010, which was later modified by Law 12.983/2014. The state or municipality files for calamity, which must be accepted by the Federal Union. After this, the Federal Government will prescribe the actions that should be performed in the affected areas and the financial amount that will be invested.<sup>9</sup> With the establishment

<sup>7</sup> Constitution, art 241.

<sup>8</sup> Law 11.107/2005, art 1. Notably, this Law provides the general rules that the Federal Union, the states, the Federal District, and the municipalities must comply with to contract public consortia for the achievement of objectives of common interest.

<sup>9</sup> Law 12.983/2014, art 2<sup>o</sup> provides that “Law No. 12,340, of December 1, 2010, will become effective with the following changes: Art. 1a-A. The transfer of financial resources for the execution of prevention actions in areas of disaster risk and response and recovery in areas affected by disasters to the organs and entities

of public calamity, several permissions, which would be considered abusive in normal situations, are granted to the entity that sought them. These permissions include the postponement of the legal limits for public expenses, the payment of debt in instalments, waiver from bid procedures, and delay in the repayment of expenses, amongst others. In 2019, seven Brazilian states invoked this situation in order to renegotiate their obligations, including Goiás, Roraima, Rio Grande do Norte, and Mato Grosso.

Public entities utilising the decree of financial calamity to obtain aid due to economic setbacks were criticised as this mechanism was not created to regulate these situations. The state of public calamity contemplates abnormal events caused by disasters, as mentioned in article 2, IV of Decree 7.257/2010. These disasters were conceptualised as “the result of adverse, natural or man-made adverse events on a vulnerable ecosystem, causing human, material or environmental damage and consequent economic and social damage”.<sup>10</sup> From this, it can be understood that the state of public calamity is intended to cover disasters related to the environment. This new idea of public financial calamity arose because public entities sought access to resources and benefits that would otherwise be inaccessible due to the failures of the Brazilian legal system.<sup>11</sup>

Moreover, it is essential that specific provisions are set up to deal with illiquidity and public insolvency, not only to provide effective aid to restore the regular activities of subnational entities but also to avoid public managers using generic mechanisms and stretched interpretations to circumvent the law.

In view of this need, the Federal Government launched the Fiscal Recovery Regime in 2017, seeking to assist insolvent states to re-establish fiscal balance through the renegotiation of debts contracted with the Federal Union. The regime treats the economic crisis in a palliative way rather than in an active way, as it only assists states with specific debts without actually regulating the public crisis.

One of the moral challenges of establishing an effective legal framework that supports cases such as Rio de Janeiro and Rio Grande do Sul is the legislature’s complacent attitude in supporting acts of administrative mismanagement, which is one of the criticisms that the Tax Recovery Regime has received. A prominent example was the case of the public

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of the States, Federal District and Municipalities shall observe the provisions of this Law and may be made by means: I - deposit into a specific account held by the beneficiary entity in a federal official financial institution; or II - from the National Fund for Public Disasters, Protection and Civil Defense (Funcap) to funds constituted by the States, Federal District and Municipalities with the specific purpose of executing the actions set forth in art. 8 and in the manner set forth in paragraph 1 of art. 9th of this Law. Paragraph 1. It shall be the responsibility of the Federal Union, according to the regulation: I - define the guidelines and approve work plans for prevention actions in areas of risk and recovery in areas affected by disaster II - make the transfer of funds to the beneficiary entities in the forms provided in the caput, according to the approved work plans; III - supervise the fulfilment of the physical goals according to the approved work plans, except for the response actions; and IV - to evaluate the fulfilment of the object related to the actions foreseen in the caput” (unofficial translation).

<sup>10</sup> Decree 7.257/2010, art 2º, II.

<sup>11</sup> J Conti, “Crise leva as finanças públicas ao “estado de calamidade”” (28 June 2016), available [here](#).

*precatory*. These are requests for payments owed by the Treasury in the face of a judicial conviction.<sup>12</sup> Over the years, public managers did not regulate the enforcement of convictions against public authorities. Instead of intervening in those debtor states as contemplated by the Constitution, Congress proposed Constitutional Amendment 62/2009. Part of this amendment was held to be unconstitutional by the Federal Supreme Court, and it was consequently replaced by Constitutional Amendment 94/2016.<sup>13</sup> A special regime was established by this amendment, providing several privileges to the states, Federal District, and municipalities utilising it. These include a five-year payment term, 50% of the reserved resources available for renegotiation with creditors within the legal threshold, compensation of debts owed to creditors, as well as some other privileges.<sup>14</sup> This Constitutional Amendment 94/2016 became known as the “Default Amendment”<sup>15</sup> because it was a provision created to facilitate public bodies not paying their debts. That said, a legal reform regarding economic crisis should, by all means, be carefully analysed and supervised by local courts in order to serve as a mechanism of economic rehabilitation rather than a political instrument used to escape liabilities.

It is a general rule that legal entities of public law cannot reach a state of insolvency and, therefore, cannot be liquidated. Even public companies are excluded from Law 11.101/2005.<sup>16</sup> When a public company is in a state of insolvency, the Supreme Court has provided that the controller of its shares (that is, a public body), is responsible for the debt under article 100 of the Constitution and article 910 of the Civil Proceeding Code. LPEs under distress are not allowed to be liquidated by insolvency proceedings. LPEs as municipalities can be terminated, but only by a legal act that requires further voting of the population so that the municipality can be incorporated or merged with another municipality.

### 2.2.1 *Debt resolution mechanisms*

In Brazil, there is a strong concern about public income renunciation, as renunciation would constitute a crime of fiscal responsibility according to Law 101/2000 (Law of Fiscal Liability). In general, whenever LPEs need an outside source of financing, they do not seek private funding, as several limitations on obtaining private funding are imposed by Resolution 43/2001 of the Federal Senate. Rather, LPEs request loans from a higher level public entity (for example, as a municipality may borrow from the state or the Federal Union).

Therefore, if a public entity is unable to pay the debt that it owes to a body within an agreed period, applying a debt resolution mechanism is a very dangerous choice to make, because if the higher level entity provides discounts that entity would be renouncing some

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<sup>12</sup> Precedent ADI 4357.

<sup>13</sup> *Ibid.*

<sup>14</sup> See, eg, *Novo Regime De Pagamento De Precatórios É Promulgado Pelo Congresso*.

<sup>15</sup> R Filho, “O novo de precatórios instituído pela Emenda Constitucional nº 62/2009” (5 December 2010), available [here](#).

<sup>16</sup> Law 11.101/2005, art 2, I.

of its public income, which is a crime by law. However, what has been happening in practice is that whenever a public debt has had to be negotiated, it has been formalised through a complementary law. Complementary Laws rank alongside Law 101/2000 within the statutory hierarchy. In that sense, a complementary law will be able to overcome the limitations established by Law 101/2000 and provide for longer deadlines or renegotiation proceedings. This circumstance does not apply to private companies, as income can be negotiated and the manager of a company can incur some financial losses in order to settle.

In contrast to other jurisdictions, the legal framework of LPEs in distress in Brazil has not been influenced by external factors such as the World Bank, the UNCITRAL Model Law, or any other international organisation. The tradition of the Brazilian legal system, since the beginning of the Republic (in 1989), is that public interests, goods and properties cannot be subject to any judicial or other form of compulsory “selling” in order to pay corporate debts related thereto.

### **3. Local public entities in distress versus corporate insolvency**

The Brazilian legal framework exhibits a strong distinction between public and private law provisions. LPEs have different purposes and regulations, as they are guided by the public interest principle and are under several limitations imposed by the Federal Constitution, Law 101/2000 and Resolution 43/2001 of the Federal Senate. Therefore, the rules applicable to LPEs are completely different from those that relate to the insolvency of private companies.

Private enterprises will rely on Law 11.101/2005, complemented by the Civil Code (Law 10.406/2002) and the Civil Procedure Code (Legislative Act 13.105/2015). Whilst LPEs are guided by public interest considerations, private corporations have completely different principles to fulfil and rules to follow. Legal frameworks within public law are imperative – everyone is subject to them. Public law rules are mandatory and cannot be customised to particular situations. LPEs in distress cannot simply seek a market solution to recover their liquidity: they must follow the strict patterns of the Annual Budget Guideline Law, the Fiscal Responsibility Law, and the principles of the Constitution. Every four years, LPEs have different management voted in by a direct election system, and there are requirements placed on management in order to mitigate the burdens received by the next manager.

In this sense, the legal solutions available to private corporations are broader: mechanisms such as the automatic stay, for example, will not apply to proceedings involving LPEs. According to the Constitution and related laws, it is not possible to liquidate an LPE when it becomes insolvent and is, therefore, unable to pay its debts. Typically, whenever an LPE goes through financial distress, a superior public body will provide financial assistance. This could involve a state assisting the municipality, and the Federal Union assisting both the state and the municipality. In addition, municipalities rely on financial aid provided by the Federal Union and tend to be unable to survive without the aid.

Additionally, the concept of municipalities in Brazil is much more restrictive than in countries such as the United States, where the definition of LPEs refers to municipalities and, therefore, the applicable law is the national bankruptcy law. Economic crises are likely never restricted to a single municipality, and the burden of a local economic crisis lies on the states.

### 3.1 The treatment of creditors

There are no specific powers for either public or private creditors when it comes to LPEs. When a creditor is a public body, such as the Federal Union, it would be entitled to take a portion of the taxes that it usually remits to LPEs. However, the Judiciary prohibits this, as it harms the performance of the LPE's public services, particularly in relation to matters of health and education.

The situation is completely different in relation to corporate insolvency. The Creditors' General Assembly, chaired by the Judicial Administrator, is the most relevant body during the judicial reorganisation proceeding. This is because the Creditors' General Assembly will either allow or prevent a reorganisation plan. This body is made up of all of a company's creditors, with the exception of those who entered into an obligation after the reorganisation request, those who became creditors by obligation free of charge, financial institution lenders to exporters, fiduciaries, merchant lessors, and creditors with property charges that are effected by a contract containing an irrevocability or irreversibility clause.

Therefore, the Creditors' General Assembly is made up of creditors holding labour or accident claims (first class); credit holders with collateral (second class); holders of privileged claims, unsecured and subordinates (third class); and holders of charges classified as microenterprises or small businesses (fourth class).<sup>17</sup> For the judicial

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<sup>17</sup> Law 11.101/2005, art. 83. The classification of claims in bankruptcy follows the following order:

I - claims derived from labour legislation, limited to 150 minimum wages per creditor and those arising from work accidents; II - claims with real guarantee up to the limit of the value of the recorded asset; III - tax claims, regardless of their nature and time of establishment, except for tax fines; IV - claims with special privilege, namely:

- a) those provided for in Law 10,406, of January 10, 2002, art 964;
- b) those so defined in other civil and commercial laws, unless otherwise provided for in this Law;
- c) those whose holders the law confers the right of retention on the thing given in guarantee;
- d) those in favour of individual microentrepreneurs and micro and small businesses covered by Complementary Law 123, of December 14, 2006 (included by Complementary Law 147/2014);

V - claims with general privilege, namely:

- a) those provided for in Law 10,406, of January 10, 2002, art 965;
- b) those provided for in the sole paragraph of art 67 of this Law;
- c) those so defined in other civil and commercial laws unless otherwise provided for in this Law;

VI - unsecured claims, namely:

- a) those not provided for in the other items of this article;
- b) the balances of claims not covered by the proceeds of the sale of the assets linked to their payment;
- c) the balances of claims derived from labour legislation that exceed the limit established in item I of the caput of this article;



reorganisation plan to be approved, the four classes of creditors must approve it, with a quorum of more than half of the creditors present in each class. It is also necessary that the body of unsecured creditors and body of creditors with collateral (second and third class) have the support of creditors who hold more than half of the liabilities in their vote. With the modification brought about by Law 14.112/2020, creditors also have the option of proposing an alternative plan when a plan presented by a debtor is rejected or when the deadline for voting lapses.

### 3.2 Courts

In Brazil, there is a unified judicial system, which means that there is no administrative justice as in France or in Germany. Since the beginning of Republic, the rule has been enshrined in article 5 of the Constitution:

“XXXV - the law shall not exclude any injury or threat to a right from the consideration of Judicial Power.”

The courts that will be entitled to deal with corporate insolvency will differ, depending on the district. Some states, such as São Paulo, have specialised Insolvency Courts that will receive and oversee all reorganisation proceedings in their state. However, in states such as Pernambuco, where there are no specialised courts, the matter will be judged by common state civil courts. Both of those circumstances differ from the regime applicable to LPEs.

Legal actions initiated by LPEs must be submitted to the Public Finance Courts, which judge civil cases in which the state, the municipalities, their autarchies, public companies, mixed-capital companies, and public-law foundations are the plaintiff or defendant. However, some districts in Brazil do not have specialised courts to oversee these matters and in these cases, a local court will have jurisdiction.

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VII - contractual fines and financial penalties for violations of criminal or administrative laws, including tax fines; and

VIII - subordinated claims, namely:

a) those provided for by law or in a contract; and

b) the claims of the partners and of the administrators without employment relationship.

s 1 For the purposes of item II of the caput of this article, the value actually collected with its sale will be considered as the value of the asset actually secured with its sale, or, in the case of a block sale, the value of the individual asset considered.

s 2 The amounts resulting from the right of a partner to receive their share of the capital stock in the liquidation of the company are not opposed to the mass.

s 3 The penal clauses of unilateral contracts will not be met if the obligations stipulated therein expire due to bankruptcy.

s 4 Labour claims assigned to third parties will be considered unsecured.

### 3.2.1 Control

LPEs are subject to two types of control: external and internal control. Internal control relates to the legality, the convenience of acts,<sup>18</sup> opportunity and efficiency of the LPE. External control occurs through audits or inspections carried out in the accounting, financial, operational, and equity activities of LPEs in a timely manner to ensure that management is acting in accordance with the legal rules. External control inspection is carried out by bodies external to the organisation. It can be performed by individuals or legal entities from outside the entity; direct parliamentary control, such as that carried out by the legislature; the Audit Courts; the Public Prosecutors Office; and society where individuals exert social pressure. Internal control provides opinions only since it cannot change a management team's performance. Alternatively, external control may involve the imposition of corrections and sanctions where a management team has acted inappropriately.

Article 31 of the Constitution determines:

"Art. 31 - The supervision of the Municipality will be exercised by the Municipal Legislative Power through external control and by the internal control systems of the Municipal Executive Power according to the law.

§ 1 - The external control of the City Council will be exercised with the assistance of the Auditing Courts of Accounts of the States or of the Municipality or of the Councils or Courts of Accounts of the Municipalities, where applicable.

§ 2 - The prior opinion, issued by the competent body on the accounts that the Mayor must render annually, will only cease to prevail by the decision of two-thirds of the members of the City Council.

§ 3 - The accounts of the Municipalities will be, for sixty days, annually, at the disposal of any taxpayer, for examination and appreciation, which may question their legitimacy, under the terms of the law.

§ 4 - The creation of Courts, Councils or bodies of Municipal Accounts is prohibited."

In addition, article 70 of the Constitution provides:

"The accounting, financial, budgetary, operational and patrimonial inspection of the Federal Union and of the entities of the direct and indirect administration regarding the legality, legitimacy, economy, application of subsidies and waiver of revenues will be exercised by the National Congress through external control and by the internal control system of each power."

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<sup>18</sup> In Brazil, an act is convenient when its legal content produces a result that meets the intended purpose, which is the satisfaction of the public interest.

Therefore, the authority responsible for overseeing the activities of LPEs under distress is the City Council that exercises external control over the LPE. It exerts control through parliamentary commissions of inquiry, by assessing crimes of responsibility of the mayor (it may summon secretaries to provide clarifications to do so), and by judging the annual budget of the mayor, which will be annexed to a pre-analysed opinion by the Court of Auditors.

The insolvency of an LPE without the interference of its creditors can be the objective of a specific plan, since this would be a plan that follows the laws applicable to the specific public entities and leads to public goods being prioritised.

There is no such control contained within the corporate insolvency framework. A company's creditors will be the central figures when a company is insolvent, as they have the power to approve or reject the plan.

### 3.3 Public debts

Strict rules apply to public debts and financing. According to article 35 of Law 101/2000, credit operations between public entities and public financial institutions are forbidden. Therefore, the first limitation imposed is that it is impossible for an LPE to contract debts from public banks. Secondly, article 7 of Resolution 43/2001 of the Federal Senate<sup>19</sup> illuminates the limits on the allowed credit operations of LPEs.

It is very complex for an LPE to access financing from private institutions as, in addition to the limitations imposed by the law, the LPE would have to pay tax for financial operations. This limits the utility of borrowing from private institutions. However, when an LPE seeks financing from another public body, which commonly occurs, one of the main pillars of tax law is the reciprocal immunity between the political entities. This is because the Constitution<sup>20</sup> prevents the Federal Union, the states, the Federal District, and the municipalities from instituting or creating taxes on each other's assets, income, or services. With respect to third parties, the LPE would also not be allowed to create a tax to transfer the burden of the debt to its citizens. Article 150 of the Constitution provides that taxes will be created only by law. Nonetheless, there are taxes that have a "general" destination, which means that they can be used by the LPE to bear debt (for example, urban property and land tax).

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<sup>19</sup> Resolution 23/2001. Federal Senate, art 7 provides that "[t]he internal and external credit operations of the States, the Federal District, the Municipalities will also observe the following limits: I - the global amount of the operations carried out in a financial year cannot exceed 16% (sixteen percent) of the current net revenue, defined in art. 4th;  
 II - the annual commitment to amortisations, interest and other charges of the consolidated debt, including related to amounts to be disbursed from credit operations already contracted and to be contracted, cannot exceed 11.5% (eleven integers and five-tenths percent) of the net current revenue;  
 III - the amount of the consolidated debt may not exceed the ceiling established by the Federal Senate, in accordance with the provisions of the Resolution that sets the global limit for the amount of the consolidated debt of the States, the Federal District and the Municipalities".

<sup>20</sup> Constitution, art 150, VI, a.

It must be noted that insolvency due to financing is a situation that can provoke the intervention of a higher level public body. According to article 34 of the Constitution:

“The Federal Union shall not intervene in the states or in the Federal District, except: [...]

V- to reorganize the unit of the Federation that:

- a) Stops the payment of its founded debt for more than two consecutive years except for reasons of force majeure;
- b) Fail to deliver to the municipalities the tax revenues established in this Constitution, within the period of time set forth by law.”

The state or municipalities can make a similar intervention.

It is not possible to compare this situation with the one that happens with private corporations. Companies will have access to public and private financial institutions and will be able to gain credit in numerous ways. Whilst private companies can perform private negotiations, renounce income to extend deadlines, and establish contracts that determine the conditions of the financing operation, LPEs can only take on debt that they are previously authorised to do so by the law. It is not possible to incur any type of public expenditure without a previous budget reserve. The Annual Budget Law will determine the limit of the expenditure and provide guidance for the LPE’s financial management.

### **3.4 Management and intervention**

Whenever an LPE needs to go through a restructuring in order to avoid further insolvency, it usually follows the principles and rules established by the Federal Union. If this does not happen, the Federal Union will not provide financial aid to assist in rectifying financial issues. There is no specific restructuring legal framework for LPEs. However, financial distress is one of the cases in which a higher level public body can intervene. If such a body decides to intervene, a decree will be sanctioned containing the terms of the intervention. Such decrees will be subject to the political control of the Legislative Houses.

Meanwhile, in a corporate restructuring, the approval of the plan depends only on a company’s creditors, except in cram down cases. The parties involved actively participate in every step of the restructuring plan, and the judiciary only supervises the legality of the proceeding.

During a period of insolvency, the mayor of a municipality or a governor of a state will remain in charge of their respective entities, unless there is an intervention by the hierarchically superior public body. This intervention is an option when the local public entity is unable to pay the public debts established in article 29. I of the Complementary Law 101/2000. In this case, the intervenor, who will be responsible for the direction of a municipality or state, will be appointed by a governor (in the event of the insolvency of a municipality) or president (in the event of the insolvency of the state). After 24 hours, the intervention will be subject to a political review by a legislative body, which will ratify or

annul it.<sup>21</sup> If ratified, the intervenor will remain in charge for a fixed period or until the problem is solved. There is no special qualification required to be an intervenor.

In a public intervention, an intervenor remains responsible for the management of a public entity and has the same powers as a mayor / governor. Meanwhile, in a corporate reorganisation, an administrator appointed by the judiciary will essentially act as an assistant that will monitor and supervise the proceeding without exercising any management powers. However, if a company files for bankruptcy, an administrator will manage the bankrupt estate.

There are specific qualifications recommended by article 21 of Law 11.101/2005 for the administrator to be appointed. An administrator should be a suitable professional with preferably a legal, economic, or financial background. Article 24 of Law 11.101/2005 dictates that the remuneration of a judicial administrator will be determined by the judge of the court in which a corporate reorganisation proceeding is ongoing.<sup>22</sup> Meanwhile, the fee paid to the intervenor appointed to a public entity will be established by the decree that regulates the intervention.<sup>23</sup> In any case, the maximum fee will be the value of the salary of the mayor / governor during his period in office.

#### **4. Local public entities in distress in practice - the case of Rio de Janeiro**

On 17 June 2016, Rio de Janeiro declared a state of public calamity. Decree 45.692 listed several reasons, namely: (i) the severe economic crisis that plagued the State of Rio de Janeiro, (ii) the decrease in tax collection, especially regarding goods, services, royalties, and special interests in oil, (iii) all financial reprogramming efforts that had already been undertaken to adjust state accounts, (iv) that this crisis had prevented the State of Rio de Janeiro from honouring its commitments to the Rio 2016 Olympic and Paralympic Games, (v) that this fact had been causing severe difficulties in the provision of essential public services and may have also resulted in a total collapse in public safety, health, education, mobility, and environmental management, (vi) the popular interruption of the provision of essential public services would greatly affect the population of the State of Rio de Janeiro,

<sup>21</sup> *Idem*, arts 35 and 36.

<sup>22</sup> Law 11.101/2005, art 24. The judge will determine the amount and form of payment of the judicial administrator's remuneration, observing the debtor's ability to pay, the degree of complexity of the work, and the values practiced in the market for the performance of similar activities. "§ 1 In any event, the total paid to the judicial administrator will not exceed 5% of the amount due to creditors submitted to judicial recovery or the sale value of the assets in bankruptcy. Paragraph 2. 40% of the amount due to the judicial administrator will be reserved for payment after complying with the provisions of arts 154 and 155 of this Law. § 3 The substituted judicial administrator will be remunerated in proportion to the work performed unless he resigns without relevant reason or is removed from his duties due to negligence, fault, intent, or non-compliance with the obligations set forth in this Law, in which case he will not be entitled to remuneration. § 4º The administrator who has his accounts disapproved will also not be entitled to remuneration. § 5 The remuneration of the judicial administrator is reduced to the limit of 2% in the case of micro and small companies".

<sup>23</sup> Constitution, art 36, para 1. The intervention decree, which will specify the scope, term and conditions of execution and which, if applicable, will appoint the intervenor, will be submitted to the National Congress or the State Legislative Assembly within 24 hours.

(vii) that as early as June 2016, foreign delegations would arrive in the city of Rio de Janeiro in order to allow the acclimatisation of the athletes for the competition that was to begin on 5 August 2016, and (viii) that the events were of global importance, and failings of any institution would tarnish the image of a country that was struggling financially.<sup>24</sup>

It can be seen from the reasons presented that the crisis in Rio de Janeiro was not due to increases in expenses, but mainly due to the decrease in revenues. The documentary of journalist Fernando Gabeira<sup>25</sup> points out that from 2014 to 2016, net public revenue fell by more than R\$ 25 billion. The state supported its economy in the oil and gas sectors, and whilst oil royalty revenue was about R\$12 billion in 2013, in 2016, it fell to less than R\$ 4 billion. In addition, the Brazilian oil sector was directly hit by the Petrobras scandals.<sup>26</sup> In addition to these circumstances, the documentary about Rio de Janeiro's bankruptcy also describes a policy of economic development with excessive tax incentives, which missed out on R\$ 4 billion to R\$ 5 billion. In addition, over the years the Rio de Janeiro administration adopted policies of large debt contraction, and each year transferred "unpaid" amounts (expenses of previous administrations) to the next management, thereby accumulating state debts.

Amongst the solutions proposed in the documentary, the Brazilian economist Mauro Osório pointed out the need to increase the productivity of the state so that tax collection and wealth production is further encouraged. However, it is not always possible to implement economic solutions without legal support - to invest, the State of Rio de Janeiro needed revenue, but the debts undertaken needed to be paid prior to making any expenditures. Without renegotiation, possibilities were limited, and restructuring was unviable. Given this scenario, coupled with the lack of prospects for improvement and the domino effect that the crisis produced (notably reaching other states, such as Minas Gerais, Rio Grande do Sul and Goiás), the Federal Government sanctioned the Fiscal Recovery Regime. The measure is still considered limited, but it ratified the conclusion that Brazil needs to regulate the insolvency of its public bodies. On 31 July 2017 the State of Rio de Janeiro filed an application for adhesion to such a programme, aiming to extend the payment of the debts it contracted with the Federal Union, and to have access to a loan of almost R\$ 4 billion.

The Fiscal Recovery Regime was instituted by articles 1 and 2 of Complementary Law 159, and its purpose is to "correct the deviations that affected the balance of public accounts through the implementation of emergency measures and institutional reforms determined in the Recovery Plan previously prepared by the federative entity".<sup>27</sup> The Law was published in May 2017 and was first regulated by Decree 9109 of 27 July 2017, which established the practical specificities of the regime. In order to be eligible to pursue such

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<sup>24</sup> Decree 45.692/2016.

<sup>25</sup> F Gabeira, "The Economic Bankruptcy of Rio de Janeiro" (2019) available [here](#).

<sup>26</sup> This involved corruption schemes resulting in a Federal Police operation known as "car wash", that was related to embezzlement and money laundering involving directors of Petrobras, large contractors and politicians. The scheme may have embezzled more than R\$ 10 billion.

<sup>27</sup> Complementary Law 159, art 1º, s 2º.

a programme, the state must have more debt than available cash, as well as annual revenue less than the debt of the last financial year and expenses paid to personnel, including interest and amortisation equal to, or greater than, 70% of net current revenue for the last financial year.<sup>28</sup> The political opposition has criticised the eligibility criteria, accusing the regime of rewarding situations of administrative mismanagement without any considering the accountability of public managers. They also add that the law is the result of political lobbying by the states of Rio de Janeiro, Rio Grande do Sul and Minas Gerais, which have already decreed public calamity, and this is disrespectful to the states that have managed to maintain solvency even in the face of a crisis that reached the whole country.

To be able to join the Fiscal Recovery Regime, a state must present a plan (Recovery Plan) that is backed by legislative proposals. The petitioning state must also demonstrate its financial imbalance. It should also provide for the timeframes and measures that will be taken to re-establish the fiscal adjustment.

Through the first Fiscal Recovery Regime, states can have their debts with the Federal Union suspended for three years, and extended for another three years. Additionally, states may be able to engage in several different federally guaranteed credit operations that seek, *inter alia*, to fund programmes for voluntary dismissal or audit of the active and inactive payroll processing system, restructure debt, modernise treasury administration, or pursue the remaining activities foreseen by the Recovery Plan.<sup>29</sup> On the other hand, the laws that compose the plan must provide fiscal adjustment measures, such as the privatisation of companies and reduction of tax incentives.<sup>30</sup> In addition, a series of restrictions relating to, for example, the creation of public tenders other than vacancy replacement, the implementation of positions that burden the public accounts, and advertising expenses that are not related to public utility would be implemented.<sup>31</sup> The Fiscal Recovery Regime begins with the approval of the President – which must be preceded by a favourable opinion of the Minister of Finance and the appointment of the members of the Supervisory Board – and ends with the expiration of the established legal period, or with the materialisation of the goals set forth in the Recovery Plan.

In June 2019, realising the possible inefficiency of the Fiscal Recovery Regime, the Federal Government sent to Congress a proposal for an emergency programme for aid to subnational entities – the Fiscal Balance Promotion Plan. This programme aims to function alongside other restructuring mechanisms to improve the fiscal situation of Brazilian states and municipalities.

In the same way as with individuals, in order for federated entities to be able to find loans, lenders require guarantees to protect them in situations of default. In the case of states, the Federal District and municipalities, it is the Federal Union that acts as a guarantor of

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<sup>28</sup> *Idem*, art 3°.

<sup>29</sup> *Idem*, art 11.

<sup>30</sup> *Idem*, art 2°, s 1.

<sup>31</sup> *Idem*, Chap V.

the debts contracted. However, this possibility is not discretionary and has criteria defined in article 23 of Federal Senate Resolution 43/2001.<sup>32</sup> Amongst the foreseen requirements is the CAPAG (*Capacidade de Pagamento*, which refers to payment capacity), which is used to analyse the debt, current savings, and liquidity<sup>33</sup> situation of the federated entity. Rio de Janeiro has the worst grade of CAPAG (grade D)<sup>34</sup> and, in theory, cannot have loans guaranteed by the Federal Union. However, it is subject to a special regime consequential to the Tax Recovery Plan. The proposal was drafted by the National Treasury to allow subnational entities without payment capacity to get access to Federal Union-backed loans as long as they commit to making a plan of fiscal adjustment to regain repayment capacity. However, as reiterated by the National Treasury itself, this is a short-term measure that does not address the fiscal balance of subnational entities.

Due to the Covid-19 pandemic, the obligation on all states and municipalities to pay their debts with the Federal Union were suspended until the end of 2020 as a result of Complementary Law 173/2020. Subsequently, taking into consideration the expected changes in the Tax Recovery Regime, the Federal Supreme Court suspended the payment of debts until the new version of the regime was implemented.

#### 4.1 The new Fiscal Recovery Regime

In April 2021, following the flaws and criticisms of the “first” Fiscal Recovery Regime, Decree 10.681/2021 brought regulatory changes and instituted the “New Tax Recovery Regime”. Notably, it was established that local governments will have nine years to rebalance their financial situation by being provided with relief in debt collection. In the first 12 months there is a full suspension of debt collection, and this period does not count towards the nine-year deadline.<sup>35</sup> Therefore, the previous system that allowed three years, which could be renewed for another three, is now modified. Amongst the requirements that will be demanded of local governments are pension reform, privatisation of state-owned companies, a spending ceiling limiting the growth of expenses according to inflation, the reduction of tax incentives by 20%, and a review of civil servants’ benefits.

In October 2021, the government of Rio de Janeiro presented to the National Treasury a new plan for the Tax Recovery Regime.<sup>36</sup> It foresaw the receipt of approximately R\$ 100 billion in extra revenue over the 10 years following the report, largely due to taxation of investments and securitisation of state debts. However, this seems to be another emergent measure without a proper assessment of how the regulation of public insolvency should be designed in order to facilitate long-term financial rebalance.

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<sup>32</sup> Resolution 43/2001.

<sup>33</sup> Portaria n 501/2017.

<sup>34</sup> See, eg, *Estado Do Rio De Janeiro: Guia Para O Governador*.

<sup>35</sup> Law 10.681/2021, art 23, s 2º.

<sup>36</sup> See, eg, [https://sisweb.tesouro.gov.br/apex/f?p=2501:9:::9:P9\\_ID\\_PUBLICACAO\\_ANEXO:14060](https://sisweb.tesouro.gov.br/apex/f?p=2501:9:::9:P9_ID_PUBLICACAO_ANEXO:14060).



## Local public entities in distress - a critical analysis of the Canadian approach

By Stephanie Ben-Ishai\*

### 1. The general context of insolvency law

#### 1.1 A fragmented legislative landscape

While its first insolvency laws date back to 1919, Canada presently has two main statutes for managing insolvent corporations: the Bankruptcy and Insolvency Act<sup>1</sup> and the Companies' Creditors Arrangement Act.<sup>2</sup> There are also industry-specific insolvency statutes, including the Farm Debt Mediation Act,<sup>3</sup> the Canada Transportation Act<sup>4</sup> for railways, and the Winding-Up and Restructuring Act<sup>5</sup> for financial institutions. The application and scope of the latter two statutes are unclear at present, since they have rarely been invoked.<sup>6</sup>

The Bankruptcy and Insolvency Act is federally enacted legislation which provides a framework to liquidate and reorganise individuals and corporates who have become insolvent. Under this statute, an administrative proposal process is used to reorganise or liquidate insolvent debtors. The current iteration of the Bankruptcy and Insolvency Act can be traced back to 1992, with substantive amendments made in both 1997 and 2008.<sup>7</sup> The Companies' Creditors Arrangement Act was enacted federally in 1933, although it has experienced amendment and periods of relative obscurity during that time, falling into disuse until the 1980s.<sup>8</sup> Like the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act can be used to reorganise or to liquidate a corporation, although in terms of this statute it is done by way of a court-driven process.<sup>9</sup> This statute is the main reorganisation instrument for insolvent corporations, or groups of related corporations, subject to claims in excess of CAD 5,000,000.

The reasons why a corporation or their creditors might choose to use one statute over the other are complex. In the case of restructurings, larger firms tend to prefer the flexibility of

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<sup>1</sup> Bankruptcy and Insolvency Act 1985.

<sup>2</sup> Companies' Creditors Arrangement Act 1985.

<sup>3</sup> Farm Debt Mediation Act 1997.

<sup>4</sup> Canada Transportation Act 1996, ss 140-146.

<sup>5</sup> Winding-Up and Restructuring Act 1985.

<sup>6</sup> S Ben-Ishai and T Telfer (eds), *Bankruptcy and Insolvency Law in Canada: Cases, Materials, and Problems*, (4<sup>th</sup> ed, Irwin Law, Toronto, 2019) at 18-22.

<sup>7</sup> *Idem*, at 509.

<sup>8</sup> V Torrie, *Protagonists of Company Reorganization: A History of the Companies' Creditors Arrangement Act (Canada) and the Role of Large Secured Creditors* (Dphil Thesis, University of Kent, 2015), at 1-3.

<sup>9</sup> S Ben-Ishai and T Telfer (eds), *Bankruptcy and Insolvency Law in Canada: Cases, Materials, and Problems*, (4<sup>th</sup> ed, Irwin Law, Toronto, 2019) at 510-513.

the Companies' Creditors Arrangement Act, while smaller firms prefer using the Bankruptcy and Insolvency Act's more predictable processes.<sup>10</sup> The Bankruptcy and Insolvency Act also imposes more rules than the Companies' Creditors Arrangement Act regime and subjects debtors to more stringent timelines (the Companies' Creditors Arrangement Act has no prescribed timelines for completion of the restructuring process at all). While allowing for a more bespoke approach, proceedings in terms of the Companies' Creditors Arrangement Act also tend to involve greater expense than other formal proceedings, due in large part to the size of the debtor involved and the greater degree of the involvement of professionals and the courts in these processes. Practically, this means that the Bankruptcy and Insolvency Act's proposal process is often used for smaller, less complex reorganisations. However, the Companies' Creditors Arrangement Act is becoming increasingly rules-based and used frequently for liquidations, making it more likely that this bifurcated statutory regime will eventually be consolidated.<sup>11</sup>

## 1.2 Bankruptcy processes under the legislation

The role of various parties will depend on what type of proceeding is being used. Under the Bankruptcy and Insolvency Act, creditors may apply to a registrar in bankruptcy or to the court (depending on the province) for a bankruptcy order if the debtor owes at least CAD 1,000 and has committed an "act of bankruptcy" (a term of art which is defined in the statute).<sup>12</sup> An interim receiver may be appointed by the court if it is convinced that the assets are likely to disappear.<sup>13</sup> When a corporation is in bankruptcy, a licensed trustee will be appointed by the creditors.<sup>14</sup> Once appointed, the trustee is responsible for controlling the bankrupt's assets and liquidating them for the benefit of creditors.<sup>15</sup> Inspectors also assist in the administration of the estate by verifying the balance of the estate, the trustee's accounts, and the security filed by the trustee; and they approve the trustee's final statement of receipts and disbursements.<sup>16</sup> Trustees are in a fiduciary relationship with the creditors of the estate.<sup>17</sup>

Companies' Creditors Arrangement Act proceedings are initiated by the corporation itself through an application to the court, which imposes a stay on creditors taking legal action against the corporation.<sup>18</sup> The corporation's current management stays in place while it tries to come up with a plan that will be accepted by its creditors. This is similar to Chapter

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<sup>10</sup> *Idem*, at 510.

<sup>11</sup> *Idem*, at 511.

<sup>12</sup> *Idem*, at 101; and Bankruptcy and Insolvency Act 1985, s 43(1). The most common "act of bankruptcy" is when a debtor "ceases to meet his liabilities generally as they become due".

<sup>13</sup> Bankruptcy and Insolvency Act 1985, s 46(1).

<sup>14</sup> S Ben-Ishai and T Telfer (eds), *Bankruptcy and Insolvency Law in Canada: Cases, Materials, and Problems*, (4<sup>th</sup> ed, Irwin Law, Toronto, 2019) at 104-105.

<sup>15</sup> *Ibid.*

<sup>16</sup> *Idem*, at 104.

<sup>17</sup> *Ibid.*

<sup>18</sup> *Idem*, at 506.

11 proceedings in the United States.<sup>19</sup> Whilst the company comes up with a plan on a court-directed timetable, a monitor, who is an officer of the court, is appointed to oversee management throughout the restructuring proceedings.<sup>20</sup> In particular, the monitor is responsible for ensuring that both creditors and the court receive accurate and timely information about the state of the company.<sup>21</sup> As with bankruptcy trustees, monitors must be licensed and have a degree of independence from the corporation.<sup>22</sup> After creditors and the corporation agree on a plan, it must be approved by the court.<sup>23</sup>

### 1.3 Reorganisation processes under the legislation

As stated above, the Bankruptcy and Insolvency Act allows an insolvent debtor to initiate a reorganisation by issuing a notice of intent to make a proposal. This filing triggers an automatic 30-day stay of proceedings, subject to further extensions in increments of 45 days for a period of up to six months, as granted by the court. In addition to precluding the debtor's creditors from pursuing certain legal actions against it, the notice of intent affords a debtor the time to make a proposal to its creditors and reorganise its financial affairs, with the ultimate aim of continuing to operate as a going concern and emerging from its insolvent state intact. However, should a debtor's proposal be rejected by its creditors, an assignment in bankruptcy is automatically imposed on the debtor.

The Companies' Creditors Arrangement Act allows debtors to attempt to restructure under the supervision of a court-appointed monitor. During these proceedings, the debtor remains in possession of its assets and the debtor continues to operate as a going concern under the control of management. A stay of proceedings under the Companies' Creditors Arrangement Act is not automatic and is triggered only after a court grants the debtor's application for a stay. While the duration of the stay is considerably shortened under the Companies' Creditors Arrangement Act, similar extension rules apply as those under the Bankruptcy and Insolvency Act, although the length of the extension is entirely at the discretion of the court in these circumstances. These proceedings convert from a restructuring to an insolvency where a debtor's proposal is rejected by its creditors, and then the stay of proceedings applies only to unsecured creditors.

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<sup>19</sup> *Idem*, at 506-507.

<sup>20</sup> *Ibid.*

<sup>21</sup> *Idem*, at 548.

<sup>22</sup> *Ibid.*; and Companies' Creditors Arrangement Act 1985, s 11.7. For example, a monitor cannot be appointed as a trustee if he served as a director of the corporation.

<sup>23</sup> S Ben-Ishai and T Telfer (eds), *Bankruptcy and Insolvency Law in Canada: Cases, Materials, and Problems*, (4<sup>th</sup> ed, Irwin Law, Toronto, 2019) at 510.

## **1.4 Key actors in the insolvency space**

### **1.4.1 *Insolvency regulator***

The Office of the Superintendent of Bankruptcy is the federal insolvency regulator. Since bankruptcy and insolvency are under federal jurisdiction, there are no provincial regulators. The Office of the Superintendent of Bankruptcy is responsible for supervising all estates under the Bankruptcy and Insolvency Act, and certain matters under the Companies' Creditors Arrangement Act. It also regulates the insolvency profession as a whole, including issuing licenses to trustees. The Office of the Superintendent of Bankruptcy's mandate also extends to the supervision of the administration of estates in both commercial and personal restructuring and insolvencies, proposals, and receiverships; the maintenance of public records of filings; and the investigation of complaints regarding insolvency processes.<sup>24</sup>

### **1.4.2 *Insolvency officeholders***

Insolvency officeholders act as impartial fiduciaries and must obtain a license through the Office of the Superintendent of Bankruptcy, as previously mentioned.<sup>25</sup> Two common forms of insolvency officer are the monitors appointed under the Companies' Creditors Arrangement Act and proposal trustees appointed through the Bankruptcy and Insolvency Act proposal process. These officials are primarily charged with keeping the court apprised of the status of the debtor and providing the debtor with strategic and financial recommendations.

### **1.4.3 *The courts***

Courts play a key supervisory role during formal restructuring and bankruptcy proceedings. The level of court involvement varies based on the statute used and the level of complexity of the proceedings. In the insolvency space, courts may be called upon to do a wide variety of things, including approving administrative processes, adjudicating disputes between stakeholders, and ruling on the appropriateness of an arrangement. Specialised resources are dedicated to the administration of insolvency matters in Canada, including maintaining a roster of highly-trained judges tasked with hearing insolvency, bankruptcy and restructuring matters.

### **1.4.4 *Debtors***

Debtors typically initiate restructuring processes and are obliged to meet procedural requirements under the operative statute. Most importantly, debtors are subject to the

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<sup>24</sup> Office of the Superintendent of Bankruptcy, "About the OSB" (12 October 2018), available [here](#).

<sup>25</sup> *Ibid.*

court's supervision and are restrained from disposing of assets, unless this is done in the ordinary course of business.

#### **1.4.5 Creditors**

Creditors hold the right to vote on a proposal for restructuring. A vote to approve any proposal requires two-thirds of creditors holding a majority of the dollar value in that class. A vote binds all creditors in that class once the aforementioned majority is obtained. Other rights owed to creditors are predominantly governed by contract. Unsecured creditors tend to have the fewest rights, and corresponding responsibilities, under a formal restructuring.

#### **1.4.6 Other stakeholders**

Debtor's employees who continue to work in the normal course of business are entitled to the same wages and benefits as would normally be the case. Labour and employment standards continue to apply throughout the restructuring process and unionised employees' collective agreements remain in force. Pension plan holders are also given special protections under Canadian law. Pension plans cannot be used to satisfy an insolvent debtor's liabilities or operating expenses, since they are considered separate from the general assets of the corporation.

### **1.5 Perceptions about the insolvency regime**

The Canadian restructuring and insolvency regime prioritises the rehabilitation of debtors by giving companies considerable breathing room to continue as going concerns and, where this is impossible, attempts to minimise the impact of debtor's insolvency by ensuring an equitable distribution of its assets. Despite the many advantages accrued to debtors, historically Canada has been regarded as a creditor-friendly jurisdiction. Creditors, especially secured creditors, remain well protected under the Canadian regime and play a central role in restructuring proceedings. However, this has recently shifted to where there is a comparatively more balanced approach between creditor and debtor interests.<sup>26</sup>

### **1.6 Reforms underway**

Canada's insolvency environment continues to evolve as financial markets innovate and parties' interests and incentives shift. Amendments to the Bankruptcy and Insolvency Act and Companies' Creditors Arrangement Act came into force in late 2019. Both statutes now have increased "look-back" timelines to allow a court to review a debtor's transactions and require a duty of good faith for "any interested person." The Companies' Creditors Arrangement Act was additionally amended to reduce the initial stay of proceedings from

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<sup>26</sup> L Williams, M Grossell and P Fesharaki, "Restructuring & Insolvency in Canada", *Lexology* (2019) available [here](#).

30 days to ten days, limit the relief available in the initial order, and create additional disclosure requirements for interested parties.<sup>27</sup>

As of September 2021, there are no further amendments to either statute being openly contemplated in response to Covid-19. Given the scale and the pace of the crisis, emergency legislation may be forthcoming at any time.

Cities and city-run organisations, including transit authorities, are already sounding the alarm over the increased pressures caused by the Covid-19 pandemic. Sources of revenue, including transit fares, land transfer taxes, fees to use recreation centres, and fines from parking infractions, have dwindled in concert with increased demands for services. In response, municipal leaders are seeking additional assistance from the federal and provincial governments.<sup>28</sup> Similar solutions are being proposed by municipally-owned transit authorities, some of whom have seen their ridership drop 80% in response to the pandemic.<sup>29</sup>

## 2. Local public entities

### 2.1 Definitional matters

There is no single definition of a “public entity” at any level of government in Canada, whether it be federal, provincial, or municipal. There is also no definitive list of public entities, government-owned enterprises, Crown corporations, operational enterprise agencies, or commissions across all levels of government.<sup>30</sup>

Statistics Canada uses two terms to capture the general idea of a “public entity”. The first is “institutional unit” which is defined as an “economic entity which is capable, in its own right, of owning assets, incurring liabilities, and engaging in economic activities and transactions with other entities.”<sup>31</sup> The second term is “government business enterprises”, which are “legal entities that are created for the purpose of producing goods and services for the market... [they] are owned by government units. All the profit and financial gain of the government business enterprise flows back to the government unit that owns it.”<sup>32</sup>

Provincial entities are not subject to a single definition or criteria, which can lead to often contradictory characterisations. For instance, the Ontario Lottery and Gaming Corporation

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<sup>27</sup> W MacLeod and N Stewart, “Insolvency Amendments Now in Force Under the BIA and CCAA” (2019) available [here](#).

<sup>28</sup> F Bula, O Moore and N Van Praet, “Cities Face Massive Financial Shortfalls Because of COVID. How Can They Cope When They Can’t Run Deficits?”, *The Globe and Mail* (13 April 2020) available [here](#).

<sup>29</sup> R Schmunk and J McElroy, “TransLink Announces Nearly 1,500 Layoffs, More Service Cuts”, *CBC News* (20 April 2020) available [here](#).

<sup>30</sup> D Crisan and K McKenzie, “Government-Owned Enterprises in Canada”, *University of Calgary School of Public Policy* (2013) at 26.

<sup>31</sup> Statistics Canada, “Public Sector Universe, 2017” (20 November 2018) available [here](#).

<sup>32</sup> Statistics Canada, “Canadian Government Finance Statistics” (11 December 2018) available [here](#).

is defined as an “operational enterprise agency” in the parlance of that province, while an identically-constituted agency in another province would be deemed as a Crown agency, crown corporation, or government enterprise.<sup>33</sup>

This confusion also proliferates throughout municipal and local agencies, since there is no guarantee that important services will be constituted as their own entity. Corporations that a municipality may be financially responsible for can also take the form of a Crown corporation, “City controlled corporation”,<sup>34</sup> municipal corporations, “related authorities”, or businesses that provide services to member municipalities.<sup>35</sup> For example, the transit authority for the City of Calgary is organised as a business unit.<sup>36</sup> Statutes and policies at the provincial level vary somewhat, which may help influence the multiplicity of ways that municipalities organise their institutions’ corporate structures.<sup>37</sup>

Importantly, the same linguistic imprecision is mirrored in the insolvency space, with similar terms used interchangeably when a municipality or one of its entities encounters financial difficulty. The fact that there is no single coherent definition of a local public enterprise (LPE) or its equivalent precludes statutorily codified mission statements and defining elements.

### **3. Dealing with local public enterprises in distress - the legal framework**

No formal, explicit legal frameworks exist to address insolvent public entities. The structure of these organisations means that they lack sufficient independence from their municipality to fail in a way that would implicate insolvency laws. For example, where it is necessary for these institutions to take on debt, they are able to access it through a municipal finance corporation, rather than issue bonds themselves.<sup>38</sup> Put another way, local institutions are only able to access debt through their municipality, which issues the debentures in its name.

This arises from the constitutional structure of municipalities and their institutions. Under the Canadian Constitution, Canada’s ten provinces each have exclusive jurisdiction over municipalities and their institutions residing in their territory.<sup>39</sup> Cities, towns and other municipalities are created by the provincial government, and are empowered through its laws.<sup>40</sup> That said, the province can give municipalities no more than the powers which it

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<sup>33</sup> D Crisan and K McKenzie, “Government-Owned Enterprises in Canada”, *University of Calgary School of Public Policy* (2013) at 3.

<sup>34</sup> This is the language used in Alberta, which defines a City controlled corporation as “a corporation controlled by a municipality or a group of municipalities and includes a subsidiary...of such a corporation”. See *Municipal Government Act 2000*, s 75.1(1).

<sup>35</sup> D Crisan and K McKenzie, “Government-Owned Enterprises in Canada”, *University of Calgary School of Public Policy* (2013) at 24.

<sup>36</sup> *Idem*, at 25.

<sup>37</sup> *Idem*, at 2-3 for examples.

<sup>38</sup> *Idem*, at 24.

<sup>39</sup> *Constitution Act 1982*, s 92(8); and *Canada Act 1982 (UK)*, Sch B.

<sup>40</sup> *East York (Borough) v Ontario (Attorney General)* [1997] 34 OR (3d) 789.

has itself.<sup>41</sup> As an example, a province cannot grant nor alter the priority in bankruptcy for municipal institutions, since bankruptcy and insolvency is under the exclusive jurisdiction of the federal government. Provinces do, however, routinely place restrictions on municipalities and their institutions regarding how they can raise debt.

The restrictions placed on municipalities by each province are as follows:

### 3.1 Alberta

In Alberta, municipalities are permitted to borrow through passing bylaws, subject to a debt limit set by the province's regulations.<sup>42</sup> For smaller municipalities, this limit is currently 150% times annual revenue for total debt, and 25% of annual revenue for debt servicing costs.<sup>43</sup> For the larger municipalities of Calgary, Edmonton, Medicine Hat and Wood Buffalo, the debt limit is 200%, and the debt servicing limit is 35% of annual revenue.<sup>44</sup> The provincial Minister in charge of municipalities can authorise borrowing to be made in excess of these limits if he deems it to be appropriate.<sup>45</sup> If a municipality passes a bylaw that exceeds this limit, any councillor who voted to authorise the borrowing is jointly and severally liable for the excess.<sup>46</sup>

### 3.2 British Columbia

Municipalities are permitted to borrow in order to finance activities permitted by the provincial statute.<sup>47</sup> Typically these loans are restricted to five years and require a bylaw for long-term borrowing such as efforts to finance capital expenditure.<sup>48</sup> The debt load of a municipality is subject to provincial regulations, which currently stipulate that municipalities can borrow if their debt servicing costs are at or below 25% of the municipality's revenues from the previous year.<sup>49</sup>

The situation in British Columbia is made somewhat more complex by the existence of regional districts, which supersede municipal governments but are still subordinate to the province. These districts are empowered to provide solid waste management and provide emergency services, such as fire protection.<sup>50</sup> District governments are required by the province to present an annual financial plan which must balance its proposed revenues and funding with its expenditures.<sup>51</sup> However, to smooth its consumption, district governments are permitted to borrow money to meet its expenditures before it has been

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<sup>41</sup> *Ibid.*

<sup>42</sup> Municipal Government Act 2000, ss 264 and 271(1).

<sup>43</sup> Debt Limit Regulation 2000, s 2(1).

<sup>44</sup> *Idem*, s 2(2).

<sup>45</sup> Municipal Government Act 2000, s 602.28.

<sup>46</sup> *Idem*, s 275.

<sup>47</sup> Community Charter 2003, s 174.

<sup>48</sup> *Idem*, s 179.

<sup>49</sup> Municipal Liabilities Regulation 2015, s 2.

<sup>50</sup> Government of British Columbia, "Regional Districts in B.C." available [here](#).

<sup>51</sup> Local Government Act 2015, s 374(5).



received through passing a bylaw. This bylaw is restricted to CAD 50,000, plus CAD 2 times the population of the district, and must be repaid within the lesser of five years or the life expectancy of the capital asset that the debt is being taken out to finance.<sup>52</sup> If a regional government defaults, the municipalities that make up the regional district become jointly and severally liable.<sup>53</sup>

### 3.3 Manitoba

Manitoba also empowers its municipalities to make loans for capital projects through passing bylaws.<sup>54</sup> As with other provinces, the instrument to borrow the funds cannot exceed the lifetime of the capital property.<sup>55</sup> Municipal debt cannot exceed 30% of the amount that it estimates it will raise in tax revenue in that year. Exceptions to this limit can be granted with prior written approval of the Municipal Board set up by the province.<sup>56</sup>

### 3.4 New Brunswick

New Brunswick permits municipal governments to borrow for both operating and capital expenses. For operating expenditures, borrowing is limited to the greater of 4% of its operating budget or CAD 15,000. For capital expenditures, the municipality is restricted to 2% of the value of the real property per year, up to 6% in total. However, this figure does not include money lent to the municipality by the province or federal government, or any money borrowed to finance the construction or renovation of a generation facility, water or wastewater disposal system.<sup>57</sup> Borrowing for these purposes is limited to 50% of revenue for that year.<sup>58</sup>

Municipal borrowing is subject to a provincially-controlled Municipal Capital Borrowing Board. A municipality seeking to obtain or guarantee a loan or issue debentures to finance a capital expense must receive approval from both its council and written approval from the Municipal Capital Borrowing Board.<sup>59</sup> In an emergency, the Municipal Capital Borrowing Board can authorise up to an additional CAD 10,000 for capital borrowing.<sup>60</sup>

### 3.5 Newfoundland and Labrador

Municipalities in Newfoundland and Labrador can borrow for their current operating expenses up to 20% of their expected revenues for the year, not including water and sewage subsidies. The municipality borrowing these funds must inform the relevant

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<sup>52</sup> *Idem*, ss 404 and 405.

<sup>53</sup> *Idem*, s 412.

<sup>54</sup> Municipal Act 1992, Division 2.

<sup>55</sup> *Idem*, s 179.

<sup>56</sup> Loan Limit Regulation 1997, ss 1 and 2.

<sup>57</sup> Local Governance Act 2017, s 100.

<sup>58</sup> *Idem*, ss 116m and 117(13).

<sup>59</sup> Municipal Capital Borrowing Act 1973, ss 6 and 7.

<sup>60</sup> *Idem*, s 4(4).

Minister within 30 days of the loan being made, and the loan must be repaid within the financial year that the borrowing takes place. Borrowing in excess of 20%, or on an extended time horizon, can only happen with the prior written approval of the Minister.<sup>61</sup> Borrowing for capital purposes, or leasing personal or real property for more than five years can also be done only with the prior written approval of the Minister.<sup>62</sup>

### 3.6 Nova Scotia

Nova Scotia's municipalities are only permitted to borrow under the following circumstances: when granted the approval of the Minister of Transportation to improve streets, to pay and retire debentures; where it is statutorily authorised to give and honour a guarantee; to demolish a building or structure it owns; to contribute a capital grant to a hospital; or to make a loan to a registered fire department or emergency services provider.<sup>63</sup> This borrowing is restricted by statute to 50% of the previous year's taxes and grants from other governments.<sup>64</sup> This borrowing must be approved by the Minister before it happens, and it will not be approved until the annual capital budget has been received.<sup>65</sup> Any funds borrowed without the issue of debentures must be repaid within one year, unless the Minister approves of another plan. This new term cannot exceed ten years.<sup>66</sup>

### 3.7 Ontario

Ontario permits temporary borrowing to smooth consumption until taxes and other revenues are received. This is limited to 50% of total estimated revenues from the beginning of January to last day of September, and 25% of estimated revenues for the remainder of the year.<sup>67</sup>

Municipalities may borrow for capital projects, subject to provincial regulations and the approval of a provincially-constituted Board.<sup>68</sup> After reviewing the previous year's financial returns, the Board will calculate the amount of funds that it was able to raise on its own (this amount is not inclusive of provincial or federal government transfers), less any debt-servicing costs. The maximum borrowing permitted by that municipality is 25% of that figure.<sup>69</sup>

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<sup>61</sup> Municipalities Act 1999, s 93.

<sup>62</sup> *Idem*, s 94.

<sup>63</sup> Municipal Government Act 1998, s 66(4).

<sup>64</sup> *Idem*, s 84.

<sup>65</sup> *Idem*, ss 87 and 88.

<sup>66</sup> *Idem*, s 92(2).

<sup>67</sup> Municipal Act 2001, s 407.

<sup>68</sup> Debt and Financial Obligation Limits Regulation 2002, s 2.

<sup>69</sup> *Idem*, s 3.

Ontario's statute is unique in expressly precluding its municipalities from accessing either bankruptcy proceedings or a reorganisation through the Bankruptcy and Insolvency Act.<sup>70</sup>

### 3.8 Prince Edward Island

Municipal borrowing in Prince Edward Island is restricted to 10% of the current assessed value of real property in the municipality for capital projects.<sup>71</sup> Like in New Brunswick, money borrowed as part of a funding agreement with the province and / or federal government is not included in that calculation.<sup>72</sup> Bylaws may be passed to permit borrowing of up to 50% of the total estimated annual revenues on a short-term basis to cover operating expenses.<sup>73</sup> As is the case in Alberta, council members can be held jointly and severally liable for exceeding the debt limit. This can be enforced by the municipality, a voter in the municipality, or the creditor who provided the excess credit.<sup>74</sup>

### 3.9 Québec

Québec, unlike the other provinces, operates under a civil law system. Nevertheless, its treatment of municipalities is fairly consistent with the common law jurisdictions in the rest of Canada. Borrowing is restricted to capital projects and may not exceed a term of 40 years or the useful life of the capital asset.<sup>75</sup> This maximum period is currently further limited to 20 years, as effected by the regulations.<sup>76</sup> Borrowing to cover an operating deficit is permitted once a bylaw to that effect has been passed and approval has been received from the Minister of Municipal Affairs.<sup>77</sup>

Unlike the other provinces, municipalities of 100,000 individuals or more in Québec may delegate their borrowing powers to the municipal treasurer.<sup>78</sup>

### 3.10 Saskatchewan

Compared to other provinces, Saskatchewan has a generous debt limit for its municipalities at 100% of the municipality's source revenues from the preceding year.<sup>79</sup> Borrowing that will exceed that limit, that is repayable in three years or more, or that is secured by the issue of debentures must be approved by the Saskatchewan Municipal Board and then affirmed through a bylaw.<sup>80</sup> Debt may be allowed to finance operating

<sup>70</sup> *Idem*, s 17(1).

<sup>71</sup> Municipal Government Act 1988, s 164.

<sup>72</sup> *Idem*, s 164(5).

<sup>73</sup> *Idem*, s 166.

<sup>74</sup> *Idem*, s 170.

<sup>75</sup> Act Respecting Municipal Debts and Loans 1988, s 1.

<sup>76</sup> Regulation Respecting the Maximum Reimbursement Period of a Loan Effected by a Municipality 1986, s 1.

<sup>77</sup> Act Respecting Municipal Debts and Loans 1988, s 3.

<sup>78</sup> *Idem*, s 2.

<sup>79</sup> The Muicipalities Act 2005, s 161.

<sup>80</sup> *Idem*, ss 162-165.

expenses; however, it is limited to tax increases in the year of the borrowing and unconditional grants from the federal or provincial government.<sup>81</sup>

#### 4. Dealing with local public entities in distress - law in practice

There is no explicit mechanism provided to resolve financially distressed LPEs in the provincial laws. The practical result of municipalities and their institutions being constituted as creatures of the province is that the insolvency of these institutions becomes a question for municipal councils and / or provincial governments, with their rescue likely coming from provincially-sourced funds. In exceptional circumstances where provincial funds are not available, or the financial need of an LPE surpasses that which the province can provide, the federal government may step in to provide assistance.<sup>82</sup> Whether this assistance will actually be forthcoming given current fiscal realities, what form it will take, and any conditions that may be attached to it, is more a question of politics than of legislative interpretation. Irrespective of which government steps in, if this intervention takes place, it will likely have consequences for the intervening government's finances and tax rates moving forward. This is because debt resolution in the case of an LPE almost always comes in the form of a bailout. However, since this would likely arise in a complex, post-crisis fiscal environment, it is difficult to definitively conclude how the assistance would affect taxes.

Additionally, the structure of municipal pension plans makes it unlikely that insolvent municipalities would be able to access workers' pensions to service outstanding LPE debts. Employees of municipalities and their institutions have their pensions managed through arms-length pension funds, often pooled at the provincial level to some extent. Alberta, British Columbia and Ontario have a single province-wide plan that provides pensions to all municipal employees. Manitoba and Saskatchewan pool the pensions in smaller and rural districts, while larger cities operate their own plans. Quebec, Newfoundland and Labrador, Prince Edward Island, New Brunswick, and Nova Scotia manage their plans on a municipality-by-municipality basis.<sup>83</sup> Where plans are pooled provincially, an insolvent municipality would have no opportunity to reduce benefits. Even where the city has more control over the pension plan, there appears to be significant safeguards in place to protect pension plans. For instance, public municipal pensions in Winnipeg can only be reduced if the city council passes resolutions supported by a two-thirds majority of members.<sup>84</sup>

Further, since this area of law is a creature of executive action and / or administrative decision making, there is no body of case law to point to which can instruct on how these organisations are to be unwound or restructured. Municipal bankruptcies in Canada have

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<sup>81</sup> *Idem*, s 166.

<sup>82</sup> S Paikin and J McGrath, "#onpoli Newsletter: What it Will Take to Restart the Economy", *TVO* (28 April 2020) available [here](#).

<sup>83</sup> B Baldwin, "Municipal Employee Pension Plans in Canada: An Overview", *Munk School of Global Affairs* (2015) at 13-14.

<sup>84</sup> *Idem*, at 14.

been relatively rare, due in large part to the aforementioned financial constraints placed on municipalities by their provincial overlords. Despite this general trend, during the 1930s several municipalities, including the cities of Windsor, York, and Burnaby, defaulted on payments. In all three cases, however, the municipalities either amalgamated with adjoining cities to tackle their debt or remedied their financial ails outside of the formal restructuring processes available under the Bankruptcy and Insolvency Act or Companies' Creditors Arrangement Act.<sup>85</sup>

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<sup>85</sup> T Dunn and S Skorbinski, "Municipal Insolvency in Canada", *Public Sector Digest* (2020).

## Local public entities in distress - a critical analysis of the Croatian approach

By Lidija Šimunović\*

### 1. The general context of insolvency law

In Croatia, the principal piece of legislation applicable to companies in financial or economic distress is the Bankruptcy Act.<sup>1</sup> The Bankruptcy Act is regarded as debtor-friendly<sup>2</sup> and it regulates pre-bankruptcy and bankruptcy proceedings, where bankruptcy proceedings can result in the company's liquidation or in the adoption of a restructuring plan.<sup>3</sup>

There is also the Act on Extraordinary Administration Proceedings in Companies of Systemic Importance for the Republic of Croatia.<sup>4</sup> This statute regulates extraordinary administration proceedings for companies of systemic importance for the country. These procedures are available only to companies that can enter into pre-liquidation and liquidation procedures under the Bankruptcy Act.<sup>5</sup>

The Consumer Bankruptcy Act<sup>6</sup> outlines the bankruptcy rules available to consumers as natural persons who enter into legal transactions or operate in the markets outside of any commercial, business, trade or professional capacity.<sup>7</sup>

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<sup>1</sup> *Stečajni zakon*, Official Gazette no 71/2015, 104/2017, 36/2022 which came into force on 1 September 2015 (the Bankruptcy Act).

<sup>2</sup> The Bankruptcy Act follows the German Insolvency Code that is also debtor-friendly. In this respect, see J Garašić and S Petrović, "National Report for Croatia" in J Chuah and E Vaccari (eds), *Executory Contracts in Insolvency Law. A Global Guide* (Edward Elgar Publishing, Cheltenham, 2019) at 173.

<sup>3</sup> Bankruptcy Act, arts 1 and 303.

<sup>4</sup> *Zakon o postupku izvanredne uprave u trgovačkim društvima od sistemskog značaja za Republiku Hrvatsku*, the so-called *Lex Agrokor*, Official Gazette no 32/2017, which came into force on 6 April 2017 (the Extraordinary Management Procedure Act).

<sup>5</sup> Extraordinary Management Procedure Act, art 1. Companies of systemic importance for the Republic of Croatia are those that, either independently or jointly with their subsidiaries and related companies, cumulatively employ over 5,000 workers on average and with a balance sheet obligation exceeding HRK 7,500,000,000.00. The Extraordinary Management Procedure Act, arts 1 and 4. Thus far, extraordinary management proceedings have been conducted only for one company, Agrokor, which is why this law is often colloquially called the *Lex Agrokor*. This act may, in theory, be applicable to some public limited companies under majority ownership of the Republic of Croatia (such as the Croatian Post) or local public entities (such as Zagrebački Holding, the biggest holding in the Republic of Croatia owned by the City of Zagreb).

<sup>6</sup> *Zakon o stečaju potrošača*, Official Gazette no 100/2015, 67/2018, which came into force on 1 January 2016 (the Consumer Bankruptcy Act).

<sup>7</sup> Consumer Bankruptcy Act, arts 1 and 4.

## 1.1 Pre-bankruptcy proceedings

According to the Bankruptcy Act, pre-bankruptcy proceedings regulate the debtor's legal position with their creditors with the purpose, where possible, of rescuing the debtor's operations and reorganising their business.<sup>8</sup> Pre-bankruptcy proceedings can be initiated by a debtor only.<sup>9</sup>

A petitioner has to show the imminent insolvency of a debtor, meaning that a debtor should be at risk of not fulfilling their obligations when they become due.<sup>10</sup> A petitioner has to submit a proposal for a restructuring plan together with a petition.<sup>11</sup>

Key players in pre-bankruptcy proceedings are commercial courts and appointed pre-bankruptcy trustees.<sup>12</sup> Commercial courts examine creditors' claims and confirm proposed restructuring plans, which are also known as pre-bankruptcy agreements.<sup>13</sup> Pre-bankruptcy trustees supervise a debtor's business operations, file the list of assets and obligations of the debtor, and examine the authenticity of the claims of creditors.<sup>14</sup> An important role in pre-bankruptcy proceedings is also played by a debtor's creditors, who discuss and propose changes to the restructuring plan.<sup>15</sup>

A debtor's creditors will vote on any proposed restructuring plan. If the statutory majorities are met, a commercial court will confirm a proposed plan.<sup>16</sup> A confirmed pre-bankruptcy plan is legally binding on all creditors, except the debtor's employees, those creditors with the rights on assets not belonging to the debtor, and creditors with separate satisfaction rights.<sup>17</sup>

## 1.2 Bankruptcy proceedings

According to the Bankruptcy Act, bankruptcy proceedings seek the collective satisfaction of a debtor's creditors through the liquidation of a debtor's assets and by the distribution of the proceeds amongst a debtor's creditors or by maintaining the debtor's business

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<sup>8</sup> Bankruptcy Act, art 2, para 1. See also J Garašić and S Petrović, "National Report for Croatia" in J Chuah and E Vaccari (eds), *Executory Contracts in Insolvency Law. A Global Guide* (Edward Elgar Publishing, Cheltenham, 2019) at 171.

<sup>9</sup> Bankruptcy Act, art 25, para 1.

<sup>10</sup> *Idem*, art 4, paras 1, 3 and 4.

<sup>11</sup> *Idem*, art 26, para 3.

<sup>12</sup> *Idem*, art 21.

<sup>13</sup> *Idem*, art 22 contains more information on the roles of the commercial court in pre-bankruptcy proceedings.

<sup>14</sup> *Idem*, art 24 contains more information on the roles of the pre-bankruptcy trustee.

<sup>15</sup> *Idem*, arts 21, 35, 38, and 52-55.

<sup>16</sup> *Idem*, arts 56-61.

<sup>17</sup> *Idem*, arts 66 paras 1 and 2. See also J Garašić and S Petrović, "National Report for Croatia" in J Chuah and E Vaccari (eds), *Executory Contracts in Insolvency Law. A Global Guide* (Edward Elgar Publishing, Cheltenham, 2019) at 171.

operations by reaching an agreement on a bankruptcy plan.<sup>18</sup> Bankruptcy proceedings can be initiated by a debtor, its creditors,<sup>19</sup> or by the Financial Agency (FINA).<sup>20</sup>

These proceedings can be opened if the debtor is insolvent (unable to pay its debts as they fall due);<sup>21</sup> over-indebted (when the debtor's liabilities exceed the value of its assets);<sup>22</sup> and, in some cases, facing imminent insolvency.<sup>23</sup>

The parties traditionally involved in bankruptcy proceedings are commercial courts, bankruptcy administrators and a debtor's creditors, who operate through an assembly or board.<sup>24</sup> Commercial courts examine the claims of creditors,<sup>25</sup> whilst bankruptcy administrators represent debtors in bankruptcy<sup>26</sup> and exercise the rights and discharge the obligations of a debtor's managing and supervisory bodies.<sup>27</sup> If a debtor continues its affairs during a bankruptcy procedure, a bankruptcy administrator must manage these affairs. In particular, a bankruptcy administrator is obliged to: (i) update the books and records of a debtor from the day of the opening of the bankruptcy proceedings, (ii) prepare an estimate of the costs of the bankruptcy proceedings and submit them to a creditors' committee for approval, (iii) set up a commission to take an inventory, (iv) prepare an opening balance sheet, (v) see to it in the manner of a good manager that the commenced and unfinished transactions of the debtor to which they are appointed are finished and that actions necessary to prevent damage to the debtor's assets are carried out, (vi) ensure that the claims of the debtor to which they are appointed are satisfied, (vii) conscientiously conduct that debtor's affairs if the affairs are being continued, (viii) liquidate or turn into cash, with the care of a good manager, the assets of the debtor to which they are appointed that comprise the bankruptcy estate, (ix) prepare a distribution to creditors and, after approval, execute the distribution, and (x) deliver a closing balance of the proceedings to a creditors' committee, and execute the subsequent distribution to the debtor's creditors.<sup>28</sup> Furthermore, the bankruptcy administrator must submit written reports on the course of the bankruptcy proceedings and the state of a bankruptcy estate every three months.<sup>29</sup>

If a restructuring plan is prepared by a bankruptcy administrator, creditors can propose changes thereto.<sup>30</sup> The restructuring plan is then subject to a creditors' vote and a

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<sup>18</sup> Bankruptcy Act, art 2, paras 2-3.

<sup>19</sup> *Idem*, art 109, para 1.

<sup>20</sup> *Idem*, art 110, para 1.

<sup>21</sup> *Idem*, art 6, para 1.

<sup>22</sup> *Idem*, art 7, para 1.

<sup>23</sup> *Idem*, art 5.

<sup>24</sup> *Idem*, art 75.

<sup>25</sup> *Ibid* contains more information on the role of commercial courts in bankruptcy proceedings.

<sup>26</sup> *Idem*, art 88, para 3.

<sup>27</sup> *Idem*, art 88, para 1.

<sup>28</sup> *Idem*, art 89.

<sup>29</sup> *Idem*, art 89 para 2.

<sup>30</sup> *Idem*, arts 321-326.



commercial court's approval.<sup>31</sup> A confirmed bankruptcy plan is legally binding on all of a debtor's creditors, including those who have not filed claims (provided that they were served a bankruptcy order) and any dissenting participants.<sup>32</sup>

During the Covid-19 pandemic, changes were temporarily introduced to the Bankruptcy Act through the Act on Emergency Measures in Enforcement and Bankruptcy Procedures during Special Circumstances (1 May 2020).<sup>33</sup> This act's purpose was to implement emergency measures in enforcement and bankruptcy proceedings,<sup>34</sup> and state that it was not possible to open a bankruptcy or pre-bankruptcy procedure against a company that became insolvent whilst the act was in force.<sup>35</sup> The only exception to this rule was in cases where a bankruptcy claim was filed for the protection of the interests and security of the Republic of Croatia, the environment, or people's health.<sup>36</sup> This prohibition on commencing bankruptcy proceedings is no longer in force.<sup>37</sup>

In Croatia, the main goals currently pursued by the legislator are to reduce the number of bankruptcy procedures initiated and improve the efficiency of the system.<sup>38</sup> The Ministry of Justice and Administration had authorised the drafting and passing of statutory reforms, which were implemented in 2022.<sup>39</sup> To achieve this, a working group had been set up to draft the Act on Amendments to the Bankruptcy Act and the Draft Act on Amendments to the Consumer Bankruptcy Act in order to harmonise the law with the European Union's Restructuring and Insolvency Directive<sup>40</sup> (which Act was implemented on 31 March 2022). The changes have not affected the treatment of local public entities in distress as they are not dealt with by the above-mentioned directive.

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<sup>31</sup> *Idem*, arts 327-337.

<sup>32</sup> *Idem*, art 340, para 1. See also J Garašić and S Petrović, "National Report for Croatia" in J Chuah and E Vaccari (eds), *Executory Contracts in Insolvency Law. A Global Guide* (Edward Elgar Publishing, Cheltenham, 2019) at 172.

<sup>33</sup> *Zakon o interventnim mjerama u ovršnim i stečajnim postupcima za vrijeme trajanja posebnih okolnosti*, Official Gazette no 53/2020, which came into force on 1 May 2020 (the Act on Emergency Measures).

<sup>34</sup> *Idem*, art 1, para 1.

<sup>35</sup> *Idem*, art 1, para 2.

<sup>36</sup> *Ibid.*

<sup>37</sup> The Decision on the Extension of the Duration of Special Circumstances, Official Gazette no 83/2020, which extended the duration of special circumstances until 18 October 2020.

<sup>38</sup> The statutory purposes are available in the official counselling on the Draft Act on Amendments to the Bankruptcy Act introduced by the Ministry of Justice and Administration, which was opened on 10 October 2021, available [here](#).

<sup>39</sup> The schedule of the mentioned legislation activities is available [here](#).

<sup>40</sup> Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132, OJ L 172, 26.6.2019, pp 18-55.

## 2. Local public entities

Under Croatian law, “public entities” are not defined in the Constitution.<sup>41</sup> However, pursuant to the Administrative Disputes Act, the term is used to refer to (i) the state and other governmental institutions, including local and regional institutions such as counties, cities, and municipalities (LR units), (ii) legal entities with public authority, and (iii) legal entities that perform public services, but without public powers (public service providers).<sup>42</sup> Similarly to the Administrative Disputes Act, GAPA provides that public law institutions are state administration and other governmental institutions, institutions of a local and regional unit of local self-governance, or legal entities with public authority that conduct and resolve administrative matters, within the competence determined by law.<sup>43</sup>

In this context, amongst local public entities, “basic” and “hybrid” local public entities should be distinguished. Basic local public entities<sup>44</sup> are local (municipalities and cities) and regional (counties) entities.<sup>45</sup> Hybrid local public entities are companies, public institutions,<sup>46</sup> associations,<sup>47</sup> foundations,<sup>48</sup> and other legal entities funded and / or owned by a basic local public entity that seeks to provide public services (such as transport, social housing and care, education, hospitals, utility services, etcetera).

Local public entities are subject to specific rules for reporting their financial results pursuant to the Act on the Financing of Local and Regional Units (AFLRU)<sup>49</sup> and the Budget Act.<sup>50</sup> These reports are overseen by the Ministry of Finance.<sup>51</sup> The Budget Act outlines

<sup>41</sup> *Ustav Republike Hrvatske*, Official Gazette no 56/1990, 135/1997, 113/2000, 28/2001, 76/2010, 5/2014, which came into force on 22 December 1990 (the Constitution). The Constitution generally regulates the order and separation of competences amongst individual government institutions (for example, the competences and duties of the president of the Republic of Croatia, the Government of the Republic of Croatia, the judiciary, etc). Constitution, arts 71-121.

<sup>42</sup> *Zakon o upravnim sporovima*, Official Gazette no 20/2010, 143/2012, 152/2014, 94/2016, 29/2017, which came into force on 12 February 2010 (the ADA). See ADA, art 2; and *Zakon o općem upravnom postupku*, Official Gazette no 47/2009, which came into force on 4 June 2009 (GAPA), art 2.

<sup>43</sup> GAPA, art 1.

<sup>44</sup> In Croatian: *jedinice lokalne i područne (regionalne) samouprave* (basic local public entities).

<sup>45</sup> *Zakon o lokalnoj i područnoj (regionalnoj) samoupravi*, Official Gazette no 33/2001, 60/2001, 129/2005, 109/2007, 125/2008, 36/2009, 36/2009, 150/2011, 144/2012, 19/2013, 137/2015, 123/2017, 98/2019, which came into force on 11 April 2001 (the LRA) art 3.

<sup>46</sup> *Zakon o ustanovama*, Official Gazette no 76/1993, 29/1997, 47/1999, 35/2008, 127/2019, which came into force on 16 August 1993 (the Institutions Act). Article 72 explicitly provides that bankruptcy proceedings of institutions can be conducted in accordance with the Bankruptcy Act.

<sup>47</sup> *Zakon o udrugama*, Official Gazette no 74/2014, 70/2017, 8/2019, which came into force on 18 June 2020 (the Associations Act). See Association Act, art 36, para 3, which explicitly provides that bankruptcy proceedings can be conducted over an association.

<sup>48</sup> *Zakon o zakladama*, Official Gazette no 106/2018, 98/2019, which came into force on 30 November 2018 (the Foundations Act). Foundations Act, art 36, para 3 explicitly provides that bankruptcy proceedings can be conducted over foundations.

<sup>49</sup> *Zakon financiranju jedinica lokalne i područne (regionalne) samouprave*, Official Gazette no 127/2017, which came into force on 2 January 2018 (AFLRU).

<sup>50</sup> *Zakon u proračunu*, Official Gazette no 87/2008, 136/2012, 15/2015, which came into force on 25 July 2008 (the Budget Act), arts 109-113.

<sup>51</sup> AFLRU, art 13.

specific financial and accounting processes in the form of semi-annual and annual reports, which must be submitted on a regular basis to the Ministry of Finance.<sup>52</sup> The annual report on the execution of the budget of basic local public entities is to be submitted to the Ministry of Finance and the State Audit Office.<sup>53</sup> If a basic local public entity does not submit the mentioned report within the time limit and in the manner prescribed by the law, it will be suspended from the remittance of assistance and from equalisation assistance from the state budget.<sup>54</sup> This also carries misdemeanour and criminal liability implications for the managers of local public entities.<sup>55</sup>

Local units operate to meet the needs of the citizens in their jurisdiction. Basic services provided include housing; urban planning; communal services; childcare; social care; primary healthcare; primary education; culture, physical culture and sports; technical culture; consumer protection; the protection and enhancement of the natural environment; firefighting; and civil defence.<sup>56</sup>

Regional units conduct activities of regional significance, particularly those related to education, health, urban planning, economic development, traffic and infrastructure, as well as the planning and development of a network of educational, health, social and cultural institutions.<sup>57</sup>

Whilst the Administrative Disputes Act and GAPA regulate basic local public entities,<sup>58</sup> hybrid local public entities are not defined by the law. The representative bodies of basic local public entities (municipal councils, city councils, or the county assembly) may establish legal entities for the performance of their economic, social, communal, and any other activity and duty attributed to them by the law.<sup>59</sup> The decision on how to perform these functions is left to the basic local public entity. Furthermore, the executive bodies of the basic local public entities (such as mayors or prefects) have the power to appoint and dismiss the management team of the controlled hybrid local public entities.<sup>60</sup> These powers extend to the appointment of a steering committee or any other collegial body in the hybrid local public entity.<sup>61</sup>

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<sup>52</sup> Budget Act, arts 108-112.

<sup>53</sup> *Idem*, art 112.

<sup>54</sup> *Idem*, art 113.

<sup>55</sup> *Idem*, art 124.

<sup>56</sup> Constitution, art 129(a). See also LRA, art 19.

<sup>57</sup> Constitution, art 129(a). See also LRA, art 20.

<sup>58</sup> Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132, OJ L 172, 26.6.2019.

<sup>59</sup> LRA, art 35.

<sup>60</sup> *Idem*, art 48.

<sup>61</sup> *Idem*, art 35. The special laws which regulate the individual activities can also provide additional defining elements of the legal entity funded by the LR units (for example, in health, water supply, communal services, etc). See, for example, the requirements for the provision of communal services which are in the jurisdiction of the local units in the *Zakon o komunalnom gospodarstvu* no 68/2018, 110/2018, 32/2020, which came into force on 4 August 2018 (the Act on the Communal Economy).

Local public entities can participate in the formation of private companies and buy shares in privately-owned companies on the market in the form of associations (such as a company, association, and / or a public institution) for the accomplishment of their common goals and missions and for the performance of economic, social, communal, and other activities of interest.<sup>62</sup>

Depending on the chosen legal framework, some entities may be liable for the debt of other hybrid local public entities. For example, if two basic local public entities establish a hybrid local public entity as a public institution according to the Institutions Act, they are fully and jointly liable for its obligations.<sup>63</sup> If two companies founded and / or owned by basic local public entities establish a new company (such as a limited liability company), then, according to the rules of the Companies Act,<sup>64</sup> the local public entities are not liable for the obligations of such a company if they did not provide any special warranty.<sup>65</sup>

Under the Bankruptcy Act, hybrid local public entities are free to use remedies provided for general companies, including filing for protection from their creditors in insolvency. However, such steps are usually taken in consultation with the basic local public entity since the representatives of the basic local public entity are members of the hybrid local public entity's board.<sup>66</sup>

Basic local public entities are usually funded through taxation, direct transfers from the state, and from revenues and fees arising from the activities and services that they provide.<sup>67</sup> Hybrid local public entities are mainly funded through charges for the services that they provide. Both basic and hybrid local public entities may take loans and subscribe to financial instruments on the market in accordance with their annual budget.<sup>68</sup>

Local public entities' tax rates are prescribed by special laws, and there is no upper limit to them. Some municipalities, cities, and counties are entitled to fiscal equalisation funds from the state.<sup>69</sup> Furthermore, the Government may introduce restrictive measures on the borrowing of local and regional self-government units and extra-budgetary users (such as

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<sup>62</sup> LRA, art 35, para 5.

<sup>63</sup> Institutions Act, art 59.

<sup>64</sup> *Zakon o trgovačkim društvima*, Official Gazette no 111/1993, 34/1999, 121/1999, 52/2000, 118/2003, 107/2007, 146/2008, 137/2009, 125/2011, 152/2011, 111/2012, 68/2013, 110/2015, 40/2019, which came into force on 1 January 1995 (the Companies Act). See Companies Act, art 10.

<sup>65</sup> *Ibid.*

<sup>66</sup> LRA, art 48, para 6.

<sup>67</sup> Local public entities are also financed by the joint revenues of the state, municipality, and city from contracted annual fees for concessions (for pumping mineral, geothermal and natural spring waters to capture water for the public water supply). See AFLRU, art 3, para 5.

<sup>68</sup> Budget Act, art 75, para 1.

<sup>69</sup> AFLRU, art 8.

the Croatian Institute for Pension Insurance or the Croatian Institute for Health Insurance) specified in the law for a period of up to a year.<sup>70</sup>

Basic local public entities can guarantee loans and financial instruments of hybrid local public entities, but the amount that their guarantees may total is limited. The overall liabilities of basic local public entities cannot exceed 20% of the annual profits in the year prior to the year of the assumption of the debt. The legal entity under majority ownership or co-ownership of basic local public entities and hybrid local public entities can only assume long-term debt for investments approved by a majority owner or founder.<sup>71</sup>

There is no active debt resolution mechanism from the state or other public authorities over LR units. State oversight is provided by the State Audit Office Act,<sup>72</sup> according to which the State Audit Office controls the expenditure of public funds carried out by basic and hybrid local public entities.<sup>73</sup> According to the Budget Act, the Ministry of Finance oversees the usage of the budget of local public entities.<sup>74</sup> Other private entities are neither subject to control from the State Audit Office nor oversight from the Ministry of Finance. Furthermore, other companies (private and public) and public institutions funded and / or owned by LR entities can be subject to different types of audit on the basis of their size and their significance to the national economy, in accordance with the Audit Act and special, applicable acts.<sup>75</sup>

Regional units can guarantee loans taken on by local entities in their jurisdiction with the prior consent of the Government. A basic local public entity can provide guarantees to controlled entities and to the institutions that provide public services under their control. The local public entity must obtain the consent of the Minister of Finance prior to issuing a guarantee. A guarantee agreement is concluded by the municipal or city mayor or the prefect of the county on behalf of the LR unit.<sup>76</sup>

Local public entities are allowed to invest when they are in a situation of financial distress because there is no explicit provision to prohibit them from doing so.

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<sup>70</sup> Budget Act, art 75, para 3. For more details, see the provisions of *Zakon o izvršavanju Državnog proračuna Republike Hrvatske za 2020. godinu*, Official Gazette no 118/2016, which came into force on 2 December 2019.

<sup>71</sup> Budget Act, arts 88 and 90.

<sup>72</sup> *Zakon o Državnom uredu za reviziju*, Official Gazette no 25/2019, which came into force on 21 March 2019 (the State Audit Office Act or SAOA).

<sup>73</sup> *Idem*, art 9.

<sup>74</sup> Budget Act, arts 1, 115 and 116.

<sup>75</sup> *Zakon o reviziji*, Official Gazette no 127/2017, which came into force on 1 January 2018 (the Audit Act).

<sup>76</sup> *Idem*, art 91.

### 3. Dealing with local public entities in distress

#### 3.1 The legal framework

The Bankruptcy Act explicitly provides that pre-bankruptcy and bankruptcy proceedings cannot be commenced against basic local public entities – that is, local and regional units such as municipalities, cities, and counties. Hybrid local public entities are subject to the general provisions outlined in the Bankruptcy Act.<sup>77</sup> The reason is for the preservation of state, local and regional organisations. Local public entities secure their own funds for the performance of activities under their competence in accordance with the Act on the Financing of Local and Regional Units.<sup>78</sup> If they cannot be funded through charges for the services that they provide, the Government will allocate additional funds for selected services (such as primary and secondary education, social services, healthcare and firefighting).<sup>79</sup> Further funds can be secured at a local level.<sup>80</sup>

If basic local public entities do not guarantee debt as the funders or owners of hybrid local public entities, these entities may be subject to any type of bankruptcy proceeding (pre-bankruptcy proceedings, bankruptcy proceedings with liquidation, or bankruptcy proceedings with the adoption of a bankruptcy plan).<sup>81</sup> However, such bankruptcy proceedings are rarely opened against hybrid local public entities because the financial difficulties of such entities are usually mitigated by basic local public entities (for example, by issuing guarantees, contractual subventions and capital support). Hybrid local public entities may be rescued by increasing the price of the services provided by such entities, securing additional funds from the budget of basic local public entities, and / or increasing local and regional taxes and contributions.

As mentioned above, basic local public entities are generally not liable for the obligations of hybrid local public entities established as companies and do not own their debts.<sup>82</sup> This rule does not apply to public institutions funded by basic local public entities. For these institutions, the Institutions Act<sup>83</sup> provides that the controlling local public entity has unlimited and joint liability for their obligations.<sup>84</sup>

Furthermore, a special rehabilitation procedure may be carried out on such public institutions established or owned by local public entities in order to preserve the continuity

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<sup>77</sup> Bankruptcy Act, arts 3, para 2; and 7.

<sup>78</sup> AFLRU, art 2

<sup>79</sup> *Idem*, art 10, para 1.

<sup>80</sup> *Ibid.* See the Constitution, art 31, para 3. The Constitution provides that the Republic of Croatia must assist financially weaker local units. So, in cases of particular financial distress, an area can be placed under special state protection in order to provide financial support to the local unit from the state.

<sup>81</sup> Bankruptcy Act, arts 21, 75 and 303.

<sup>82</sup> Companies Act, art 10.

<sup>83</sup> Institutions Act, art 59.

<sup>84</sup> *Idem*, art 59.

of the public service introduced by the Rehabilitation of Public Institutions Act.<sup>85</sup> This procedure cannot be applied to hybrid local public entities that are established as companies under the Companies Act. Rehabilitation can be conducted for a public institution controlled by a basic local public entity that cannot cover its losses or meet its monetary obligations in a timely manner.<sup>86</sup> In these circumstances, the representative body of the basic local public entity will ask the Croatian Government to assist in the institution's rehabilitation. The Ministry charged with dealing with public institution matters assesses whether the decision of the representative body of the basic local public entity is justified or not. If it is, the Government carries forward the rehabilitation; otherwise, the request is rejected.<sup>87</sup>

The legal consequence of the initiation of a rehabilitation process for a public institution controlled by a basic local public entity is the displacement of its management for a period of up to two years. The management will be replaced by a rehabilitation manager and council with specified rights, obligations and authority as granted by the law.<sup>88</sup> A rehabilitation manager and council are appointed by the Government upon the motion of the ministry competent for the public institution.<sup>89</sup>

A rehabilitation council needs to prepare a rescue programme for the public institution to be rehabilitated. This plan often entails the reorganisation and rationalisation of the business operations of the relevant public institution. A rehabilitation manager, rehabilitation council and the Ministry implement the rehabilitation programme for a period of up to 12 months following its adoption.<sup>90</sup>

The decision on the rehabilitation of a public institution is made by the Government upon the motion of the ministry competent for the public institution funded by the LR unit and other funders. A rehabilitation manager and a rehabilitation council will continue to manage a public institution for two years after a decision is made regarding the rehabilitation proceedings.<sup>91</sup>

Croatian law does not promote aggregations between different local public entities if one of them faces financial difficulties. Such aggregations can only be implemented on a voluntary basis. Nevertheless, it is possible, in practice, for higher-ranking authorities, by changing the law, to impose a change of the boundaries in basic local public entities in such a way as to dissolve the financial distress of a basic local public entity.<sup>92</sup>

<sup>85</sup> *Zakon o sanaciji javnih ustanova*, Official Gazette no 136/2012, 151/2014, 27/2016, 73/2019, which came into force on 7 December 2012 (the Rehabilitation of Public Institutions Act or RPIA).

<sup>86</sup> *Idem*, art 2.

<sup>87</sup> *Idem*, art 5.

<sup>88</sup> *Idem*, art 4.

<sup>89</sup> *Idem*, art 9.

<sup>90</sup> *Idem*, art 7.

<sup>91</sup> *Idem*, art 9.

<sup>92</sup> *Zakon o lokalnoj i područnoj (regionalnoj) samoupravi*, Official Gazette no 33/01, 60/2001, 129/2005, 109/2007, 125/2008, 36/2009, 36/2009, 150/2011, 144/2012, 19/2013, 137/2015, 123/2017, 98/2019, 144/2020, which came into force on 11 April 2010 (the LR Act), art 7; and the *Zakon o područjima*

The mentioned procedure is set out in the LR Act and the Act on the Territories of Counties, Cities and Municipalities in the Republic of Croatia.<sup>93</sup> This procedure was initially designed to effect organisational changes to the boundaries of basic local public entities. However, it may be used as a debt resolution mechanism to aid basic local public entities in distress. The decision to change the boundaries of basic local public entities must be made by representative bodies of the involved parties at the proposal of the Government. This must take place after obtaining the opinion of citizens who live in the area in which the relevant basic local public entity operates.<sup>94</sup>

Based on a representative body's decision, the prime minister will conclude an agreement in which the boundaries are described in writing. The inclusion of the relevant cartography is a mandatory part of the agreement. The signed agreement will be submitted to the central state administration body responsible for local self-government affairs, the State Geodetic Administration, and the Central Bureau of Statistics.

### 3.2 Parties

There is no special procedure for approving, examining and confirming the restructuring plan or other bankruptcy proceedings involving hybrid local public entities in distress.

As in any other bankruptcy proceedings, a commercial court will examine and establish any claims lodged by creditors. Commercial courts have the authority to confirm, approve, or examine the plans and other procedures involving entities funded or owned by local public entities. The role of the court is the same as in "general" formal bankruptcy procedures.<sup>95</sup> The first-instance proceedings in pre-bankruptcy and bankruptcy proceedings are conducted by a single judge.<sup>96</sup> The appellate court in pre-bankruptcy and bankruptcy proceedings (the High Commercial Court) decides on appeals in a panel consisting of three judges.<sup>97</sup>

A bankruptcy plan is considered approved if a majority of each group of creditors approve it, and if the sum of all the claims of the creditors who voted in favour of the bankruptcy plan is twice as large as the claims of the creditors who voted against it.<sup>98</sup> After the

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*županija, gradova i općina u Republici Hrvatskoj*, Official Gazette no 86/2006, which came into force on 28 July 2005 (the Act on the Territories of Counties, Cities and Municipalities in the Republic of Croatia). See Act on the Territories of Counties, Cities and Municipalities in the Republic of Croatia, arts 26 and 27.

<sup>93</sup> *Idem*, arts 26 and 27.

<sup>94</sup> *Ibid.*

<sup>95</sup> Bankruptcy Act, arts 333-334 provide that a commercial court can reject a bankruptcy plan if the rules on the right of submission and the content of the bankruptcy plan are violated, or if such a flaw cannot be removed or is not removed by an initiating party within the appropriate deadline determined by the court. If a bankruptcy plan is not rejected, a court will invite a board of creditors to make a declaration on the plan. A court will schedule a hearing at which a bankruptcy plan will be discussed and voted upon. For more on the role of the commercial courts in bankruptcy proceedings, see Bankruptcy Act, art 75.

<sup>96</sup> *Idem*, art 8, para 3.

<sup>97</sup> *Idem*, art 8, para 4.

<sup>98</sup> *Idem*, art 333.



bankruptcy plan is approved by a debtor and its creditors, a court will decide whether to confirm the bankruptcy plan.<sup>99</sup>

Similar to bankruptcy procedures, a commercial court, bankruptcy administrator and creditors are all independent of each other and possess specific duties outlined by the law. Administrative authorities of local public entities only have an indirect influence on proceedings involving hybrid local public entities. They can give directions to a debtor's management and a bankruptcy administrator, but their role is not explicitly provided for and there is no explicit obligation of a debtor or the bankruptcy administrator to follow their instructions.

The members of executive bodies (such as directors) of the hybrid local public entities retain their legal representative status until the initiation of the bankruptcy proceedings. Similarly to when general corporate bankruptcy proceedings are utilised, they must submit a proposal for the initiation of bankruptcy proceedings within 21 days from the occurrence of the grounds for bankruptcy.<sup>100</sup>

In pre-bankruptcy proceedings, management will be replaced by a pre-bankruptcy trustee, whilst in bankruptcy proceedings, management will be replaced by a bankruptcy administrator.

A pre-bankruptcy trustee and bankruptcy administrator of a debtor that is a local public entity are also subject to the same rules that are applicable in corporate procedures with regard to qualifications, the calculation of fees, and their duties and obligations. They have the right to receive remuneration for their work and compensation for the costs incurred in performing a procedure. A court determines the remuneration for a bankruptcy administrator through the Decree on the criteria and manner of the calculation and payment of remuneration to bankruptcy administrators.<sup>101</sup>

Their fees are liquidated by courts based upon detailed reports from pre-bankruptcy trustees and bankruptcy administrators themselves.<sup>102</sup> Pre-bankruptcy trustees have the right to a fee between HRK 3,000 and HRK 20,000.<sup>103</sup> The maximum remuneration for bankruptcy administrators is HRK 795,000.<sup>104</sup> If there are insufficient funds for the remuneration and compensation of costs of a bankruptcy administrator, it will be paid from the Fund for the Compensation of Costs of Bankruptcy Proceedings.<sup>105</sup>

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<sup>99</sup> *Idem*, art 334.

<sup>100</sup> *Idem*, art 100.

<sup>101</sup> *Uredba o kriterijima i načinu obračuna i plaćanja nagrade stečajnim upraviteljima*, Official Gazette no 105/2015, which came into force on 10 October 2015 (the Decree).

<sup>102</sup> Bankruptcy Act, art 94.

<sup>103</sup> Decree, art 3, para 1.

<sup>104</sup> *Idem*, art 7.

<sup>105</sup> Bankruptcy Act, art 94.

A dispute in bankruptcy proceedings (such as a dispute over disputed claims) may be resolved by mediators or arbitrators.<sup>106</sup> Unless the parties involved in mediation have agreed otherwise, each party bears its own costs, and the parties bear the costs of the mediation in equal parts.<sup>107</sup> If requested to do so, an arbitral tribunal will determine which party and to what extent it will reimburse the other party for the costs of conducting the proceedings. The reimbursement will include amounts for representation and fees of the arbitrators. The reimbursing party will also bear its own costs.<sup>108</sup> The costs that a debtor bears for fees to mediators and arbitrators are treated as costs of the bankrupt estate and are paid before other creditors receive any payment.<sup>109</sup>

If parties have agreed to mediation and expressly undertake not to initiate or continue legal, arbitral, or other proceedings during a specified period or until a specified condition is met, such an agreement will be binding.<sup>110</sup> The award of the arbitral tribunal will have the force of a final judgment against the parties unless the parties have expressly agreed that the award may be challenged before a higher arbitral tribunal.<sup>111</sup>

The involvement of previous company directors is not directly prescribed or banned. Consequently, they can participate in the insolvency proceedings of local public entities as consultants, but they are not considered officers of the court. For instance, this is possible when a court appoints non-creditors to a creditors' committee in order to protect the interests of creditors in bankruptcy proceedings if those members can contribute to the work of that committee.<sup>112</sup> Such members are entitled to a reward for their work. The reward is calculated by paying up to a maximum amount of the average daily salary of the Republic of Croatia for each day worked. An exceptional reward for such members of a creditors' committee may be determined by the scope and complexity of the business entrusted to them.<sup>113</sup>

Affected parties are involved in the negotiation of a rescue or restructuring plan in accordance with the rules of the Bankruptcy Act that are applicable to any other private entity. In pre-bankruptcy proceedings affected parties are debtors, pre-bankruptcy

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<sup>106</sup> *Idem*, arts 262 and 269. If a bankruptcy administrator has disputed a claim from a bankruptcy creditor or if a bankruptcy creditor has disputed a claim recognised by a bankruptcy trustee, then the creditor of the disputed claim, the creditor who disputed the recognised claim, or the bankruptcy trustee with the consent of the creditors' committee may propose a mediation procedure in accordance with the provisions of the Mediation Act. See *Zakon o medijaciji*, Official Gazette 18/11, which came into force on 28 January 2011 (the Mediation Act).

<sup>107</sup> *Idem*, art 20.

<sup>108</sup> *Zakon o arbitraži*, Official Gazette 88/01, which came into force on 28 September 2001 (the Arbitration Act). See Arbitration Act, art 35; and, for instance, the arbitral award in case St-95/2019 of 24 June 2021, available [here](#).

<sup>109</sup> Arbitration Act, arts 154-155.

<sup>110</sup> Mediation Act, art 18. In that case, the court, arbitrators, or other bodies with whom the proceedings are instituted on the same subject matter of the dispute shall reject, at the request of the other party, the act initiating or continuing the proceedings.

<sup>111</sup> Arbitration Act, art 31.

<sup>112</sup> *Idem*, art 96.

<sup>113</sup> *Idem*, art 102.

trustees (equivalent to a bankruptcy administrator in bankruptcy proceedings), and various groups of creditors. The pre-bankruptcy proceedings are conducted before a competent commercial court with the assistance of the Financial Agency.<sup>114</sup>

Affected parties in bankruptcy proceedings are debtors, bankruptcy administrators and various groups of creditors (bankruptcy creditors, creditors with a separate satisfaction right, creditors with the right of exemptions, and creditors of a bankruptcy estate). A bankruptcy plan can be submitted by a bankruptcy debtor or bankruptcy administrator.<sup>115</sup> Creditors cannot submit alternative proposals. They can instruct a bankruptcy administrator to develop a bankruptcy plan and, at this stage, only play an advisory role.

In order to protect the interest of creditors in bankruptcy proceedings, a commercial court can establish a creditors' committee and appoint its members. Alternatively, creditors may decide to appoint a creditors' committee to supervise a bankruptcy administrator and assist him in conducting the proceedings, monitoring the process, and inspecting the books and reports.<sup>116</sup> A committee may have a mandatory, controlling or consultative function.<sup>117</sup> A committee advises on the drafting of a bankruptcy plan,<sup>118</sup> gives comments on that plan,<sup>119</sup> and supervises its implementation.<sup>120</sup>

Under the Bankruptcy Act, an insolvent estate cannot include goods belonging to the Republic of Croatia, the Croatian Health Insurance Fund, or the Croatian Pension Insurance Institute. Additionally, it cannot include funds allocated from the state budget or by local and self-government units.<sup>121</sup> Furthermore, bankruptcy proceedings cannot be commenced against entities whose main activity is the production of weapons or the provision of services to the military without the prior consent of the Minister of Defence.<sup>122</sup>

Pre-bankruptcy proceedings cannot be initiated against a financial institution, credit union, investment company, institution for payments, or an institution for electronic money.<sup>123</sup> Where bankruptcy proceedings are not available, the shareholders and funders of an entity are jointly liable for its obligations, except for instances where the entity benefits from limited liability.<sup>124</sup>

The treatment of hybrid local public entities in distress depends on the political will to preserve them. If there is no political will to preserve a hybrid local public entity, it will be

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<sup>114</sup> *Idem*, art 2.

<sup>115</sup> *Idem*, art 304.

<sup>116</sup> *Idem*, art 96.

<sup>117</sup> Ž Šimić, "Tijela stečajnog postupka", (Pravosudna akademija, Zagreb, 2016) at 38 available [here](#).

<sup>118</sup> Bankruptcy Act, art 304, para 2.

<sup>119</sup> *Idem*, art 318.

<sup>120</sup> *Ibid*.

<sup>121</sup> *Idem*, art 347.

<sup>122</sup> *Idem*, art 3, para 3.

<sup>123</sup> *Idem*, art 3, para 6.

<sup>124</sup> *Idem*, art 3, para 5.

liquidated under the provisions of the Bankruptcy Act in the same way as any other private entity.

### 3.3 Technical rules / procedure

An automatic stay of enforcement actions does not apply to basic local public entities in distress as they cannot be subject to bankruptcy proceedings. However, a local public entity's bank accounts may be closed and its creditors paid according to the general order of distribution of assets following liquidation.

For hybrid local public entities (such as companies or public institutions) that may be subject to pre-bankruptcy or bankruptcy proceedings, the rules on the automatic stay of enforcement proceedings under the Bankruptcy Act will apply. Under these rules, it is prohibited to initiate litigation, enforcement, administrative proceedings, or proceedings against a debtor that are related to claims that arose prior to the opening of the proceedings, whilst all ongoing proceedings are suspended.<sup>125</sup>

However, this does not frequently happen in practice. In order to preserve the continuity of public services, hybrid local public entities may receive additional funding from basic local public entities or increase the fees for their services. For some LR units, special laws provide that their property is exempted from bankruptcy (such as telecommunication lines, plumbing pipes, etcetera).<sup>126</sup>

Courts have the ability to investigate the causes of financial distress only after the pre-bankruptcy proceeding is voluntarily proposed.<sup>127</sup> Thereafter, a court is obliged to decide on the proposal for opening pre-bankruptcy proceedings within eight days from the day the complete proposal is submitted. In this regard, a court may order an amendment to the proposal if it is incomplete, reject the proposal, or, if the court finds that the eligibility requirements have been met, issue a decision to commence a different procedure.<sup>128</sup>

Bankruptcy proceedings are not voluntary. Based on a proposal to open bankruptcy proceedings, a court will issue a decision on initiating preliminary proceedings or may initiate bankruptcy without initiating preliminary proceedings. The latter rarely occurs in practice.<sup>129</sup>

Preliminary proceedings are conducted in order to determine whether a debtor is eligible for bankruptcy proceedings, and a temporary bankruptcy trustee may be appointed.<sup>130</sup> If a court finds that financial distress is attributable to the behaviour of certain directors or political interference, the offending directors face the same consequences as those of

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<sup>125</sup> *Idem*, arts 68, 169 and 170.

<sup>126</sup> *Idem*, art 61.

<sup>127</sup> *Idem*, art 33.

<sup>128</sup> *Ibid.*

<sup>129</sup> *Idem*, art 116.

<sup>130</sup> *Idem*, art 119.

private companies.<sup>131</sup> The extent to which political authorities can be held accountable for the failure of the local public entity is not limited by the law.

Creditors in bankruptcy proceedings are divided into classes: bankruptcy creditors (who are assigned a higher- or lower-priority ranking), creditors with the right of exemption, creditors with a separate satisfaction right, and creditors of a bankrupt estate.<sup>132</sup>

Creditors with a right of exemption are those who can prove that a certain item does not fall into the bankrupt estate based on their proprietary or personal claims against it. They have the right to request the exclusion of such items from the bankrupt estate and the enforcement of their rights outside the bankruptcy proceedings.<sup>133</sup>

Creditors with a separate satisfaction right are creditors to whom the bankruptcy debtor is personally liable. These may be creditors whose claims are secured, for example, by mortgages. They have a right to proportional compensation from a bankrupt estate only if they waive their right to separate compensation or if they are unable to enforce their claim separately.<sup>134</sup>

Creditors of a bankrupt estate are creditors with claims related to bankruptcy proceedings (judicial and attorney costs) and other obligations of a bankruptcy estate. The obligations of a bankrupt estate will be compensated by a bankruptcy administrator in the order of their accrual.<sup>135</sup>

The categorisation of the participants in a bankruptcy plan is somewhat different. Creditors with different legal positions are admitted to separate classes. Creditors with a right to separate compensation are treated differently depending on whether a bankruptcy plan also affects their rights. Employees are always grouped in a separate class.<sup>136</sup>

A bankruptcy plan cannot affect the rights of creditors with a separate satisfaction right to compensation from items that are subject to separate compensation, unless those creditors that accepted a bankruptcy plan provide otherwise.<sup>137</sup> If a bankruptcy plan does not provide otherwise, a creditors' approval terminates any claims against a debtor arising before the commencement of a procedure.<sup>138</sup> All the participants of a specific group must be treated equally under a bankruptcy plan.<sup>139</sup>

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<sup>131</sup> *Idem*, art 110, para 2.

<sup>132</sup> *Idem*, arts 137, 147, and 153-154.

<sup>133</sup> *Idem*, art 147.

<sup>134</sup> *Idem*, art 153.

<sup>135</sup> *Idem*, art 154.

<sup>136</sup> *Idem*, art 308.

<sup>137</sup> *Idem*, art 309.

<sup>138</sup> *Idem*, art 311.

<sup>139</sup> *Idem*, art 312.

Nobody can exclude or limit the voting rights of creditors or shift them to a lower priority class. It is possible for a court to void a creditors' vote if it appears that the creditors acted against the interests of creditors collectively. If a creditor wishes to reduce his voting rights, then such creditor should waive part of his claim against a debtor, but it is hard to imagine such a situation in practice. Generally, neither a bankruptcy court nor a creditors committee has the authority to exclude or reduce the voting rights of a creditor.

Under the Croatian bankruptcy regime some creditors, such as employees, are granted preferential treatment over other bankruptcy creditors. However, there are no specific provisions regarding environmental claims arising out of a debtor's insolvency.<sup>140</sup> Despite this, the Environment Protection Act prescribes that costs of repair of environmental damage on a site held by a bankrupt company can, under certain conditions, be treated as expenses of the bankrupt estate.<sup>141</sup>

Pursuant to the Bankruptcy Act, in pre-bankruptcy proceedings, a hybrid local public entity may be authorised to take on new loans with the consent of two-thirds of the creditors admitted to a procedure. These funds should be used for temporary financing to ensure business continuity during pre-bankruptcy proceedings.<sup>142</sup> In bankruptcy proceedings, hybrid local public entities can provide guarantees or other security if this is necessary for the fulfilment of their obligations. Furthermore, in bankruptcy proceedings, basic local public entities or the state may act as co-debtor.<sup>143</sup>

Bankruptcy proceedings do not impact pensions because the pension system is guaranteed by the state with ring-fenced funds.

The debt of a local public entity in distress does not ultimately become the final responsibility of higher-ranking entities, such as local or national governments unless they voluntarily assume those debts. Basic local public entities are not liable for the obligations of hybrid local public entities and do not own their debts.<sup>144</sup> The only exception to this rule applies to public institutions funded by basic local public entities, for which the Institutions Act provides that the funders of the public institutions have unlimited joint and several liability for their obligations or rehabilitation or changing of their boundaries.<sup>145</sup>

Pre-bankruptcy proceedings must be completed within 300 days from the opening of the procedure. A court may authorise an extension for up to 60 days if it deems it expedient to conclude a pre-bankruptcy agreement.<sup>146</sup>

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<sup>140</sup> *Idem*, art 308, para 3.

<sup>141</sup> *Zakon o zaštiti okoliša*, Official Gazette 80/13, 153/13, 78/15, 12/18, 118/18, which came into force on 28 June 2013 (the Environmental Protection Act), art 198 para 5.

<sup>142</sup> *Idem*, art 62(a), para 1.

<sup>143</sup> *Idem*, art 124.

<sup>144</sup> In this respect, see, for example, the Companies Act, art 10.

<sup>145</sup> Institutions Act, art 59; LR Act, art 7; and the Act on the Territories of Counties, Cities and Municipalities in the Republic of Croatia, arts 26 and 27.

<sup>146</sup> Bankruptcy Act, art 283, para 5.

The rehabilitation of public institutions funded or owned by basic local public entities has to finish within two years of their commencement.<sup>147</sup> A rehabilitation manager and rehabilitation council will continue to manage a public institution for two years after a decision on its rehabilitation proceedings.<sup>148</sup>

#### 4. Law in practice

There is no case law on pre-bankruptcy or bankruptcy proceedings for basic local public entities, as this would be contrary to the mandatory norms of the Bankruptcy Act. However, the bank accounts of basic and hybrid local public entities can be blocked, and their bank accounts can be attached.<sup>149</sup> Enforcement action may not be taken against entities that deal with facilities, weapons and equipment intended for defence; and equipment and facilities intended for the work of local and regional self-government units.<sup>150</sup>

For example, the City of Slavonski Brod and the City of Opatija, amongst others, have experienced serious financial difficulties.<sup>151</sup> Media attention subsided after a while, and the cities still operate as autonomous local public entities, but it is not known how the financial losses were addressed, as the manner in which they were addressed has not been made known to the public.

Hybrid local public entities have been subjected to bankruptcy proceedings. Bankruptcy proceedings for corporations and public institutions controlled by basic local public entities are rare, but they have occurred in the past. Bankruptcy proceedings in Croatia have a long duration, and one such example is the bankruptcy proceedings for Komunalna Infrastruktura d.o.o., which provides communal services and is owned by the City of Velika Gorica. The bankruptcy proceedings commenced in 2000, and they have not yet been concluded to date.

A closer analysis of the procedures involving hybrid local public entities shows that, once proceedings are initiated, there are not many differences to bankruptcy proceedings involving private companies. The main differences occur before the opening of a procedure. This is largely the case as proceedings can only be commenced by a political decision made by a representative and executive bodies of the basic local public entities. This means that a decision on initiating a bankruptcy proceeding depends on the political will of a basic local public entity. If a funder / owner provides financial support, there will be no grounds for bankruptcy, and bankruptcy proceedings will not be initiated. If a basic

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<sup>147</sup> *Idem*, art 4.

<sup>148</sup> *Idem*, art 9.

<sup>149</sup> *Zakon o provedbi ovrhe na novčanim sredstvima*, Official Gazette no 68/18, 02/20, 46/20, 47/20, which came into force on 18 September 2018, art 13.

<sup>150</sup> *Ovršni zakon*, Official Gazette no 112/12, 25/13, 93/14, 55/16, 73/17, 131/20, which was implemented on 15 October 2012 (the Enforcement Act) art 4, para 6.

<sup>151</sup> This was reported on by the daily newspapers. See, for example <https://www.rtl.hr/vijesti-hr/novosti/8496/osijek-i-slavonski-brod-pred-bankrotom/> and <https://www.nezavisne.com/novosti/ex-yu/Opatija-pred-bankrotom/131680>.

local public entity does not provide financial support, then bankruptcy proceedings can be initiated and conducted like any other bankruptcy proceeding involving a private company.

It is worth noting here that numerous public institutions that were funded and / or are owned by basic local public entities have been subject to rehabilitation proceedings. The proceedings have mostly been initiated in relation to hospitals and other healthcare institutions. For example, in 2012 the County Hospital in Vinkovci suffered losses, and the County Assembly of the Vukovar-Srijem County adopted a decision on the initiation of rehabilitation proceedings for the County General Hospital in Vinkovci. The Croatian Government terminated the rehabilitation procedure in 2016 due to the lack of any significant improvement in the financial situation of the hospital. In fact, the overall debt of the Vinkovci hospital increased from HRK 53,58 million to HRK 68,98 million during the procedure despite the Croatian Government investing HRK 62,33 million into the rehabilitation procedure.<sup>152</sup> The termination of the rehabilitation proceedings ended the mandate of the rehabilitation manager, and the management of the hospital was given back to Vukovar-Srijem County, which was its funder.

The decision to suspend the rehabilitation procedure was made following a proposal from the ministry responsible for health, which determined that the rehabilitation had not achieved the expected results and that further implementation of the rehabilitation procedure would not be appropriate.<sup>153</sup> After the suspension of the rehabilitation procedure, according to the last available financial report of the hospital in 2020, it still operates with total losses of HRK 193 million. Despite this, no type of insolvency proceedings has been initiated against the hospital. It is to be assumed that the losses are covered by the revenues of the hospital, the financial support of the Croatian Health Insurance Fund (a quasi-public body that administers the universal health care system in Croatia), the county, and / or the state.<sup>154</sup>

It is indicative of the effectiveness of these provisions that these proceedings are not very successful in practice and that institutions subject to them end up with even more debt. Nobody knows whether and until when the liabilities will be covered by basic local public entities and “swept under the rug”. However, it is evident that there is a need to create a legal framework that will be effective and beneficial in situations of financial distress of basic local public entities, as, currently, there is no legislative framework for counties, cities and municipalities in financial distress

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<sup>152</sup> Data was gathered from the media as there is no official data on this matter. In this regard, see [here](#).

<sup>153</sup> See the Decision on Suspension of the Rehabilitation Procedure of the County General Hospital in Vinkovci, Official Gazette no 33/2016, which was rendered on 6 April 2016, point I.

<sup>154</sup> See the Official Financial Report, which is available [here](#).



## Local public entities in distress - a critical analysis of the English approach

By Eugenio Vaccari\* and Yseult Marique\*\*

### 1. General context of insolvency law

Early common law offered no collective procedure to administer an insolvent's estate. Creditors could seize either the body of a debtor or his effects, but not both. As a result, people would end up in prison if they were unable to pay their debts.<sup>1</sup>

The idea that creditors may act collectively was first recognised with the enactment of the English Bankruptcy Act 1542. Initially, only traders could be declared bankrupt. The possibility of being discharged from one's debts was only introduced in 1705. Before the emergence of the doctrine of separate legal personality and limited liability in the law (that took place in 1855) and by the judiciary (*Salomon v Salomon*),<sup>2</sup> bankruptcy served as a surrogate for limited liability. Another important change in the law was the extension of insolvency remedies to non-traders in 1861.

Deficiencies in the law and the United Kingdom (UK) gaining membership of the European Economic Community (EEC) pushed insolvency reform to the top of the government's agenda. A group of experts, known as the Review Committee on Insolvency Law and Practice, was appointed in 1977. Its final report (Report of the Review Committee on Insolvency Law and Practice), known as the Cork Report (named after its chairman), was published in 1982. Some of its key recommendations were translated into law by the Insolvency Act 1985 and Insolvency Act 1986.

Today, the Insolvency Act 1986 still represents the backbone of the English corporate insolvency framework. With its enactment, the English legislator adopted a unified approach to regulating corporate insolvency rules (at least until recent years). Significant changes to insolvency practice were introduced by, amongst others, the Enterprise Act 2002; the Companies Act 2006; and the Small Business, Enterprise and Employment Act 2015. Insolvency rules were completely overhauled in 2016 in an attempt to reduce red-tape challenges and streamline the insolvency process. Finally, major reforms were introduced by the Corporate Insolvency and Governance Act 2020 and by the Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 (Regulations 2021).

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<sup>1</sup> V Finch and D Milman, *Corporate Insolvency Law. Perspectives and Principles* (3<sup>rd</sup> ed, Cambridge University Press, Cambridge, 2017) at 10.

<sup>2</sup> [1897] AC 22 HL.

## 1.1 Corporate insolvency procedures

Companies in distress can now choose one of the following options to either rescue, restructure, or liquidate their business:

- informal workouts;<sup>3</sup>
- liquidation;
- administration and pre-packaged sales;
- company Voluntary Arrangements;
- Part 26 Schemes of Arrangement; and
- Part 26A Restructuring Plans.

Separate procedures deal with personal debt.<sup>4</sup>

### 1.1.1 Liquidation

Liquidation is a procedure of last resort. It is used to collect, realise and distribute the assets and proceeds of a company to its creditors. Liquidation is still the most used insolvency procedure.<sup>5</sup> Under the current law, companies can be liquidated in one of three ways.<sup>6</sup>

A members' voluntary liquidation (MVL)<sup>7</sup> can be initiated only by a company itself if its directors issue a statutory declaration that the company is solvent. A creditors' voluntary liquidation (CVL)<sup>8</sup> can be triggered only by a company itself whenever it is insolvent and after a resolution of its shareholders (approved by a 75% majority). There is no automatic moratorium, but parties may apply to a court for a stay on enforcement actions. Finally, an involuntary liquidation (IL)<sup>9</sup> may be triggered by creditors, directors, a company's shareholders, and, under certain circumstances, the Department of Trade and Industry

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<sup>3</sup> Not discussed as it falls outside the scope of this study.

<sup>4</sup> Not discussed as it falls outside the scope of this study.

<sup>5</sup> During the second quarter of 2021, there were 3,116 (seasonally adjusted) registered company insolvencies, comprising 2,819 creditors' voluntary liquidations (CVLs), 102 compulsory liquidations, 169 administrations, 25 company voluntary arrangements (CVAs), and one receivership appointment. In this regards, see The Insolvency Service, "Company Insolvency Statistics: April to June 2021" (30 July 2021) available [here](#).

<sup>6</sup> Companies may also be wound up by the Department of Business, Enterprise and Regulatory Reform (BERR) or the Financial Services Authority (FSA) if it will be in the public interest.

<sup>7</sup> Insolvency Act 1986, Part IV, Ch III.

<sup>8</sup> *Idem*, Ch IV.

<sup>9</sup> *Idem*, Ch VI.

(DTI), usually upon proof that the company is unable to pay its debts.<sup>10</sup> Once a winding-up order is made, no action may be started or proceeded with against a company without the permission of a court.

### 1.1.2 Administration

Administration was first introduced by the Insolvency Act 1986 as an alternative to liquidation.<sup>11</sup> It allows an insolvent<sup>12</sup> company, partnership or other entity to conceive a rescue plan whilst trading. During this period, a company is protected by a moratorium against creditor actions.

Any administration has to pursue one of three objectives, which are listed below in order of importance. If the first objective is unreasonable, the second should be sought to be achieved. Actions should only align with the third objective where the first two objectives cannot be adhered to. The objectives are to:<sup>13</sup>

- (a) rescue the company as a going concern;
- (b) achieve a better result for the company's creditors as a whole than would be likely if the company were wound-up; or
- (c) realise the property and distribute the proceeds.

To make an administration order, a court has to be satisfied that a company is, or is likely to become, unable to pay its debts<sup>14</sup> and that an administration order is reasonably likely to achieve a stated purpose of administration. The applicant has to prove on the balance of probabilities test that these thresholds are met.<sup>15</sup>

Following admission to a procedure, a company is usually controlled by an administrator, who will be a licensed insolvency practitioner.<sup>16</sup> Admission may be granted via a court-based procedure (application by a company's creditors to a court) or via an out-of-court route (by a qualifying floating charge holder, a company itself, or a company's creditors).

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<sup>10</sup> *Idem*, s 122 sets out the specific grounds to petition the court.

<sup>11</sup> *Idem*, Sch B1.

<sup>12</sup> The Insolvency Act 1986 uses two definitions of insolvency, namely cash-flow and balance-sheet insolvency. The statutory definition is included in the Insolvency Act 1986, s 123(1) and (2).

<sup>13</sup> *Idem*, Sch B1, s 3(1).

<sup>14</sup> The "inability to pay its debts" is defined by the Insolvency Act 1986, s 123 as both want of liquidity (ie, cash flow insolvency) and balance sheet insolvency. In assessing the latter, the court is required to have regard to prospective and contingent liabilities (*BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2013] UKSC 28).

<sup>15</sup> *Re AA Mutual International Insurance Co Ltd* [2004] EWHC 2430 (Ch).

<sup>16</sup> There are, however, examples of debtor-in-possession administrations, known as "light touch administrations", where the existing management continues to run the company during administration under the supervision of the administrator - see the discussion under "English framework and treatment of local authorities" below.

A *sui generis* form of administration that has continued to gain popularity in recent years<sup>17</sup> is the pre-pack procedure.<sup>18</sup> Pre-packs are arrangements for the sale of a debtor's business that are negotiated with prospective purchasers and agreed upon by the debtor's major creditors prior to the formal commencement of a statutory administration procedure. The sale is completed shortly after an administration order is made. Significant reforms to this procedure have been introduced by the Regulations 2021. These rules restrict an administrator's ability to dispose of a company's assets to a connected party in the first eight weeks of the procedure unless the administrator obtains a company's creditors' approval or a written "qualifying report" from an independent evaluator dictating that the grounds and consideration for the disposal are reasonable.

### 1.1.3 *Company voluntary arrangements*

Company Voluntary Arrangements (CVAs)<sup>19</sup> were first introduced by the Insolvency Act 1986. These are agreements between a registered company (not necessarily insolvent), its shareholders, and its creditors. The agreements - which take the form of a reorganisation plan - usually involve delayed or reduced debt payment or capital restructuring, but cannot modify the rights of secured creditors except with the consent of a creditor concerned.

The use of a CVA does not result in a statutory moratorium being granted automatically. The Corporate Insolvency and Governance Act 2020 introduced the possibility for companies undertaking a restructuring procedure to rely on a short stay, known as a Part A1 moratorium. This stay initially lasts for 20 business days, but it can be extended for up to one year. Whilst CVAs can be used as autonomous procedures, they are frequently complemented by an administration, a winding-up, or a Part 26 scheme of arrangement.

### 1.1.4 *Part 26 schemes of arrangement*

Schemes of arrangements (SoAs)<sup>20</sup> present an alternative to formal insolvency proceedings and are regulated under general company law. Schemes facilitate the entrance of a company into a compromise or arrangement with its creditors (including secured ones).

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<sup>17</sup> J Armour, "The Rise of the 'Pre-Pack': Corporate Restructuring in the UK and Proposals for Reform" in R P Austin, F J G Aoun (eds), *Restructuring Companies in Troubled Times: Director and Creditor Perspectives* (Law Publishing Unit, Sydney, 2012). See also the introductory analysis in T Graham, "Graham Review into Pre-pack Administration" (The Insolvency Service, 2014) available [here](#).

<sup>18</sup> For an analysis, see (amongst others) E Vaccari "English Pre-Packaged Corporate Rescue Procedures: Is there a Case for Propping Industry Self-Regulation and Industry-Led Measures such as the Pre-Pack Pool?", *ICCLR* (2020) 31 (3) at 169.

<sup>19</sup> Insolvency Act 1986, Part I, ss 1-7B; and Insolvency Rules 2016, Part II, rules 2.1-2.45.

<sup>20</sup> Companies Act 2006, Part 26.

Under English law, a company is entitled to enter into a scheme if it is capable of being wound-up in England and Wales. This is possible if a company has a “sufficient connection” with those territories, a concept that courts have construed in a very broad manner.<sup>21</sup>

### 1.1.5 Part 26A restructuring plan

This plan was introduced by the Corporate Insolvency and Governance Act 2020. This procedure was used for the first time in the restructuring of *Virgin Atlantic Airways*, which was sanctioned by the High Court on 2 September 2020.<sup>22</sup> Since then, it has been used in several other high-profile cases.<sup>23</sup>

Drawing extensive inspiration from SoAs, Part 26A restructuring plans (regulated by Part 26A of the Companies Act 2006) are powerful and flexible court-supervised restructuring procedures. They are likely to find favour amongst large companies with limited connection to the UK, but R3 (the Association of Business Recovery Professionals) is currently working on producing a model plan with small and medium sized enterprises in mind. Unlike SoAs, the new Part 26A restructuring plans can be imposed on a dissenting class of creditors (“cross-class cram-down”) if certain conditions are met. Part 26A restructuring plans are only available to companies in financial difficulties that are not yet insolvent.

The introduction of this procedure in the Companies Act 2006 has broken the unitary character of the English corporate insolvency framework.

## 1.2 English framework and treatment of local authorities

The English framework is mainly creditor-friendly. This is largely due to mandatory set-off rights in insolvency, the relevant number of management displacement procedures, as well as the secured creditors’ and financiers’ protections in each of the procedures mentioned above.<sup>24</sup> However, things have gradually changed for a variety of reasons. These reasons include the revival of light-touch administrations, a procedure that allows existing management to run an insolvent company under the supervision of an

<sup>21</sup> In *Re Van Gansewinkel Groep BV* [2015] EWHC 2151 (Ch), the court was required to determine if it had jurisdiction to sanction schemes of arrangement in respect of Dutch and Belgian companies with no establishment in England. It held that a sufficient connection had been shown in that the governing law of all the finance documents was English. Also see *Re Hibu Group Ltd* [2016] EWHC 1921 (Ch).

<sup>22</sup> *Re Virgin Atlantic Airways Ltd* [2020] EWHC 2376 (Ch).

<sup>23</sup> *Re Deep Ocean 1 UK Ltd* [2021] EWHC 138 (Ch); *Re Virgin Active Holdings* [2021] EWHC 1246 (Ch); *Re National Car Parks* [2021] EWHC 1653 (Ch); and *Re Hurricane Energy Plc* [2021] EWHC 1759 (Ch), where the High Court refused to sanction a restructuring plan because the dissenting creditors would not be better off under it than in the alternative corporate liquidation procedure. On the importance of this judgment, see K Stephenson and Z Stemberge, “Sanctioning a restructuring plan: not a port for every storm”, *PLC Mag* (2021) 32(7) at 10.

<sup>24</sup> S Shandro and B Jones, “Bankruptcy jurisdiction in the US and Europe: reconsideration needed!”, *Insolv Int* (2005) 18(9) at 129; and K Akintola, “Pro-commerce outlooks: the bane of English corporate insolvency law?”, *Insolv Int* (2021) 34(1) at 6.

administrator;<sup>25</sup> the introduction of new rescue mechanisms, such as a standalone moratorium<sup>26</sup> and the debtor-in-possession Part 26A restructuring plans; and new restrictions on terminating supply contracts for insolvency-related reasons.<sup>27</sup> All of these factors have lessened the extent of the pro-creditor attitude of the English regime.

These procedures are not available to local authorities, and there is currently no legal framework tailored to the insolvency of a local authority. Local authorities are required by law to balance their budgets and, in theory, can always reduce expenditure and / or raise additional taxes, such as the council tax. Technically, they cannot become insolvent.

In reality, local authorities are not free to increase council tax rates at their will. The Localism Act 2011 (applicable only in England) establishes that local authorities are required to determine if the proposed increase is “excessive”. The Secretary of State sets thresholds of excessiveness, known as “referendum principles”. A local referendum must be held and won for an authority to increase council tax by more than the amount specified in the principles.<sup>28</sup>

However, whilst there is no insolvency procedure available to local authorities, there are a number of measures available to them when they are facing financial difficulties. When all other remedies have proven ineffective, local authorities can resort to a section 114 notice<sup>29</sup> by a local authority’s chief financial officer (CFO). This notice bars all new expenditures, except for those that safeguard vulnerable people and statutory services. Before issuing a section 114 notice, an issuing CFO is likely to have formed the view that future expenditure cannot be brought under control, that the authority is projected to end the financial year with a deficit, and that there is no way of brokering a solution without issuing the section 114 notice. Once this notice is issued, local authorities have a 21-day window in which all new expenditure is barred except for expenses required to deliver statutory responsibilities.

Following the extreme financial difficulties experienced by Croydon Council in 2020, the Housing, Communities and Local Government Committee launched an inquiry on local authority financial sustainability, as well as their restructuring regime.<sup>30</sup> The results of this

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<sup>25</sup> This is possible thanks to the provisions in the Insolvency Act 1986, Sch B1, para 64(1). On this point, see C Shuffrey, “Crisis Management and Insolvency”, *NLJ* (2020) 170 at 15; and E Vaccari, “Corporate Insolvency Reforms in England: Rescuing a “Broken Bench”? A Critical Analysis of Light Touch Administrations and New Restructuring Plans”, *ICCLR* (2020) 31(12) at 645.

<sup>26</sup> Insolvency Act 1986, Part A1. For a comment on the impact on the creditor-friendly attitude of the English corporate framework, see L Doyle, “Part A1 moratorium monitorship: some practical problems and pitfalls”, *Insolv Int* (2020) 33(4) at 107.

<sup>27</sup> Insolvency Act 1986, s 233B. On the risks associated with the introduction of this debtor-friendly mechanism, see F Toubé and J Rumley, “A brave new world? Should the UK ban ipso-facto clauses in non-executory contracts?”, *Insolv Int* (2018) 31(3) 78 at 81.

<sup>28</sup> M Sandford, “Council tax: local referendums” (House of Commons Library, 3 March 2022) available [here](#).

<sup>29</sup> Local Government Finance Act 1988, s 114(3).

<sup>30</sup> Housing, Communities and Local Government Committee, “Local authority financial sustainability and the section 114 regime” (HC 2021-22, 33) available [here](#).

inquiry were published in a report by the same Committee on 19 July 2021.<sup>31</sup> The findings of this report and implications for this study will be discussed later in this chapter. It is likely that the UK government will implement some of the recommendations included in the report, as the financial situation of several local authorities has worsened in recent times.

## 2. Local public entities

### 2.1 Local authorities in England

Elected local authorities across England and Wales were only established in the 19<sup>th</sup> century. They inherited their powers from the justices of the peace and a plethora of *ad hoc* authorities. They were corporate bodies incorporated either by a charter granted under the royal prerogative or by statute.<sup>32</sup>

The incorporation of boroughs has a long history. Early on, local communities petitioned the Crown for charters of incorporation granting rights and privileges, as well as freedom from control by royal officials. A bargain was often struck between the community and the Sovereign, the former making substantial contributions to the royal exchequer in exchange for the charter. The Municipal Corporations Act 1835 introduced fundamental reforms to borough governments (such as elective principles, powers in relation to police, street lighting, local byelaws, and a right to levy a rate). This statute also introduced the roles of mayor, aldermen, and burgesses for each borough.<sup>33</sup>

Incorporation in modern times occurs either by the granting of a charter of incorporation by the Sovereign or in accordance with an act of Parliament. When incorporated under the royal prerogative, boroughs have the same capacity as a natural person.<sup>34</sup> This principle is also contained in section 1(1) of the Localism Act 2011, which provides that a local authority “has [the] power to do anything that individuals generally may do”.

The law relating to local authorities was simplified by the Local Government Act 1933. The Local Government Act 1972, operative from 1 April 1974, reformed local authorities more deeply. Although amended, it still sets out the basic framework of local authorities in England and Wales. Authorities created under the Local Government Act 1972, whether boroughs or not, are statutory corporations.

For the purpose of this study, a “local public entity” (LPE) can be described as a public authority or entity partially or totally funded by tax levies. LPEs provide essential services (for example, transport, education, care or utilities) not necessarily or not always at market

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<sup>31</sup> *Ibid.*

<sup>32</sup> S Bailey, *Cross on Local Government Law* (loose-leaf ed, Sweet & Maxwell, London) at para 1.03.

<sup>33</sup> *Idem*, para 1.04.

<sup>34</sup> *Idem*, para 1.18.

price to local communities.<sup>35</sup> Examples of “basic” LPEs include municipalities, cities, districts, councils, provinces, and other political subdivisions.

The term used in the UK to refer to an LPE is “local authority”. This chapter will look at which authorities and entities fall within this definition in England. Slightly different rules apply in Scotland, Wales and Northern Ireland, as each jurisdiction determines which entities constitute a local authority. In these countries, there is usually one tier of local authorities, whilst in England, there are two tiers.

A local authority (often called a local council) is an elected body that provides a range of services for a particular geographical area in the UK. Under the law,<sup>36</sup> an “English local authority” means:

- (a) a county council in England, a district council, or a London borough council;
- (b) the Council of the Isles of Scilly;
- (c) the Common Council of the City of London in its capacity as a local authority; and
- (d) the Greater London Authority so far as it exercises its functions through the Mayor.

Local authorities in England can be divided into two groups. The traditional distinction is between county councils (upper tier) and district, borough and city councils (lower tier).

At a very local level, there are town and parish councils in England and community councils in Wales with limited powers. On the opposite end of the spectrum, large cities such as London tend to organise all the services provided by local authorities within one tier of local government. For instance, in London, services such as fire, police and public transport are provided through a “joint authority” (the Greater London Authority). Besides the Greater London Authority, there are 32 borough councils in London that deal with the services usually allocated to county and district councils, such as education, adult social care, refuse and tax collection.

Consequently, it is also possible to divide local authorities into billing local authorities, which bill and collect council tax, and precepting authorities such as county councils, which issue a precept to a billing authority to collect council tax on their behalf.

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<sup>35</sup> On this point, see *Bromley LBC v Greater London Council* [1983] 1 AC 768, where the House of Lords held that councils and local transport entities are under a statutory obligation to conduct transport services on business principles and have regard to the fiduciary duty owed to ratepayers. In this case, the House of Lords said that it was not a fair balance of the duties owed to taxpayers and transport users to increase taxes to reduce transport costs, where many users came from areas outside London not affected by the tax rise.

<sup>36</sup> Local Government Act 1972, s 1; and Local Government Act 1999, s 1(2).



However, the distinction has lost some of its relevance today. It has already been mentioned that in large cities the two-tier system has been replaced by a unitary one. This has not only happened in large cities. Since 1972, when the two-tier system was created, unitary authorities have been established in a number of areas. Scotland and Wales adopted a single-tier pattern of local government in 1996. Where it exists, this single tier carries out all of the functions of county and district councils. This pattern of government is commonly referred to as a “unitary local government”.

The creation of unitary authorities has frequently been contingent on government policy or local initiative at a given time rather than any fixed rationale relating to the local economy, geography or identity. In recent times, there has been a growing demand for the creation of more unitary authorities.<sup>37</sup> Alternatively, there have been proposals for the establishment of a uniform pattern of unitary government across all of England.<sup>38</sup> These calls have been associated with various other policy issues, such as local government finance (discussed as part of this study), Covid-19 and devolution deals. The Government is considering reforms to introduce a one-tier system of local authorities in England, but this proposal has not yet been published at the time of writing.

The process of changing from a two-tier to a unitary local government system is normally referred to as “restructuring” or “reorganisation”. The legal procedure can be found in sections 1 to 7 of the Local Government and Public Involvement in Health Act 2007. A separate procedure under sections 8 to 10 of the same act applies to the merger of different district councils. For the moment, access to this procedure is elective, and there is no obligation to merge the responsibilities of county and district councils into unitary entities.

As of April 2021, there are 333 local authorities in England. Of these, 24 are county councils, 181 are district councils, and 128 are single-tier authorities. Of the latter, 33 are London boroughs and 36 are metropolitan boroughs.<sup>39</sup> Besides that, ten combined authorities have been established in England via the Local Democracy, Economic Development and Construction Act 2009. These are not local authorities but joint legal bodies through which groups of authorities can work together.

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<sup>37</sup> M Sandford, “Unitary local government” (House of Commons Library, 22 July 2021) available [here](#).

<sup>38</sup> In 1969, the Redcliffe-Maud commission recommended a system of single-tier unitary authorities for the whole of England, apart from for three metropolitan areas of Merseyside, Selnece (Greater Manchester), and the West Midlands (Birmingham and the Black Country). This report was accepted by the Labour Party government of the time despite considerable opposition. However, the Conservative Party won the June 1970 general election on a manifesto that committed them to a two-tier structure.

<sup>39</sup> M Sandford, “Local Government in England: Structures” (House of Commons Library, 15 September 2021) available [here](#).

## 2.2 Functions / missions

Under section 101 of the Local Government Act 1972, counties and districts are at liberty to agree to undertake functions for one another. If they do so, the responsibility for the function remains with the council to which it legally belongs.

County councils are responsible for providing services for the areas that they administer. These services include education, transport, planning, fire and public safety, social care, libraries, and waste management. District councils cover a smaller area and are responsible for services like rubbish collection, recycling, council tax collections, housing and planning applications.

In England, the Government retains the legal power to replace a local authority in delivering the functions attributed to them.<sup>40</sup>

The rules on reporting financial results was previously outlined by the Audit Commission Act 1998. According to this statutory provision, the auditors appointed by a local authority had to be satisfied that the authority had made proper arrangements for ensuring that it used its resources in an economical, efficient, and effective manner;<sup>41</sup> had a statutory right to documents and information underpinned by criminal sanction;<sup>42</sup> had considered whether to make a report in the public interest;<sup>43</sup> and sought a judicial declaration that an item of account was contrary to the law.<sup>44</sup>

The current framework is outlined in the Local Audit and Accountability Act 2014. This Act introduced a new audit regime for local authorities and abolished the pre-existing Audit Commission. The framework for local audit encompasses procurement, contract management and delivery, the code of audit practice, and regulation and accountability for performance. Currently, six different entities have a statutory role in overseeing and monitoring the framework for local authority accounting and auditing. However, none of them has a statutory responsibility to act as a system leader or to ensure the coherent actions of all the parties involved in the procedure. Consequently, the Redmond review suggested introducing significant changes to the auditing system,<sup>45</sup> currently being considered by the Government.<sup>46</sup>

The Government is also considering a significant overhaul of the structure, mandate and funding of local authorities. In England, there has for a long time been increasing pressure to merge county and district councils, thus abandoning the two-tier system of local

<sup>40</sup> Local Government Act 1999, s 15. Also see the discussion under "Principles and framework" below.

<sup>41</sup> Audit Commission Act 1998, s 5.

<sup>42</sup> *Idem*, s 6.

<sup>43</sup> *Idem*, s 8.

<sup>44</sup> *Idem*, s 17. See N Dobson, "Local authority corporate law", *JLGL* (2003) 6(3) 50 at 55.

<sup>45</sup> T Redmond, "Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financing Reporting" (September 2020) available [here](#).

<sup>46</sup> See the discussion under "Parties" below in this regard.

government introduced in 1972 and still implemented in practice only in this country. This pressure is spearheaded by independent reports<sup>47</sup> that have outlined the benefits in terms of efficiency and costs arising from merging local entities, as well as by reports on devolution in England commissioned by the Levelling Up, Housing and Communities Committee.<sup>48</sup>

Mergers between different local entities may result in long-term financial savings and better services for the citizens. However, they also carry financial and performance risks, especially where the new unitary authority will have to operate alongside other trusts and entities to provide local services to the communities it is tasked with overseeing. If more than one new unitary authority were to be created in a county area, this might require services that have been previously delivered across the whole area to be split or disaggregated across multiple organisations, thus adding complexities and co-ordination issues.

In the Levelling Up White Paper<sup>49</sup> released on 2 February 2022,<sup>50</sup> the Government recently confirmed their intention to deal with this issue. At the heart of the White Paper is a promise that more mayors will be appointed and local entities will gain oversight of larger authorities whilst having increased powers. It also announces negotiations for two new or revised Mayoral Combined Authorities, as well as negotiations for “trailblazer” devolution deals with the West Midlands and Greater Manchester. It is the Government’s intention for these deals to act as blueprints for other Mayoral Combined Authorities to follow. In other words, the Government seems to have opted for a process of consolidation of local authorities driven by local communities under their supervision and support.

However, the White Paper also calls for the introduction of a stricter “accountability framework” for mayors. Additionally, there is no provision for a mandatory move to a one-tier system. Finally, mergers are difficult to negotiate, as evidenced by the attempted deal between Stratford-on-Avon and Warwick. Despite the councils being of similar size and financially in good conditions, and despite an independent report highlighting no major issues to the merger,<sup>51</sup> the deal was ultimately unsuccessful over some concerns on a joint-venture participated in by one of the councils.<sup>52</sup>

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<sup>47</sup> PwC, “Evaluating the importance of scale in proposals for local government reorganisation” (August 2020) available [here](#).

<sup>48</sup> Housing, Communities and Local Government Committee, “Progress on devolution in England. Fourth Report of Session 2021-22” (HC 36, 1 October 2021) available [here](#).

<sup>49</sup> Press release, “Government to publish Levelling Up White Paper” (4 May 2021) available [here](#).

<sup>50</sup> HM Government, “Levelling Up the United Kingdom” (White Paper, CP 604, 2022) available [here](#).

<sup>51</sup> C West, “Stratford-on-Avon DC and Warwick DC Financial Disclosure Review” (Local Government Association, 24 May 2021) available [here](#).

<sup>52</sup> O Rudgewick, “Authorities scrap merger amid council-owned company concerns” (Public Finance, 22 April 2022) available [here](#).

## 2.3 Funding

Local authorities can rely on different sources of funding. Besides receiving central government funding and a portion of business rates, local authorities rely on the council tax, fees and charges for the services that they provide (such as planning applications), and loans. The bulk of the funds from these sources is not ring-fenced, meaning that local authorities can spend the money as they choose.

Government funding is allocated through a number of grants, the largest of which is the annual Revenue Support Grant. This grant is not ring-fenced, whilst some additional grants are ring-fenced (for example, the Public Health Grant). Additional grants are distributed between authorities according to separate criteria.

The Government's standard annual funding, which has been cut dramatically in recent years, is complemented by the public works loan board (PWLB) for more significant capital projects. In recent years, councils have increasingly relied on loans from the PWLB. Furthermore, local authorities retain 50% of the business rate, even if the Government intends to increase this percentage to 75%. Some areas have piloted a retention rate of 100% from 2017-18 onwards.

With reference to council tax, local authorities can set their own rates, and they retain all of the revenues they receive from council tax. However, rates need to comply with council tax bands fixed by the Government. Additionally, annual rises in council tax are subject to "referendum principles" set by the Secretary of State.<sup>53</sup> Finally, fees and charges are not really an additional source of revenue. In most cases, fees must not exceed the cost of providing services, and in many cases, their levels are set nationally.

Local authorities may also receive commercial income deriving from their ownership of assets or investments. In recent years, some councils have sought to generate alternative sources of revenue by borrowing to invest in commercial property. This results in uncertain revenue streams, as well as in the risk of huge losses should these investments prove unsuccessful and unprofitable.<sup>54</sup>

Each year, the amounts allocated through central government grants for local authorities in England are determined through the annual Local Government Finance Settlement. The annual settlement covers all county, district, and unitary authorities in England. It also includes fire and rescue authorities and the Greater London Authority, together with mayoral combined authorities. Police, education funding and housing benefits are not included in the annual settlement. In December 2015, the Government published indicative funding levels for the following four financial years (2016-20), but there have been no more multi-year settlements since 2020.

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<sup>53</sup> See the discussion under "English framework and treatment of local authorities" above in this regard.

<sup>54</sup> M Loughlin, "Innovative financing in local government: The limits of legal instrumentalism", *Public Law* (1990) 372-408 (part 1) and (1991) 568-599 (part 2).

## 2.4 Other bodies

Not all public services are delivered by local authorities – some are delivered at a local level by national organisations that are not accountable to local governments. An example of such a service is health services, which are delivered via the National Health Service (NHS). Other examples include welfare benefits and employment services, probation and prison services.

Local authorities deal with other national organisations established by the Government to carry out specific functions or distribute funding. Examples include the Environment Agency, Natural England, the Homes and Communities Agency, Highways England, the Arts Council, the Skills Funding Agency, and the Education Funding Agency. Whilst local authorities deal with them, these organisations are only accountable to their sponsoring central governmental department.

All parts of England are covered by (at least) one local enterprise partnership. These are voluntary bodies that were established in 2010-11 to co-ordinate economic development and growth policy in local areas. They have a close working relationship with local authorities (and any combined authority) in their area. They frequently have councillors sitting on their management boards, but they are not formally accountable to local authorities.<sup>55</sup>

The rules outlined in this chapter do not apply to the bodies mentioned in this subsection.<sup>56</sup>

Hospitals in the UK are not funded in the same way as local authorities. This is despite the fact that health is similar to other public services provided by local authorities. The NHS is funded through taxes and a portion of national insurance contributions. Funding for health services in England is provided by the Department for Health and Social Care's budget.

A small portion of the money is generated by patient charges. Individual NHS organisations – such as hospital trusts – can generate additional income, for example, through parking charges, land sales and treating private patients.

To ensure that the service provided by NHS trusts is financially viable, the Government created NHS Improvement. NHS Improvement (NHSI) is responsible for overseeing the National Health Service's foundation trusts and NHS trusts, as well as independent providers that provide NHS-funded care. NHSI is working hard to reduce the number of NHS trusts in deficit from the peak of 66% in the 2015-16 financial year.<sup>57</sup> In any case, the discipline of NHS trusts is separate from the laws regulating local authorities in distress.

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<sup>55</sup> The Government is conducting a review on the role, structure and functioning of local enterprise partnerships. This may lead to councils losing their role of governance in these partnerships.

<sup>56</sup> To maintain space and consistency with the other chapters of this publication, the focus here is only on the treatment of local authorities.

<sup>57</sup> See <https://www.kingsfund.org.uk/projects/nhs-in-a-nutshell/trusts-deficit>.

### 3. Dealing with local public entities in distress - the legal framework

#### 3.1 Principles and framework

The general approach followed by English law is to provide a series of mechanisms to local authorities to deal with financial difficulties before they become insolvent. There is, in other words, a preventive restructuring framework aimed at reducing the risk that local authorities default on their debts. These preventive restructuring measures include reducing costs, sharing services with other local authorities, and mergers between local authorities. It is also possible for councils to rely on loans from PWLB, bonds, and loans, as well as raising local taxes.<sup>58</sup>

There are few incentives for local authorities to deal with a situation of financial imbalance at an early stage. To make things worse, there are perverse incentives associated with not disclosing any ongoing financial difficulties, as disclosure would lead to the local authority's existing management being supervised and eventually replaced by independent commissioners appointed by the Government.

Not everyone agrees with this assessment. In recent oral evidence presented to the Housing, Communities and Local Government Committee, Richard Watts (Chair of the Local Government Association) argued that the punitive nature of the statutory provisions has resulted in "very significant engagement by local authorities under real financial pressure to effectively take the kinds of measures you would undertake in a section 114 process, but without formal issuing of the notice".<sup>59</sup>

Watts provided no evidence in support of this statement. Additionally, punitive corporate insolvency frameworks have traditionally pushed companies to delay dealing with their financial or economic issues rather than promote the adoption of timely restructuring measures. It is not clear why local public entities would react differently when subject to the same (dis)incentives for early filing or restructuring. In fact, in the most recent instance of a section 114 notice being utilised (Croydon), the local representative acknowledged that the council should have issued a notice sooner.<sup>60</sup>

Whilst the insolvency framework for people and companies encourages debtors to deal with their situation of financial or economic distress as early as possible, it does not go as far as preventing debtors (or their assets) from being liquidated. The effect of the English framework on local authorities in distress is exactly this: to devise a series of mechanisms aimed at avoiding the liquidation of local authorities. Under the law, local authorities cannot be liquidated.

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<sup>58</sup> For a clear outline of the preventive restructuring solutions, see N Gavin-Brown, "Restructuring Options for UK Local Authorities" (20 August 2018) available [here](#).

<sup>59</sup> Housing, Communities and Local Government Committee, "Oral evidence: Local authority financial sustainability and the section 114 regime" (HC 309, 2021) Q42.

<sup>60</sup> *Idem*, (HC 1054, 2021) Q107.

Under English law, the framework is outlined by the Local Government Finance Act 1988 and the Local Government Act 1999. The key figures are the CFO of the local authority and the Secretary of State.

A CFO, also known as a local authority's treasurer or section 151 officer, has the legal role of being the most senior financial advisor in a local authority and leading its financial plans. CFOs must be qualified accountants belonging to one of the recognised chartered accountancy bodies. As section 151 officers, they have a number of statutory duties, including a duty to report any unlawful financial activity involving the authority (past, present or proposed) or failure to set or keep to a balanced budget. They also have a number of statutory powers to perform this role; this includes the right to insist that the local authority to which they are appointed makes sufficient financial provision for the cost of internal audits. Uniquely across the public sector, CFOs have the power and legal responsibility to suspend a local authority's spending for a period of time if they consider the council to not have a balanced budget or if there is an imminent prospect of default.

There are two types of notices that CFOs can issue. The first is the notice under section 114(2) of the Local Government Finance Act 1988, also known as an advisory notice (this is not the section 114 notice discussed earlier). This advisory notice is only issued when the local authority is about to make a decision that would be unlawful. Consequently, the only effect of this advisory notice is to prevent a local authority from pursuing such conduct.<sup>61</sup> All of the other activities and powers of a local authority remain unaffected by such a notice.

Secondly a different, more general power to stop a local authority from entering into new transactions and performing some of the existing ones is granted by section 114(3) of the Local Government Finance Act 1988. This provision dictates that:

“The chief finance officer of a relevant authority shall make a report under this section if it appears to him that the expenditure of the authority incurred (including expenditure it proposes to incur) in a financial year is likely to exceed the resources (including sums borrowed) available to it to meet that expenditure.”

CFOs will only issue such notice if they have formed the view that future expenses are out of control, to the point that the local authority to which they are appointed is likely to end the financial year with a budget deficit and that it is impossible to broker a solution without issuing a section 114 notice.

It is quite likely that the procedure<sup>62</sup> will result in the appointment of new independent commissioners for the local authority in debt. Newly-appointed independent commissioners will deal with a local authority's financial distress without liquidating it.

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<sup>61</sup> Local Government Finance Act 1988, s 115(5).

<sup>62</sup> See the outline of the procedure in “Technical rules / procedure” below.

It follows that, under English law, local authorities cannot be liquidated. They can only be rescued. Additionally, whilst the concept of “continuity of public service” is not embedded in legislation, it is clear that much of the current law is geared towards achieving this goal, including for companies strictly linked to local authorities but formally independent of them. The demise of Metronet is a clear example of taxpayers’ money being used to ensure that public services are provided, even in an instance where the debtor tasked with running public services is not a local authority. Metronet was a public-private partnership charged with maintaining, renewing and upgrading parts of the London Underground’s infrastructure in return for a set price. When the partnership overspent its budget for renovations and improvements, it went into administration in July 2007, and the company’s responsibilities were transferred back into public ownership under the authority of Transport for London (TfL).<sup>63</sup>

Local authorities cannot be subject to other debt resolution mechanisms (for example, state oversight, active supervision, or financial assistance from other authorities) apart from those outlined in this section.

There is no evidence that the principles underpinning the current framework have been influenced by policy debates at regional or international level. However, some rules – such as those on the treatment of executory contracts – mirror similar provisions outlined for formal insolvency procedures aimed at rescuing companies or their businesses.

To conclude, section 114 notices are late warning signals. The consequences of issuing such notices are severe for the councils that issue them. All but essential expenses are frozen, and councils may be forced to merge with neighbouring ones; for instance, Northamptonshire was forced to merge with a neighbouring council in 2018.

The harshness of the consequences associated with section 114 notices have been designed to push councils to take timely decisions to avoid experiencing serious financial pressures. Yet, the changed policy and funding environment described in this paper coupled with a lack of expert auditors to supervise a council’s activities may, nevertheless, lead to local authorities experiencing serious financial difficulties. If this happens, the consequences for councils, their workers, the services they provide and their existing procurement contracts are draconian.

This punitive approach towards failure has no equivalent in the English corporate or personal insolvency law framework, and it lacks proper theoretical justification. Reforms aimed at supporting local authorities experiencing financial difficulties, rather than punishing them for being indebted, are needed to realign the treatment of local public entities in distress with the rest of the English insolvency framework.

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<sup>63</sup> For an analysis of this case, see (amongst others) Transport Committee, “Update on the London Underground and the public-private (PPP) partnership agreements” (HC 100, 26 March 2010) available [here](#); and The National Audit Office, “The failure of Metronet” (HC 512, 5 June 2009) available [here](#).



### 3.2 Parties

Courts and creditors do not play an active role in procedures dealing with local authorities in distress. This is because the procedure is administrative in nature and creditors are usually repaid in full. There is no statutory space for the involvement of other figures such as mediators, arbitrators, and company doctors – even if the latter may be hired by existing management to attempt to rescue a local authority before it files for statutory protection. On the other hand, a key role is entrusted to the management of a local authority in distress.

Balancing a local authority's budget is a key obligation of CFOs. Under the law, it seems that section 114 notices should be issued whenever there is a significant imbalance in a local authority's accounts. However, this does not frequently happen in practice. Particularly, it seems that the Government intervened on multiple occasions during the Covid-19 pandemic to prevent a number of councils from issuing such notices.<sup>64</sup>

When these notices are issued, the Government intervenes to ensure that an issuing local authority addresses the issues that played the largest role in causing it to enter into financial difficulties. Usual measures include the appointment of new management (including a new CEO and CFO), cost-cutting actions, the provision of additional interim funding, and long-term policies such as a merger with neighbouring local authorities.

Besides CFOs and the Government, auditors also have a prominent role in these procedures. As previously discussed, the current local audit regime was established by the Local Audit and Accountability Act 2014 which abolished the pre-existing Audit Commission, and gave local authorities the power to procure their own private audit services at a local level. A recently published review on how the audit system operates concluded that it was in dire need of reform, as “none of the six entities with responsibility for the different elements of the framework has a statutory responsibility, either to act as a system leader or to make sure that the framework operates in a joined-up and coherent manner”.<sup>65</sup> Other reports also suggest that the local audit regime is not fit for purpose,<sup>66</sup> partially due to a shortage of experienced auditors willing to carry out work for local authorities.

It seems that the Government is acting on these recommendations. In March 2021, the Government published a White Paper setting out its plans to reform corporate audit, reporting and governance. The White Paper illuminates details regarding the Government's proposal to establish a new regulator (the Audit, Reporting and

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<sup>64</sup> Anonymous, “Whitehall has waived financial rules to save councils from S114”, *Inside Croydon* (London, 20 July 2020) available [here](#).

<sup>65</sup> T Redmond, “Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financing Reporting” (September 2020) at 10, available [here](#).

<sup>66</sup> National Audit Office, “Timeliness of local auditor reporting on local government in England, 2020” (HC 2019-20 1243) available [here](#).

Governance Authority (ARGA)) to replace the Financial Reporting Council (FRC).<sup>67</sup> Apparently, this change will become effective as soon as the second quarter of 2023.<sup>68</sup> Additionally, the Government is also considering to mandate that at least one member of the audit committees be selected from independent auditors.<sup>69</sup>

However, at the time of writing, no reforms have been implemented. Additionally, it has been argued that the proposed authority may lack the specialist expertise to deal with local authorities and powers to make changes to their budgets. A reform that may have far broader consequences is the removal of the local authorities' ability to choose their own auditors.

### 3.3 Technical rules / procedure

Preliminarily, it is appropriate to outline the key differences between existing procedures for local public entities in distress and corporate insolvency procedures.

The procedures discussed in this chapter are debtor-in-possession procedures. However, existing management is likely to lose control of a local authority as soon as a CFO issues a section 114 notice, as the supervising executory authority is likely to appoint new management to implement the financial restructuring of the distressed entity. This new management does not have to be in possession of specific qualifications under the law.

It follows that no automatic stay is granted because creditors are usually repaid in full. However, it is possible to terminate some executory contracts. Despite that, creditors do not participate in restructuring efforts and cannot influence the drafting of a restructuring plan.

As mentioned above, there are no judicial or court-supervised procedures. Their nature is purely administrative. It follows that key powers are given to the CFO, as well as the (new) management of a local authority, which operates under the supervision of the Secretary of State.

There are no specific rules on interim finance, but the Government frequently steps in to provide additional funding to allow local authorities to restructure their debt and provide the essential services they are legally bound to provide. This is because a section 114 notice is a statement that dictates that a local authority is in deep financial trouble and needs assistance from the Government. Additionally, there are no special rules applicable to a distressed local authority's assets.

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<sup>67</sup> Department for Business, Energy and Industrial Strategy, "Restoring trust in audit and corporate governance" (March 2021) CP 382 available [here](#).

<sup>68</sup> S Bouvier, "FRC officials detail ARGA transition timetable, upcoming workplan priorities", *IPE News* (London, 24 September 2021) available [here](#).

<sup>69</sup> O Rudgewick, "Government to mandate independent audit committee members", *Public Finance* (London, 31 May 2022) available [here](#).

Moving to the analysis of the current framework, the procedure for dealing with section 114 notices is outlined in section 115 of the Local Government Finance Act 1988. Similar rules apply to elected local policing bodies (such as councils and districts), fire and rescue authorities, and the police. Special rules are outlined for the Greater London Authority by section 115A of the Local Government Finance Act 1988.

Once a section 114 notice is issued, an issuing council will have 21 days to convene a meeting and discuss the implications of the notice.<sup>70</sup> This is also known as a “prohibition period”. During a prohibition period, the effect of an issued notice is to prevent any new expenditure, with the exception of those designed to fund statutory services. However, existing commitments and contracts will continue to be honoured, and local authority officers will continue to carry out their duties. Quite obviously, any spending that is not essential or that can be postponed should not take place, and essential spending will be monitored.

Only certain expenditures are permitted under an emergency protocol (which lasts until a different arrangement is agreed upon among the parties involved in the procedure). The only payments that may be made whilst an emergency protocol is in operation are those that constitute:

- existing staff payroll and pension costs;
- an expenditure on goods and services that have already been received;
- an expenditure required to deliver the relevant local authority’s provision of statutory services at a minimum possible level;
- an urgent expenditure required to safeguard vulnerable citizens;
- an expenditure required by existing legal agreements and contracts;
- an expenditure funded through ring-fenced grants; and
- an expenditure necessary to achieve value for money or mitigate additional in-year costs.

During a prohibition period, a local authority may only incur new expenses where prior authorisation has been granted by its CFO. A CFO may only authorise new expenditures if he is of the opinion that such expenditures would likely prevent the situation (that resulted in the section 114 notice) from worsening; reoccurring; or would improve the situation. Any authorisation must be in writing, identify the grounds upon which it is given, and explain the CFO’s reasons for being of the opinion that those grounds apply. Contracts entered into without authorisation in this form are void.

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<sup>70</sup> Local Government Finance Act 1988, s 115(1D).

A full council meeting marks the end of a prohibition period. In that meeting, an elected body must consider the relevant report and decide whether it agrees or disagrees with the views contained in the report and what action (if any) the body proposes to take in consequence of it.<sup>71</sup>

Following such a meeting, a report will be produced in alignment with section 115(1)(E) of the Local Government Finance Act 1988. This act dictates that a report shall include:

- (a) what action (if any) that body, authority or chief officer has taken in response to the initial report;
- (b) what action (if any) that body, authority or chief officer proposes to take in response to the initial report; and
- (c) the reasons for taking the action specified or, if it is the case, for taking no action.

A CFO of an elected local policing body must notify the body's auditor of any decisions taken by the body in accordance with section 115 of the Local Government Finance Act 1988. At a meeting, council members and auditors should work together to come up with a shared solution. However, where this is not possible, the Secretary of State may intervene and appoint new commissioners to take over the functions originally allocated to the elected members of the local authority.

Where a shared solution is found, a plan for ongoing management is sent to the Government for approval and, if approved, is then implemented by the elected officials of the local authority or by independent commissioners appointed by the Government. Where a solution is not found, a body's CFO is likely to issue a second s.114 Notice (although there is no legal requirement to do so), and the Government steps in to ensure that creditors are paid.

As mentioned above, in England, the Government retains the legal power to replace the local authority in delivering the functions afforded to them.<sup>72</sup> Formal Government interventions in the running of local authorities are rare, begin with a formal direction notice, and are typically only triggered by dramatic events capable of undermining the public's confidence in that elected local authority.

To date, ten interventions have taken place since this power was granted to the Government by the Local Government Act 1999. The most recent appointment of independent commissioners at Liverpool City Council (on 10 June 2021) was triggered by reports of failures in governance, a lack of scrutiny of the use of and regard for public

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<sup>71</sup> *Idem*, s 115(1B).

<sup>72</sup> Local Government Act 1999, s 15.

funds, and a culture of intimidation at the council.<sup>73</sup> According to guidelines published in May 2020, interventions of this kind are limited to cases where the Secretary of State is satisfied that the authority is failing to comply with the “best value duty”.<sup>74</sup>

Failure to set a balanced budget or allowing failure of a service is likely to breach the best value duty, even in the absence of a section 114 notice. If this occurs, the Secretary of State has the power to appoint an independent commissioner to inspect the alleged offending local authority’s compliance. Under section 15 of the Local Government Act 1999, the Secretary of State can impose a range of measures, including directing the authority to take the action necessary to meet its best value requirements.

Exercise of such powers is usually accompanied by financial assistance from the Government. The fact that local authorities cannot fail results in the central Government having to provide the needed funding if required. This is also as creditors cannot see their claims curtailed under any of the procedures mentioned above. Under the law, a lender can appoint a receiver where their claim exceeds GBP 10,000 and it has gone unpaid for two months or more, even although security cannot be provided by local authorities. The High Court has the power under the Local Government Act 2003 to confer on the receiver the power to collect revenues of the local authority, issue levies or precepts, or set and collect council tax.

As is evident from the above and as evidenced in a recent report by the Housing, Communities and Local Government Committee,<sup>75</sup> the current framework lacks intermediary measures that local authorities can use to flag concerns. Both of the available procedures lack clarity, partially by reason of their rarity and partially due to the very limited number of provisions covering the treatment of local authorities in distress.

A report on the financial sustainability of local authorities and the section 114 regime outlines that these measures are triggered at the very last moment, and that the regime makes it difficult for local authorities to act in a timely manner. As a result, it advises the Government to introduce an intermediary “yellow card” measure that a CFO could apply to force a council to confront the seriousness of its financial position much sooner.<sup>76</sup> The report also recommends that CFOs report on the state of finances (and, in particular, potentially serious financial problems) of the local authority to which they are appointed. Their findings must be presented to both the executive and appropriate scrutiny committees and updated on a quarterly basis.

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<sup>73</sup> Press Release, “Local Government Secretary appoints commissioners to support Liverpool City Council” (10 June 2021) available [here](#).

<sup>74</sup> Ministry of Housing, Communities and Local Government, “Statutory intervention and inspection: a guide for local authorities” (7 May 2020) available [here](#).

<sup>75</sup> Housing, Communities and Local Government Committee, “Local authority financial sustainability and the section 114 regime” (HC 2021-22, 33) available [here](#).

<sup>76</sup> *Idem*, 32-33.

However, as evidenced by the case study of Croydon,<sup>77</sup> the biggest flaw of the system does not lie in the fact that financial issues are unknown until it is too late. The main reason for concern is that (due to political reasons and the general barriers to taking tough decisions such as making redundancies and cutting services) issues are postponed until draconian measures and external funding are needed to rescue councils. Simply speaking of these issues without granting key players the power to change the local authority's financial situation at an early stage would do little to improve the current *status quo*.

#### **4. Dealing with local public entities in distress - law in practice**

In recent years, local governments have faced successive challenges to their financial sustainability. On the one hand, sustained demand for services has increased the expenses that local authorities need to sustain. Notably, the burden of social care costs has not been addressed by successive Governments through adequate funding. It is estimated that social care requirements are the most significant stressor on local authority budgets, as meeting the requirements consumes up to 70% of the budgets of top-tier councils.<sup>78</sup> Changes to the level of funding equalisation between councils, the introduction of the Business Rate Retention Scheme, and, more recently, the Covid-19 pandemic have made these issues more pressing.<sup>79</sup> As a result, some councils (Northamptonshire in 2018, Croydon in late 2020, Slough in July 2021<sup>80</sup> and Northumberland County Council in May 2022) have recently been forced to issue section 114 notices, essentially declaring that they had run out of money.

The case of Croydon has been in the news for the past year and has been extensively analysed as part of the inquiry evaluating the financial sustainability of local authorities, as well as the restructuring regime available to them.<sup>81</sup> The financial condition of the London Borough of Croydon has deteriorated since the 2017-18 tax year.<sup>82</sup> The causes of this situation were found in the growing spending pressures stemming from both children's and adult social care, low levels of financial reserves, financial mismanagement, and poor auditing records. As evidenced in a later emergency strategic review commissioned to PwC, several financial issues were associated with the London Borough of Croydon's commercial subsidiaries. Notably, their lack of proper governance and accountability, as

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<sup>77</sup> See the discussion under "Dealing with Local Public Entities in Distress - Law in Practice" below.

<sup>78</sup> Housing, Communities and Local Government Committee, "Local authority financial sustainability and the section 114 regime" (HC 2021-22, 33) at 3, available [here](#).

<sup>79</sup> P Butler, "Cost-of-living crisis for councils will make levelling up a distant dream", *The Guardian* (London, 17 June 2022) available [here](#).

<sup>80</sup> The situation in Slough is quickly evolving, with news that the council is proposing to restructure the finance department (see O Rudgewick, "Slough proposes financial department restructure", *Public Finance* (15 June 2022) available [here](#)) and that most of the council's properties may be sold (see O Rudgewick, "Slough urged to sell most of its properties", *Public Finance* (London, 27 May 2022) available [here](#)). For these reasons, the authors preferred looking at the still recent but more settled situation of Croydon.

<sup>81</sup> Housing, Communities and Local Government Committee, "Local authority financial sustainability and the section 114 regime" (HC 2021-22, 33) at 3, available [here](#).

<sup>82</sup> G Thornton, "London Borough of Croydon. Report in the Public Interest concerning the Council's financial position and related governance arrangements" (October 2020) available [here](#).

well as significant underperformance against their business plans, were held to have caused the financial issues.<sup>83</sup> Finally, the local authority was responsible for a large number of unaccompanied asylum-seeking children whose maintenance was not fully covered by the Government.

Despite the London Borough of Croydon's authority members, the Government, and the general public being aware of the borough's financial issues for a significant period of time, the borough was allowed to approve risky investments and secure additional funding through loans even when the levels of reserves were too low to sustain such investments. Some of these, such as the purchase of the Croydon Park Hotel, resulted in a significant loss (the holding company went into administration in June 2020), whilst others failed to generate satisfactory returns (such as the Brick by Brick delayed property developments and investment into the town centre's regeneration to increase tax revenues).

Despite all of these warning signs, the council was allowed to operate "as usual" until mid-2020, when it approached the Ministry of Housing, Communities and Local Government (MHCLG) for support. Eventually, the CFO was forced to issue a section 114 notice only on 11 November 2020 when it became clear that the council faced a predicted budget shortfall of between GBP 30 million and GBP 67 million by the end of 2020-21 and the Government was not willing to cover the council's deficit without a change in the existing management.

As no further cost-cutting or revenue-generating measures could be adopted in late 2020, the existing directors of the council were gradually replaced by professionals appointed by the MHCLG. Finally, in March 2021, the Government issued a capitalisation direction allowing the council to borrow GBP 70 million in 2020-21 and GBP 50 million in 2021-22 in order to allow the council to use the money to support its revenue budget position.<sup>84</sup>

This case study shows that the debtor's financial difficulties were due to common characteristics of many (but not all) corporate failures: a management's inability to follow a prudential code of conduct in investing funds, a management's lack of accountability, over-optimistic forecasts from a debtor's management, and a lack of instruments to promote the early restructuring of the debtor's financial position. The situation started to change only after the issuance of the section 114 notice and the appointment of a new management team.

This case study and the recent enquiry on local authorities make evident that, if these notices cannot be avoided, they should be served as quickly as possible because they should not be viewed as evidence of failure, but as mechanisms to deal with financial

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<sup>83</sup> PwC, "Independent strategic review of Brick by Brick Croydon Ltd, Growth Zone, Croydon Affordable Homes LLP, the Revolving Investment Fund and the Assets Investment Fund" (13 November 2020) available [here](#).

<sup>84</sup> MHCLG, "Croydon Capitalisation Direction" (16 March 2021) available [here](#).

issues proactively.<sup>85</sup> However, the law lacks any incentives for local authorities to issue these notices, and there is no obligation on auditing bodies to intervene at an early stage. Additionally, the fact that a management team is barred from running a local authority that issues a notice provides further incentives to file as late as possible, as evidenced in the case of the London Borough of Croydon.

The London Borough of Croydon's financial distress is to be ascribed mainly to the council and subsidiaries' poor management of available funds despite contingent pressure caused by asylum seekers, an ageing population, and the Covid-19 pandemic. An earlier intervention from a supervisory body – for instance, through the appointment of an improvement and assurance panel, which only happened in January 2021 – would have minimised the negative financial consequences associated with the council's financial distress, as well as their impact on local taxpayers.

In the Croydon case study, all measures that should have been issued through a section 114 notice were issued before the CFO formally issued the notice and the Government appointed a new management team. The problem was mainly the lack of managerial skills from the management team. It follows that the current system needs serious, comprehensive reforms to align its goals to the rescue-oriented and value-maximising framework of the current English insolvency system. The authors of this paper find no special reasons to justify a punitive treatment of local public authorities in distress, especially in the absence of fraudulent or illegal acts.

The powers granted to the Secretary of State to replace a local authority in delivering the functions attributed to them by utilising section 15 of the Local Government Act 1999 are sufficient and should be restricted to those cases where there is an alleged general failure of governance, such as in the case of Liverpool in 2021. In all other cases, the law should be concerned with providing mechanisms that allow auditors and council members to hold their managers accountable for their work and renegotiate obligations with creditors at an earlier stage.

The Report of the Review Committee on Insolvency Law and Practice (1982) represented a watershed moment for the English insolvency framework. It advocated for a new approach to corporate and personal insolvency in this country, and recommended not punishing debtors for failing to repay their debts. Instead, it advised viewing corporate failure as a fact of life rather than a sin caused by those controlling a failing company. These recommendations were later implemented through a series of statutory reforms, but these reforms have largely neglected the sector of local authorities.

Local public entities face new challenges caused by financial crises, geo-political tensions, increasing budget cuts, and growing expenses to meet the needs of a vulnerable and ageing population at the time of the Covid-19 pandemic. So far, these challenges have

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<sup>85</sup> Housing, Communities and Local Government Committee, "Local authority financial sustainability and the section 114 regime" (HC 2021-22, 33) at 31, available [here](#).



resulted in an increased number of local public entities experiencing financial distress. Whilst the absence of section 114 notices has been adduced as evidence that the regime has been broadly successful, this chapter has validated the perception that their limited use can be explained by the cumbersome and disruptive nature of the current regime. As evidenced in the previous analysis,<sup>86</sup> this situation suggests that it is about time that the English legislator extends the country's acclaimed rescue culture to its local authorities.

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<sup>86</sup> E Vaccari, "Municipal Bankruptcy Law: A Solution Which Should Not Become a Problem", *NIBLeJ* (2017) 5 at 2.

# Local public entities in distress - a critical analysis of the French approach

By Emilie Ghio\*

## 1. General context of insolvency law

### 1.1 History

French insolvency law has a long and ancient history, dating back from Roman law. Before the introduction of the Commercial Code of 1807, insolvency law was mostly of a coercive nature, with procedures consisting of arresting and imprisoning the defaulting debtor.<sup>1</sup>

While the Law of 4 March 1880 introduced the judicial liquidation procedure - which ran alongside the coercive bankruptcy procedure for honest bankrupts who could save their businesses through debt forgiveness from their creditors - the roots of modern insolvency law were laid down in 1967.

The Law of 13 July 1967 considerably transformed the insolvency landscape by dissociating the fate of the company from that of its management. In doing so, a “twin-track” system was established, whereby a company could either be liquidated or rescued.<sup>2</sup> Interestingly, commentators have pointed out that while Chapter 11 of the United States (US) Bankruptcy Code is more famous and has been much admired across the world, the 1967 French regime is, in actuality, one of the earliest articulations of the concept of corporate rescue.<sup>3</sup>

Since then, the French legislator and Government have been prolific at updating the insolvency regime at regular intervals. France is now equipped with a comprehensive body of insolvency procedures, all governed by Title VI of the Commercial Code (*Code de Commerce*). In addition to liquidation proceedings, French insolvency law proposes a vast array of restructuring procedures. This explains why the French regime is known internationally as a “restructuring-biased” jurisdiction,<sup>4</sup> predominantly geared towards the rescue of ailing businesses, with a view to preserving employment.

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<sup>1</sup> See generally, J-M Thiveaud, “L’ordre primordial de la dette: Petite histoire panoramique de la faillite, des origines à nos jours”, *Revue d’économie financière* (1993) 25 at 67.

<sup>2</sup> Law 67-563 of 13 July 1967. See P Omar, “A Reform in Search of a Purpose: French Insolvency Law Changes (Again!)”, *International Insolvency Review* (2014) 23 201, at 201.

<sup>3</sup> P Omar, “A Reform in Search of a Purpose: French Insolvency Law Changes (Again!)”, *International Insolvency Review* (2014) 23 201, at 201.

<sup>4</sup> M A McGowan and D Andrews, “Insolvency Regimes and Productivity Growth: A Framework for Analysis” (2016) *OECD Economic Department Working Papers* No 1309, at 18.

## 1.2 Existing corporate insolvency procedures

As of 2021, Title VI of the Commercial Code contains no less than six insolvency proceedings. Six of these are rescue proceedings, and five procedures are available to the debtor pre-insolvency. The French insolvency procedures are as follows:

- (1) *ad hoc* proceedings (*mandat ad hoc*);
- (2) conciliation proceedings (*conciliation*);
- (3) safeguard proceedings (*sauvegarde*);
- (4) expedited safeguard proceedings (*sauvegarde accélérée*);
- (5) rehabilitation proceedings (*redressement judiciaire*); and
- (6) liquidation proceedings (*liquidation judiciaire*).

The first two procedures, the *ad hoc* and conciliation procedures, were originally developed to support commercial practices, mostly as a result of the jurisprudence of the Commercial Court of Paris in the 1990s.<sup>5</sup> They were formally codified in the Law of 1984 as the amicable settlement procedure (*règlement amiable*)<sup>6</sup> and significantly reformed in 2005,<sup>7</sup> which separated the two procedures and regulated their current form. Their objective is to encourage negotiations with the company's creditors at an early stage and on a confidential and contractual basis. Therefore, they are voluntary, amicable and confidential procedures, regulated by articles L611-16 of the French Commercial Code. They are available to companies that are not yet insolvent, and are opened at the request of the debtor.<sup>8</sup> They allow the debtor to remain in possession while nominating a mediator (either a *mandataire ad hoc* or a *conciliateur*) to oversee the negotiations.<sup>9</sup> The main difference between the *ad hoc* mandate and the conciliation is that a conciliation agreement is ratified by the court at the request of the debtor. The court can either merely approve the agreement (*constatation*), which means that the confidentiality of the procedure is preserved, or it can sanction the agreement (*homologation*),<sup>10</sup> which involves

<sup>5</sup> See C Dupoux and D Marks, "Chapter 11 à la Française: French Insolvency Reforms", *International Corporate Rescue* (2004) 1 at 74.

<sup>6</sup> Introduced by Law 84-148 of 1 March 1984.

<sup>7</sup> Law 2005-845 of 26 July 2005.

<sup>8</sup> Commercial Code, art L631-1. The threshold of insolvency in France is determined by the concept of "payment failure" (*cessation des paiements*). A debtor is in a payment failure situation when due and payable debts exceed available assets. A debtor must file for insolvency within 45 days of the occurrence of such situation.

<sup>9</sup> *Idem*, art L611-3. The relevant court will be either the Commercial Court if the debtor carries out commercial or handcrafted activities, or the High Court in all other cases.

<sup>10</sup> *Idem*, art L611-8. The court can sanction the agreement through *homologation* only if certain conditions are met, including that the provisions of the agreement aim to ensure the viability of the going concern of the company.

publicising the judgment.<sup>11</sup> The adverse effect of publicity which is attached to the sanctioning of the agreement is mitigated by the fact that such sanctioning confers more legal advantages than a mere approval in the event of subsequent insolvency proceedings being opened. In particular, if the conciliation proceedings are converted into safeguard proceedings, new money providers will benefit from a protection for new financing (*privilège de conciliation*).<sup>12</sup> In 2017, the *ad hoc* mandate and conciliation procedures amounted to 16% of all debt restructuring procedures in France.<sup>13</sup>

The third procedure, the safeguard procedure, was also introduced in 2005 and was extensively reformed in 2008,<sup>14</sup> 2014<sup>15</sup> and 2016.<sup>16</sup> Modelled on Chapter 11 of the US Bankruptcy Code, the safeguard procedure is a hybrid mechanism that can serve as a preventive restructuring mechanism or as a restructuring one.<sup>17</sup> Compared to the *ad hoc* and conciliation procedures, the safeguard exhibits characteristics closer to formal insolvency proceedings. For example, it is not confidential and must involve all creditors. It triggers a stay on enforcement actions, thereby giving the company some breathing space during an observation period (*période d'observation*) in which the debtor proposes a reorganisation plan (*plan de sauvegarde*) to its creditors.<sup>18</sup> Although the debtor remains in possession, the judgment opening the procedure also triggers the appointment of an administrator (*administrateur judiciaire*).<sup>19</sup> The administrator supervises and / or assists the management to prepare the plan while an insolvency judge (*juge commissaire*) oversees the whole procedure. A creditors' representative(s) (*mandataires judiciaires*) also represents the creditors' interests and assesses the proofs of claims and valuation of the debtor's debts and assets.<sup>20</sup> This representative can be assisted by supervising creditors (*créanciers contrôleurs*) appointed by the insolvency judge.<sup>21</sup> Creditors are placed within committees for the purpose of voting on the plan, and two-thirds in value of each

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<sup>11</sup> *Idem*, art L611-9. Before the court sanctions an agreement, it must hear the debtor, the creditors who are parties to the agreement, the conciliator and some representatives of the company.

<sup>12</sup> Commercial Code, arts L611-11, L626-20, and L626-30-2.

<sup>13</sup> A Epaulard and C Zapha, "Distressed firms: how effective are preventive procedures?", *France Stratégie - La Note D'Analyse* no 84 (February 2020), at 3.

<sup>14</sup> Law 2008-1345 of 18 December 2008.

<sup>15</sup> Ordinance 2014-326 of 12 March 2014.

<sup>16</sup> Law 2016-1547 of 18 November 2016.

<sup>17</sup> Commercial Code, art L620-1.

<sup>18</sup> *Ibid.*

<sup>19</sup> *Idem*, art R-62111. The appointment of an administrator is only legally required if the company meets one of two thresholds fixed by decree of the *Conseil d'Etat* (the *Conseil d'Etat* is the French administrative supreme court): (i) 20 employees; or (ii) EUR 3 million in turnover before tax.

<sup>20</sup> *Idem*, art R-624-1(2). A creditor can dispute the valuation, and in this case, the creditors' representative must send a letter to them requesting acknowledgment of the receipt of the letter and the amount proposed for registration. Depending on the creditor's answer, the dispute may be terminated or upheld. In the case of the former, the admission decision is submitted to the insolvency judge, while in the case of the latter, the creditor is summoned to a dispute hearing before the insolvency judge. If the creditor does not respond to the letter, the insolvency judge can pronounce the total or partial rejection of the claim which results in the extinction of the right.

<sup>21</sup> *Idem*, arts L621-10 and L621-11.

committee must approve the plan.<sup>22</sup> Employees also benefit from a special protection, by being granted super-priority (*superprivilège des salaires*).<sup>23</sup>

In the wake of the global great financial crisis of the mid-2000s, developments in legal practice prompted further reforms. In 2010 and 2014, two pre-pack procedures were created, namely the expedited financial safeguard (*sauvegarde financière accélérée*)<sup>24</sup> and the expedited safeguard (*sauvegarde accélérée*),<sup>25</sup> which are both variations of the safeguard procedure.<sup>26</sup> The expedited safeguard mechanisms can only be used following a conciliation procedure; it is not stand-alone processes. In order to file for this variant of the safeguard, a company must:

- (i) have opened conciliation proceedings;
- (ii) have negotiated a restructuring plan with the creditors later involved in the expedited safeguard procedure; and
- (iii) be able to demonstrate to the court that the plan will receive the support of the creditors involved.

The decision whether to open an expedited safeguard procedure is then taken by the court on the basis of a report prepared by the conciliator expressing his opinion on the likelihood of the plan being adopted by the creditors concerned by the plan. The objective of the procedure is for the debtor to reach an agreement with its creditors in a timely fashion. The attractiveness of the expedited safeguard procedure is that it combines confidentiality and contractual flexibility during the conciliation phase, which serves to prepare the plan, with the:

- (i) protection of new financing brought forward during the conciliation phase (*privilège de conciliation*); and
- (ii) possibility for the court to bind dissenting creditors in the safeguard phase of the procedure.

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<sup>22</sup> *Idem*, art L626-30-2.

<sup>23</sup> *Idem*, art L625-7. French insolvency law has historically been geared towards protecting social policy matters. All claims stemming from employment contracts are granted a super-priority that trumps creditors' claims. In terms of Commercial Code, art L625-7 and Labour Code, art L143-10, this applies to their claims for the 60 days prior to the judgment commencing safeguard proceedings. On the French position on protecting employees' rights in insolvency, see F Mucciarelli, "Employee Insolvency Priorities and Employment Protection in France, Germany and the United Kingdom", *Journal of Law and Society* (2017) 44 at 255.

<sup>24</sup> Law 2010-1249 of 22 October 2010.

<sup>25</sup> Ordinance 2014-326 of 12 March 2014.

<sup>26</sup> The expedited financial safeguard procedure has since been merged within the expedited safeguard procedure.

Rehabilitation proceedings are governed by articles L631-1 to L632-4 of the Commercial Code. These procedures were introduced in 1985 and were heavily reformed in 2005, just like the safeguard procedure. The rehabilitation procedure exhibits many similarities to the safeguard procedure, except that it is only available to insolvent companies. Rehabilitation proceedings are court-based collective proceedings, aimed at allowing the survival of the company, the preservation of its activity and of employment, and the discharge of the company's debts.

Finally, liquidation proceedings are governed by articles L640-1 to L645-12 of the Commercial Code. The court can order the opening of liquidation proceedings without the company having to file for any other insolvency / restructuring procedure before. Alternatively, liquidation proceedings can be opened following rehabilitation proceedings, and a liquidator will be appointed.

### 1.3 Commentaries

#### 1.3.1 *The role of stakeholders*

In France, the court takes a leading role in insolvency proceedings and makes key decisions, from the opening to the closing of the case. For example, under current French law, court involvement is systematic and heavier than that in other European Union (EU) member states. Several judicial authorities are involved, particularly in safeguard proceedings. A preliminary judge (*juge commis*) may optionally be appointed to undertake an audit of the debtor's situation. The judge will gather "all information on the financial, economic and social situation of the company".<sup>27</sup> One or more supervisory judge(s) (*juge-commissaire*) is systematically appointed during the opening order of safeguard proceedings and takes the leading role in the case. The supervisory judges have their own jurisdiction and extensive powers, such as the appointment of other roleplayers during the proceedings,<sup>28</sup> as well as the approval and rejection of creditors' claims,<sup>29</sup> rendering the judges "omnipresent" during insolvency proceedings.<sup>30</sup> Several French commentators have advocated for an adjustment of the involvement and role of the judge, and have promoted the use of procedures where the debtor and its creditors are left "to their own to negotiate a fair settlement".<sup>31</sup>

<sup>27</sup> Commercial Code, art L621-1-4.

<sup>28</sup> *Idem*, arts L621-10 and L621-9. The supervisory judge will appoint the supervising creditors (*créanciers contrôleurs*) from the body of creditors and can also appoint experts if necessary.

<sup>29</sup> *Idem*, art L624-2.

<sup>30</sup> M Houssin, "Le Droit français est-il creditor friendly?", *International Journal of Insolvency Law* (2017) 1 69 at 76.

<sup>31</sup> V Rotaru, "The Restructuring Directive: A Functional Law and Economics Analysis from a French Law Perspective", *Droit et Croissance Working Paper* (30 September 2019), at para 107; and A Pietrancosta and S Vermeille, "Le droit des procédures collectives à l'épreuve de l'analyse économique du droit. Perspectives d'avenir?", *RTDF* (2010) 1 at 15.

French insolvency law is also known internationally for its rather low level of involvement of creditors and the protection of their interests *vis-à-vis* other stakeholders.<sup>32</sup> As a result, the French regime ranks quite low in international studies, which often rely predominantly on the role of creditors in insolvency procedures, as well as their recovery rates.<sup>33</sup> It is, therefore, not surprising that commentators have branded France as “bias[ed] in favour of both the management of the failing business and its shareholders”,<sup>34</sup> thereby calling for a rebalancing of the protection afforded to creditors.<sup>35</sup>

### 1.3.2 Ongoing reforms

At the time of writing, the French Commercial Code has yet to be amended to reflect the provisions of Ordinance n°2021-1193 Amending Book VI of the Commercial Code (the Ordinance).<sup>36</sup> The latter was enacted on 15 September 2021, with a view to transposing the EU Directive on Preventive Restructuring (the Directive).<sup>37</sup> These reforms will not impact the current local public entities legal framework. The following two points are of particular importance in the current reforms:

- (i) the reform of classes of creditors; and
- (ii) cross-class cram down possibilities.

Firstly, article 11 of the Ordinance states that the definition “creditors’ committees” shall be replaced by “classes” of creditors. Article 37 of the Ordinance further states that the rewritten sup-paragraph I of article L626-30 will provide that only the affected parties, divided into classes, vote on the draft safeguard plan. Affected parties are those whose rights are directly affected, and that is likely to be modified in any way by the restructuring plan. It has been decided that the equity holders can, if necessary, be integrated into the classes in this capacity, as allowed by article 9 of the Directive.

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<sup>32</sup> G Plantin *et al*, French Council of Economic Analysis, “Les notes du conseil d’analyse économique” No. 7 (June 2013), at 1; and L Spizzichino *et al*, “Les perspectives d’évolution du rôle des créanciers en droit des entreprises en difficulté”, *RPC* (2019) 3 at 1.

<sup>33</sup> See World Bank, “Doing Business Report”, published annually. The 2018 report states the recovery rate of creditors in a fictitious case under consideration is estimated at 74.8%, while it is well above 85% in other European countries such as Denmark, Finland, Ireland, the Netherlands, Norway, Slovenia and the United Kingdom. See also S Davydenko and J Franks, “Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK”, *Journal of Finance* (2008) 63 at 565.

<sup>34</sup> S Vermeille and A Pietrancosta, “A Critical Appraisal of French Bankruptcy Law Through the Lens of the Law and Economics Movement: A Solution for the Future?”, *Revue Trimestrielle de Droit Financier* (2010) 1, at para 39.

<sup>35</sup> G Plantin *et al*, French Council of Economic Analysis, “Les notes du conseil d’analyse économique” no 7 (June 2013), at 1.

<sup>36</sup> The Ordinance is available at <https://www.legifrance.gouv.fr/jorf/id/JORFTEXT000044044563>.

<sup>37</sup> Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132, OJ L 172/18.

Sub-paragraph III of the same article lists the criteria for distribution of creditors in the classes. This distribution is left to the administrator (*administrateur judiciaire*), who must rely on verifiable objective criteria (*sur la base de critères objectifs vérifiables*). The administrator must group creditors into classes of creditors, that share a sufficient commonality of economic interests (*classes représentatives d'une communauté d'intérêt économique suffisante*). These criteria are assessed according to the status of the creditors' claims as defined before the date of the opening of the procedure.<sup>38</sup> In addition to these general criteria, the Ordinance predefines a certain number of classes and provides that:

- (i) secured creditors who hold security against the debtor's property must be grouped separately from other creditors;
- (ii) the creation of classes must respect the subordination agreements concluded before the opening of the procedure;
- (iii) equity holders should be grouped within a specific class (or several); and
- (iv) claims resulting from employment contracts, professional pension rights and maintenance claims should not be affected by the plan.

Acting upon the possibility offered by the Directive,<sup>39</sup> the French legislator has decided to exclude debts resulting from employments contracts from the restructuring plan subject to a vote. This will be reflected in sub-paragraph IV of the new article L626-30.

Secondly, following the transposition of the Directive, several concepts will be introduced into French law, including the mechanism of cross-class cram-down. The new article L626-32 will allow the court, with the agreement of the debtor, to sanction a safeguard or rehabilitation plan even if creditors or classes of creditors have voted against the plan. France has decided to follow the absolute priority rule, rather than that of relative priority. The absolute priority rule is counter-balanced by the possibility for the court to take into account the specific situation of the creditors.

The mechanism should be welcomed in the French regime, as long as safeguards are put in place to ensure that creditors are not treated unfairly, which will be incumbent upon judicial authorities. One such safeguards is the best-interest-of-creditors test. This test requires that no dissenting creditor may be worse off under the restructuring plan than they would be in the case of either liquidation, or the next-best alternative scenario if the restructuring plan were not confirmed.<sup>40</sup> The current test in France is a fairness test whereby the court must verify that the interests of all creditors are sufficiently protected<sup>41</sup>

<sup>38</sup> Commercial Code, art L626-30-1.

<sup>39</sup> Directive, art 13.

<sup>40</sup> *Idem*, recital 52.

<sup>41</sup> Commercial Code, art L626-31 provides that: "*il s'assure que les intérêts de tous les créanciers sont suffisamment protégés*".



by looking at the: (i) proposed restructuring plan, and (ii) economic, social and environmental assessment drafted by the administrator.

Sub-paragraph IV of article L626-31 of the Commercial Code will now include, in alignment with the Directive, the criterion of the best-interests-of-creditors test (*critère du meilleur intérêt des parties affectées*). The French court will now need to verify if this test is met if affected parties vote against the restructuring plan. The verification must focus on three aspects:

- (i) the distribution of the assets of the debtor in a liquidation procedure;
- (ii) the distribution of the sale price in accordance with article L642-1; and
- (iii) a better alternative solution if the plan is not adopted, which means that the court must consider the possibility of the continuation of economic activity (going concern) by applying another scenario than the adoption of the restructuring plan.

## **2. Local public entities**

### **2.1 The concept of public service**

In France, (local) public entities are built on the notion of “public service” which is an activity whose objective is to satisfy a need of general interest among the population. Public services are rooted in three fundamental principles:

- (i) continuity, which implies that the activity must be carried out without discontinuity;
- (ii) mutability, which implies that public services must adapt to the evolution of collective needs; and
- (iii) equality, which prohibits discrimination between service users.

Public services can have a regulatory function (national defence, justice, civil protection, etcetera), a social and health function (social security, hospitals, etcetera), an educational and cultural purpose (education, research, audio-visual service, etcetera) or an economic and industrial one.

The diversification of public services over the years, as well as the creation of economic and industrial public service missions, have led to different ways of managing public services. They can be managed either by a public entity or by a private one. If the public service is managed by a public entity, it can be managed directly by (i) the person holding the competence (the State, a territorial authority (*collectivité territoriale*), a municipality, etcetera) or (ii) an autonomous legal entity – that is a publicly owned establishment

(*établissement public*) created either by the State or by a territorial authority or a public utility establishment (*établissements d'utilité publique*).

## 2.2 Public utility establishments (*établissements d'utilité publique*)

Public utility establishments are legal persons governed by private law, that carry out tasks of public utility. They are defined by the law as "establishments which, excluding material benefit, aim to achieve work of a philanthropic, scientific, artistic or pedagogical nature."<sup>42</sup>

## 2.3 Publicly owned establishments (*établissements publics*)

Publicly owned establishments are legal persons under public law. They are financed by public funds and must fulfil a mission of general interest. They are distinguished from public companies that are legal entities with public capital, but which are governed by private law and do not necessarily fulfil a mission of general interest. Publicly owned establishments are granted a certain amount of administrative and financial autonomy, so that they can fulfil a precisely defined mission of general interest. This task must be precisely defined and exercised under the control of the public authority upon which the public entity depends (the State or a municipality).

According to article 34 of the French Constitution, the creation of categories of publicly owned establishments is governed by law. They belong to the State or to territorial authorities, which can include a municipality, a group of municipalities, a department, a region or an overseas territory. However, the nature of the administration to which the publicly owned establishment belongs does not determine the geographical area of action of the latter. Therefore, a local publicly owned establishment may have a national, or even international, scope of action.

Publicly owned establishments include, for example, hospitals, high schools, universities and some museums. Being entities governed by public law, they can exercise certain rights and enjoy certain privileges reserved for public authorities, such as owning public domain property,<sup>43</sup> exercising the right of expropriation,<sup>44</sup> being invested with administrative police powers, and benefiting from the un-seizability of property.<sup>45</sup>

As a result, national and local publicly owned establishments are also subject to strict and regular controls by the State, via public administration entities, in respect of technical, budgetary and accounting matters.<sup>46</sup> Accounting reporting is carried out by public accountants, while controls are also carried out on a regular basis by government commissioners and state auditors as well as by the General Inspectorate of Finance (*inspection générale des finances*) and by the General Accounting Office (*Court des*

<sup>42</sup> Law 004/2001 of 20 July 2001, art 58.

<sup>43</sup> Public Property Code, art L1 (*code général de la propriété des personnes publiques*).

<sup>44</sup> Conseil d'Etat, 17 March 1972, no 79743, *Levesque*.

<sup>45</sup> Public Property Code, art L2311-1.

<sup>46</sup> See for example, Decree 53-707 of 9 August 1953, supplemented by Decree 55-733 of 26 May 1955.

*Comptes*), or the Regional Chambers of Accounts (*chambres regionales des comptes*). Pursuant to article L221-6 of the Territorial Authorities Code (*Code général des collectivités territoriales*), publicly owned industrial and commercial establishments (see below) are also subject to audits carried out by the national inspectorates: the general inspectorate of administration (*inspection générale de l'administration*), the general financial inspectorate (*inspection générale des finances*) and the general social inspectorate (*inspection générale des affaires sociales*), assisted by the relevant ministerial inspectorates (*inspections générales ministérielles*).<sup>47</sup>

Publicly owned establishments can be dissolved, even though it is a rare occurrence due to a preference in French practice for their merger. The dissolution of a publicly owned establishment is effected by an act of a similar nature to the act which created the establishment (law, ordinance or decision of the territorial authority). If a publicly owned local establishment is dissolved, its assets and liabilities are transferred to the authority to which it belongs (State or territorial authority).

### **2.3.1 Publicly owned administrative establishments (*établissements publics à caractère administratif*)**

Although the norms to which publicly owned establishments are subject can vary greatly, case law and the French doctrine have identified two main types of public entities: publicly owned administrative establishments (*établissements public à caractère administrative (EPA)*), and publicly owned industrial and commercial establishments (*établissements public à caractère industriel et commercial (EPIC)*). Generally, public entities of an administrative nature are governed by public law while public entities of an industrial and commercial nature are governed mostly by private law.

In the absence of a specific qualification by a legislative text, a publicly owned establishment is presumed to be a publicly owned administrative establishment (EPA), unless three criteria which define a publicly owned industrial and commercial establishment (EPIC) are met, namely the:

- (i) purpose of the service proposed: an EPIC will carry out the sale or production of goods or provide a service;
- (ii) origin of its resources: an EPIC is mainly funded by the revenue from the sale of goods or services; and
- (iii) way in which the entity is managed: if the establishment is managed relatively similarly to a private company, it will be considered to be an EPIC.<sup>48</sup>

<sup>47</sup> Territorial Authorities Code, art R2221-12.

<sup>48</sup> Conseil d'Etat, Ass 16 November 1956, no 26549, *Union syndicale des industries aéronautiques*.

EPA include, for example, national social security funds (*caisses nationales de la sécurité sociale*), the French public employment service (*pôle emploi*) and some cultural entities (*Bibliothèque nationale de France; musée du Louvre; musée d'Orsay; musée et domaine national de Versailles*).

They benefit from some administrative and financial autonomy so that they can carry out a task of general interest. An EPA is governed by public administrative law. Its staff is composed of public servants and its decisions amount to administrative acts. Conflicts are subject to administrative law and the administrative legal system.

### **2.3.2 Public entities of an industrial and commercial nature (*établissements publics à caractère industriel et commercial*)**

EPICs are the second category of publicly owned establishments (EPIC). They include state-controlled entities of an industrial and commercial nature. EPICs were first recognised as a specific form of public entities by the Dispute Tribunal (*Tribunal des conflits*) in 1921.<sup>49</sup> They can belong to the State (national public entity of an industrial and commercial nature) or to a territorial authority (local public entity of an industrial and commercial nature).

EPICs include, for example the French Development Agency (*Agence française de développement*), the National Consumption Institute (*Institut national de la consommation*), the RATP Group (*Régie Autonome des Transports Parisiens*), the Paris Opera (*Opéra de Paris*), and the National Forests Office (*Office national des forêts*).

EPICs are mostly governed by private law, yet some public law rules also apply to them. EPICs are created to carry out an activity similar to that of a private company - thus, to carry out an economic activity. The creation of an EPIC allows the State or a territorial authority to take control of an economic activity while also delegating the management of the activity and the public entity. Once created, an EPIC can be given an entirely new task to carry out or, alternatively, the State or territorial authority which created it can delegate a task which it previously carried out itself.

EPICs are independent and autonomous entities, which is reflected in the fact that they hold autonomous assets and they have an autonomous budget, independent from the budget of the State or territorial authority to which it belongs. This budget is made up of:

- (i) income generated from the payment of services performed or goods sold by the EPIC;
- (ii) donations; and
- (iii) loans.

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<sup>49</sup> Tribunal des conflits, 22 January 1921, no 00706, *Société commerciale de l'Ouest africain*.

## 2.4 Commentaries

### 2.4.1 *Publicly owned establishments and public utility establishments*

The distinction between publicly owned establishments and public utility establishments is peculiar to the French administrative system. This distinction has been criticised by commentators for being counterproductive and costly – creating a gap between entities belonging to the State and other social institutions.<sup>50</sup> Generally, while a publicly owned establishment is a legal person governed by public law and a public utility establishment is a private organisation governed by private law, it is, in practice, difficult to find explicit criteria to determine if an entity is a publicly owned establishment or a public utility one. As a result, the court will need to look at the intention of the public authority which created the entity in order to determine which type of entity is being dealt with.

### 2.4.2 *The case of the EPIC*

The lack of private capital of publicly owned establishments creates issues in respect of several principles, such as (i) external financing other than through indebtedness (due to the impossibility to increase the establishment's capital), (ii) incorporation into a subsidiary through another public entity or a public limited company, and (iii) payment of a dividend to the entity which created the publicly owned establishment (the State or territorial authorities), due to the absence of shareholding.

To remedy some of these issues, the French legislator has brought the EPIC's regime closer to that of a public limited company. With respect to dividends, article 79 of Law n°2001-1276 of 28 December 2001 allowed the State to receive a dividend on the profits of public entities under its supervision. Article L2102-4 of the Transport Code (*Code des transports*), introduced by Law n°2014-872 of 4 August 2014 states that the prerogatives of the *Société Nationale des Chemins de Fer* (SNCF) are similar to those that a company exercises over its subsidiaries. The SNCF can, therefore, create subsidiaries or hold stakes in companies or corporate groups with a view to carrying out any task supporting its overall mission.

While EPICs benefit from several advantages mentioned above in relation to public entities (for example owning public domain property, exercising the right of expropriation, and benefiting from the un-seizability of property), they are also subject to several constraints. The main point of contention is the fact that the governance of an EPIC is often quite complex as it combines elements of public and private law. For example, the EPIC's staff (except the head of the entity and the accounting officer) are subject to labour law,<sup>51</sup> and the contracts it enters into are governed by private law.

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<sup>50</sup> M Hauriou, "La distinction des établissements publics et des établissements d'utilité publique", Note sous Conseil d'Etat, 22 May 1903, Caisse des écoles du 6<sup>e</sup> arrondissement de Paris, 22 May 1903 *Revue générale du droit* (2014).

<sup>51</sup> Conseil d'Etat, sect, 8 March 1957, no 15219, *Jalenques de Labeau*.

Commentators have criticised the status of EPICs for being both in and out of the market and, therefore, not being fully compliant with traditional market rules. For example, EPICs do not engage with market competition<sup>52</sup> and this distortion with economic reality affects the EPIC's customer and the taxpayer, who are often the same person. Profits go to the EPIC while losses impact taxpayers.

### 3. Dealing with local public entities in distress - the legal framework

The insolvency rules under Title VI of the Commercial Code only apply to legal persons governed by private law, even those without a commercial nature.<sup>53</sup> All legal persons governed by public law are excluded from insolvency law rules, regardless of the nature of their activity and regardless of their denomination. As such, publicly owned establishments are not subject to these insolvency rules. However, insolvency rules apply to public utility establishments.

#### 3.1 Publicly owned establishments

Publicly owned establishments, as legal entities governed by public law, are not subject to insolvency law procedures by virtue of the general principle of the immunity from seizure of the assets of legal entities governed by public law, which has been recognised by French Courts, including the French Supreme Court (*Cour de Cassation*).<sup>54</sup> This rule applies to both EPAs and EPICs.

These establishments are subject to the Law of 16 July 1980 which provides that the State is the authority responsible for paying the debts of publicly owned establishments. Article 1, Section II of this Law states that:

“Where a judicial decision which has become final orders a local authority or a publicly owned establishment to pay a sum of money the amount of which is fixed in the decision itself, payment of the sum must be ordered within two months of notification of the decision, If payment is not ordered within that period, the representative of the State in the department or the supervisory authority shall give the authority or establishment formal notice to create the necessary resources; if the decision-making body of the authority or establishment has not released or created the resources, the representative of the State in the department or the supervisory authority shall do so, and if necessary shall issue a mandatory payment order.”

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<sup>52</sup> See “Dealing with Local Public Entities in Distress - Law in Practice” below in this regard.

<sup>53</sup> Before the Law of 13 July 1967, insolvency rules would only apply to legal persons conducting a commercial activity.

<sup>54</sup> *Cour de Cassation*, ch, civile, 21 December 1987, 86-14.167.

Decree of 12 May 1981 further states that:

“If the notice given has had no effect by the time these deadlines expire, the representative of the State or the authority responsible for supervision shall enter the expenditure in the budget of the defaulting authority or publicly owned establishment. The representative of the State or the authority responsible for supervision shall, as appropriate, release the necessary resources either by reducing the appropriations allocated to other expenditures and still available or by increasing resources.”

If within eight days following notification of the entry of the expenditure in the budget, the local authority or publicly owned establishment has not ordered payment of the sum due, the representative of the State or the authority responsible for supervision shall within one month issue a mandatory payment order.<sup>55</sup>

By conferring on the State important prerogatives such as the issuing of a mandatory payment order and the creation of sufficient resources, the Law of 16 July 1980 and its implementing decree intended to ensure the enforcement of final judicial decisions ordering either the State, a local authority or a publicly owned establishment to pay a sum of money. They do not prescribe any insolvency procedure such as safeguard, rehabilitation or liquidation. Rather, this law created a principle of last-resort state liability for the debts of legal entities governed by public law.

Under the French regime, the inapplicability of insolvency law to legal persons governed by public law stems from the fact that such entity’s assets are unseizable. This principle has been recognised by French case law since the end of the 19<sup>th</sup> century.<sup>56</sup> This principle, however, does not exclude traditional administrative means of execution as provided for by the Law of 16 July 1980 and procedures leading to the forced transfer (non-seizure) of assets to the private domain. These include:

- expropriation;<sup>57</sup>

<sup>55</sup> Decree of 12 May 1981, art 3-1, sub-paras 4 and 5.

<sup>56</sup> Tribunal des conflits, *Association syndicale du canal de Gignac*, 9 December 1899, at 731; and Cour de Cassation, Civ 1<sup>ère</sup>, *Bureau de recherches géologiques et minières ‘BRGM Société Lloyd Continental’*, 21 December 1987, Bull civ I, no 348; Cour d’appel de Paris, *Sté PDG et B*, 15 February 1991, no 9021744, DA 1991, no 184.

<sup>57</sup> Conseil d’Etat, sect des finances, avis, 27 April 1961, *GACE*, 3<sup>e</sup> éd, 2008, no 3, comm Y Gaudemet; Conseil d’Etat, 29 July 1994, no 111650, *Commune d’Auris-en-Oisans*, Lebon 983; LPA 24 May 1995, at 9, chron J Morand-Deville; RDI 1995. 85, chron B du Marais and C Morel; Cour Administrative d’Appel Nancy, 29 September 2005, no 02NC00297, *Syndicat intercommunal des eaux de Piennes*, AJDI 2006 212, obs R Hostiou; Cour Administrative d’Appel Lyon, 5 July 2007, no 05LY00276, *Ministre de l’équipement, du tourisme et de la mer c / Commune de Chamonix-Mont-Blanc*, AJDA 2008 59; and Cour Administrative d’Appel Nancy, 11 March 2010, no 09NC00854, *Caisse des dépôts et consignations*.

- retrocession of expropriated buildings that have not achieved their intended use;<sup>58</sup>
- sale of local authorities' and local public entities' assets by the prefect at the request of unpaid creditors;<sup>59</sup> and
- prohibition of taking security over the public entity's assets, in particular mortgages.<sup>60</sup>

On this point, it is considered that the latter (taking security) cannot be taken over public assets, because of the inalienability of the public domain, but also because even within the private domain, a mortgage would be contrary to the principle of unseizability.

This position has led commentators to argue that a unique security system could be created for certain public assets by linking them to the enforcement of procedures existing under administrative law, arguing in favour of the creation of an "administrative securities" regime. This would in turn facilitate loans to territorial authorities and lower the cost of credit by offering more security to financial partners.<sup>61</sup>

In any event, and as a result of the unlimited guarantee of the State principle, in the event of the winding-up of a publicly owned establishment, its debts will be transferred to the State or to another public entity. This is based on the principle of continuity of the public service.

### 3.2 Public utility establishments

The situation is different for public utility establishments as they are governed by private law. As such, they are subject to the "normal" rules of corporate insolvency law. Title VI of the Commercial Code applies to any legal person subject to private law, including public utility establishments. Therefore, public utility establishments can go through liquidation as well as restructuring procedures. They benefit from all traditional restructuring tools, such as a moratorium, the possibility to leave the debtor in possession, as well as the possibility to cram-down dissenting creditors.

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<sup>58</sup> D Dutrieux, "Expropriation et rétrocession", *JCP N* 2013, no 1021; D Dutrieux, "Le droit de rétrocession de l'article L 213-11 du Code de l'urbanisme", *JCP N* 2009, no 1314; and R Hostiou, "Affectation du bien exproprié et effectivité du droit de rétrocession: analyse de la situation de la France au regard de la jurisprudence de la Cour européenne des droits de l'homme", *Mélanges Y Jegouzo*, Dalloz, 2009, at 71.

<sup>59</sup> Conseil d'Etat 18 November 2005, no 271898, *Société fermière de Campoloro*, Lebon 515; Droit administratif 2006, comm 33, note C Guettier; Gazette du Palais 12-14 March 2006, at 30, obs D Linotte; Grandes décisions du droit administratif des biens, Dalloz, 2013, comm 88; and W Plateaux, "L'hypothèse de la vente forcée par une décision de justice: retour sur l'affaire du port de Campoloro", *ACCP* (December 2013).

<sup>60</sup> Y Gaudemet, "Hypothèque et domaines des personnes publiques", *Droit des affaires* (11 January 1996) 2 33; and Y Gaudemet, "L'entreprise publique à l'épreuve du droit public. Domanialité publique, insaisissabilité, inarbitrabilité", *Economica* (1996) 259.

<sup>61</sup> P Yokla, "Principe d'insaisissabilité et 'banalisation' de 'actionnariat public'", *AJDA* (2014) 460.



The courts in charge of the insolvency proceedings are the same courts that are in charge of corporate insolvency proceedings for private companies. This means that cases are either heard in the Commercial Court or the High Court (*Tribunal de Grande Instance*) depending on the nature of the debtor. Their role is the same as under corporate insolvency proceedings.

As per the “normal” corporate insolvency law rules, public utility establishments can make use of conciliation, safeguard (and its expedited variant), rehabilitation and liquidation procedures.

However, with regard to the consequences of insolvency, a distinction must be made between a public service of an administrative nature or of an industrial and commercial one. For administrative public services, if the establishment is dissolved, the service will fall back within the local authority as the principle of continuity of public service applies. The situation is more complex when the public service is of an industrial and commercial nature. Legally, these situations are often regulated by *ad hoc* legal instruments, however politically, they can lead to difficulties. For instance, if a secondary school is liquidated because of a lack of sufficient enrolment numbers, it will be necessary to ensure that the remaining students can continue with their schooling and this may lead to the putting into place of school transport systems. This may lead to discontent from the local population and a rise in costs.

### 3.3. Commentaries

A point which has been raised on occasions in French scholarship on the failure of public establishments relates to the concept of public service delegation contracts. Public service delegation occurs when a public service mission is entrusted to an external operator (public or private entity) by a public establishment. While the delegated entity is responsible for providing, operating and maintaining the public service mission, the public establishment remains responsible for the service and must therefore exercise control to ensure that it is carried out in the public interest.

As mentioned above, public establishments benefit from an automatic, unlimited, guarantee from the State. The question as to the payment of debts contracted by the public service mission when the delegated entity becomes insolvent therefore arises. To ensure the continuity of the public service, the process is akin to a personal guarantee as it leads to a change of debtor (for instance, the State) which means that the delegatee’s creditors will be repaid out of the public domain if the delegates become insolvent. As a result, the French system derogates to the principle according to which a transfer of competence leads to a transfer of responsibility.<sup>62</sup>

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<sup>62</sup> L Bahougne, “La responsabilité subsidiaire des personnes publiques pour les dettes de leurs délégués insolubles”, *RFDA* (2017) at 1149.

#### 4. Dealing with local public entities in distress - law in practice

The fact that French publicly owned establishments benefit from an automatic, unlimited, guarantee from the State has been criticised on several occasions by the European institutions.

##### 4.1 *Électricité de France*

On 16 December 2003, the European Commission published its decision on the issue of state aid granted by France to *Électricité de France* (EDF), the national gas service.<sup>63</sup> EDF produces, transmits and distributes electricity throughout France. At the time, the European Commission noted that EDF was one of the largest groups on the European energy market and related markets.<sup>64</sup> EDF was set up by Law n°46-628 of 8 April 1946 in the form of a publicly owned establishment, which meant that it was not subject to corporate insolvency law rules.

The European Commission made reference to articles 87 and 88 of the treaty establishing the European Community (EC Treaty)<sup>65</sup> and determined that France was allocating an unlimited state guarantee to EDF and announced that France should withdraw such aid. It argued that the unlimited state guarantee precluded the application of the legislation on the administration and compulsory liquidation of firms in difficulty.<sup>66</sup> It referred, in particular, to the matter of state aid in the form of guarantees as per the EC Treaty, which is comprised of “the more favourable funding terms obtained by enterprises whose legal form rules out bankruptcy or other insolvency proceedings or provides an explicit State guarantee or coverage of losses by the State.”<sup>67</sup> The European Commission thus took the view that the fact that EDF could not be subject to insolvency law proceedings - and by extension, could not be declared insolvent - was equivalent to a general unlimited guarantee covering all of its liabilities. Such a guarantee cannot be remunerated according to the rules of the market and because it is unlimited in scope, time and amount, it was declared to constitute unfair state aid.<sup>68</sup>

The issue found by the European Commission was the discrepancy in the risks facing creditors. Where a private company is no longer able to pay its debts and cannot be restructured, it is placed under compulsory liquidation. Its assets are seized and sold and the proceeds of their sale serve to pay off creditors according to the legal ranking in France. However, since in practice the assets of the company are often worth much less than its liabilities, the proceeds of the sale are seldom sufficient to repay all of the creditors’

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<sup>63</sup> Commission Decision of 16 December 2003, on State aid granted by France to EDF and the electricity and gas industries, 2005/145/EC, OJ L 49/9.

<sup>64</sup> *Idem*, para 8.

<sup>65</sup> Currently the Treaty on the Functioning of the EU (TFEU), arts 107 and 108.

<sup>66</sup> Commission Decision of 16 December 2003, on State aid granted by France to EDF and the electricity and gas industries, 2005/145/EC, at para 2.

<sup>67</sup> *Idem*, para 56.

<sup>68</sup> *Idem*, para 57.

claims. The creditors of a private company are, therefore, exposed to two risks in case of insolvency: (i) the company can be put into compulsory liquidation should it suspend payments, and (ii) the procedure does not guarantee that the creditors will recover their claims.

Publicly owned establishments, on the other hand, cannot be put into compulsory liquidation and their assets are unseizable – it cannot be sold to repay creditors. The debts of public establishment are paid in accordance with a special procedure established by Law n°80-539 of 16 July 1980, whereby they must, if they have insufficient funds, obtain the necessary resources.<sup>69</sup> If the publicly owned establishment does not comply, the supervisory authority (the State or a territorial authority such as a municipality) itself issues a mandatory payment order for the expenditure in question. The Law of 16 July 1980 does not rule out the possibility for the supervisory authority to release the necessary resources itself, either by reducing the funds allocated to other expenditures or by increasing resources.

The European Commission found that EDF might be placed in an economic advantage, mainly through funding terms considered more favourable, even if EDF and its subsidiaries were not the subject of a financial rating by an external rating agency. EDF might also have been advantaged in its dealings with customers and suppliers in so far as they believed their claims to be covered by a state guarantee. In addition, the European Commission stressed that there had never been a winding-up of publicly owned establishments in which the obligations of the establishments were also cancelled. In the event of publicly owned establishments being closed down by decision of a public authority, the rights and obligations of publicly owned establishments that are closed down are always taken over by another body and, failing that, by the State. In other words, the debts of public owned establishments are always transferred to another legal person, which cannot refuse them, so that each creditor can therefore be certain that the right arising from its claim may be invoked against another body.

The creditors of a public establishment, therefore, are not exposed to any risk of their claims not being paid – not only can the public establishment not be declared insolvent, but the law also guarantees the payment of their claims through special administrative procedures. The special procedure applicable to public establishments cannot, therefore, be compared to the compulsory liquidation procedure available to private companies. On the contrary, the European Commission found that French law strengthened the effect of the unlimited state guarantee enjoyed by EDF on account of the fact that it cannot be declared insolvent. The European Commission also found that EDF, due to the impossibility of becoming insolvent, could therefore borrow at lower rates than those normally offered to private companies which can be subject to insolvency procedures, since the credit terms obtained by an enterprise vary according to its risk of insolvency (the higher the risk, the more costly the credit terms). The unlimited state guarantee was thus deemed to confer on EDF an advantage that strengthened its position in relation to its

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<sup>69</sup> See Law 80-539 of 16 July 1980, art 1.

competitors. As a result, it was found that it distorted competition within the meaning of article 87(1) of the EC Treaty. The European Commission reiterated its position in its 2015 decision,<sup>70</sup> which was confirmed by the General Court of the Court of Justice of the European Union (CJEU) in 2015.<sup>71</sup>

#### 4.2 *La Poste*

Similarly, in a decision on 26 January 2010, the European Commission found that the public establishment *La Poste* (the French national postal service), by virtue of its status as a public establishment (EPIC) benefited from an implicit, yet unlimited, guarantee from the State.<sup>72</sup> The European Commission's position was confirmed by the CJEU who argued that the inapplicability of insolvency law to public establishments – which inherently excludes the possibility of failure by these establishments – guarantees that a creditor's claim will always be repaid, thereby giving the public establishment a financial advantage over the rest of the market, and making the State the guarantor of EPICs' debts. The CJEU observed that this conferred a notable advantage to EPICs while also draining public resources.<sup>73</sup>

#### 4.3 *Institut Français du Pétrole*

Against the background of these decisions set out above, it is interesting to consider the decision rendered by the European Commission on 29 June 2011.<sup>74</sup> The *Institut Français du Pétrole* (IFP) was a public owned industrial and commercial establishment (EPIC) created by decree in July 2006.<sup>75</sup> The IFP performed three tasks: (i) research and development in the fields of oil and gas prospecting and refining and petrochemicals technologies, (ii) the training of engineers and technicians, and (iii) the provision of sector information and documentation. The IFP also indirectly controlled commercial enterprises with which it had concluded exclusive research and licensing agreements. IFP was the parent company of a corporate group, for the purposes of EU competition law.

What was of particular interest in this case was that the European Commission distinguished between the economic and non-economic activities of the IFP, which was an EPIC. While the European Commission took the view that the primary activities of research organisations are normally of a non-economic character, it also considered that research carried out under contract with industry, the renting out of research infrastructure and

<sup>70</sup> Commission Decision of 22 July 2015, on State aid SA 13869 (C 68/2002) (ex NN 80/2002) – reclassification as capital of the tax-exempt accounting provisions for the renewal of the high-voltage transmission network (RAG) implemented by France in favour of EDF, 2016/154/EU, OJ L 34/152.

<sup>71</sup> Case T-747/15, *EDF v European Commission*, ECLI:EU:T:2018:6.

<sup>72</sup> Commission Decision of 26 January 2010, on State aid C-56/07 (ex E 15/05) granted by France to La Poste, 2010/605/EU, OJ L 274/1.

<sup>73</sup> Confirmed in Case C-559/12, *French Republic v European Commission*, ECLI:EU:C:2014:217, at para 98.

<sup>74</sup> Commission Decision of 29 June 2011, on State aid granted by France to the Institut Français du Pétrole (Case C 35/08 ex NN 11/08), 2012/26/EU, OJ L 14/1.

<sup>75</sup> Decree 2006-797 of 6 July 2006. IFP has since been replaced by the IFP Energies Nouvelles.

consultancy work, constitutes economic activities.<sup>76</sup> In the case at hand, while the majority of IFP's activities were considered non-economic, IFP also provided services consisting in renting out infrastructures and premises, providing staff and supplying legal services for third parties and its subsidiaries, as well as some technology transfers between IFP and its subsidiaries. The latter were considered to be economic activities.<sup>77</sup> The European Commission determined that among the activities carried out directly by IFP, there could be a state aid element only in the guarantee-cover given to activities of an economic character, as provided by article 107 of the TFEU.<sup>78</sup>

Additionally, while the *La Poste* decision focused on inferring an economic advantage for *La Poste* based on the implicit guarantee of the State which benefits the publicly owned establishment in the context of its relations with banking and financial institutions in particular, a later decision (*Institut Français du Pétrole*) extended the scope of the benefit to the entity's relations with its suppliers and customers as well.

This decision was significant since the European Commission considered that given the residual nature of IFP's economic activities,<sup>79</sup> the state aid conferred on the institution by the unlimited state guarantee was compatible with internal market rules. This was an important clarification because many publicly owned establishments are in a similar situation to IFP with regard to the scope of application of competition law and state aid.<sup>80</sup>

#### 4.4 Commentaries

Following these several decisions by the European Commission regarding French public entities, several large French public service entities (EPIC) were converted into companies.<sup>81</sup> Two comments can be made in this regard. Firstly, this change of status was mostly the result of the French legislator's desire to adopt this legal form, rather than a requirement by the European Commission.<sup>82</sup> Secondly, the European Commission noted that the State was a majority shareholder in most of these newly created companies and associated this fact with another type of state aid. Thus, the problem was displaced but not resolved.

Another issue that should be noted is that in order to meet the competition requirements of the European Commission, the assets of these companies should essentially be subject to normal legal rules. However, in view of their public service purpose, the French

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<sup>76</sup> Commission Decision of 29 June 2011, on State aid granted by France to the *Institut Français du Pétrole* (Case C-35/08 ex NN 11/08)), 2012/26/EU, OJ L 14/1, at paras 183 and 185.

<sup>77</sup> *Idem*, paras 187-188.

<sup>78</sup> *Idem*, para 190.

<sup>79</sup> *Idem*, para 266.

<sup>80</sup> TFEU, arts 107 and 108.

<sup>81</sup> *France Télécom* in 2003; *Électricité de France* and *Gaz de France* in 2004; *Aéroports de Paris* in 2005; *La Poste* in 2010; and *SNCF* in 2018.

<sup>82</sup> See, for example, Law 2018-515 of 25 June 2018. See generally M Lombard, "L'établissement public industriel et commercial est-il condamné?", *AJDA* (16 January 2006) at 82.

legislator has attached to them a number of legal servitudes, described as “quasi-public property” provisions. These include, for example, the functional unseizability of the assets or a mechanism preventing their transfer. These provisions are rooted in a functional understanding of proprietary assets according to which it is the usage alone that dictates the legal regime of property, not its ownership.

The European Commission’s condemnations have been criticised by some commentators who argue that the very existence of a guarantee given by the State to public entities is highly questionable.<sup>83</sup> Since Law n°2001-692 of 1 August 2001 came into effect, guarantees granted by the State must be explicit, not implicit. Even if one were to consider that an implicit guarantee existed, the unlimited character of the guarantee could be removed. During the debates around EDF, the then commissioner of the European Commission in charge of Competition (Mario Monti), recalled that EU law is without prejudice to the rules governing the system of property ownership in the member states. The unlimited nature of the guarantee granted to EDF, and not its existence was the issue.

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<sup>83</sup> See for example, C Barthélémy, “La garantie implicite, gratuite et illimitée de l’État aux établissements publics: mythe ou réalité?”, *RJEP* (2004) at 423; and D Labetoulle, “La responsabilité des autorités administratives indépendantes dotées de la personnalité morale: coup d’arrêt à l’idée de garantie de l’État - A propos de l’avis du Conseil d’État du 8 septembre 2005”, *RJEP* (2006) at 359.

## Local public entities in distress - a critical analysis of the Ghanaian approach

By Kenneth NO Gharthey\*

Research into insolvency law and the legal implications of severe personal and corporate indebtedness in Ghana is limited.<sup>1</sup> It is little wonder, therefore, that the legal treatment of financial distress of local public entities has received close to no attention within the Ghanaian legal academic literature. This chapter sheds light on the Ghanaian insolvency landscape and legal framework, and sets out the treatment of the distressed entities which qualify as local public entities in that context. It aims to provide a background for future policy making and law reform.

### 1. General context of insolvency law

Ghanaian corporate law has been influenced by the transplantation of English legal rules through colonialism. The territories that now compose the modern nation of Ghana gained independence from British colonial rule on 6 March 1957. The original development of Ghanaian corporate and insolvency law was marked by the adoption and adaptation of mid-20<sup>th</sup> century English corporate and insolvency frameworks in the decade following independence. The Ghanaian legal system has in recent years witnessed an overhaul of its general corporate law and insolvency and rescue regulatory system. Two significant pieces of legislation, the Companies Act 1963 (Act 179) and its counterpart legislation, the Bodies Corporate (Official Liquidation) Act 1963 (Act 180) were repealed in 2019 and 2020 respectively. Acts 179 and 180 were replaced by the Companies Act 2019 (Act 992) and the Corporate Insolvency and Restructuring Act 2020 (Act 1015) respectively.

#### 1.1 The existing legal framework for liquidation and corporate rescue in Ghana

The existing legal framework for liquidation and rescue of companies is covered by two relatively new laws: the Companies Act 2019 and the Corporate Insolvency and Restructuring Act 2020. The Companies Act 2019 deals primarily with the winding-up or liquidation of solvent companies. It also provides rules to reorganise or restructure companies in temporary financial distress not approaching insolvency. The Corporate Insolvency and Restructuring Act 2020 provides the framework for the administration and official winding-up of insolvent companies and other bodies corporate and related matters. The Corporate Insolvency and Restructuring Act 2020 provided, for the first time under Ghanaian law, a formal framework for the turnaround of financially distressed or insolvent companies.

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<sup>1</sup> S B Adarkwah, "The development of insolvency law in Ghana", *Commonwealth Law Bulletin* (2016) 42(4) 485 at 485.

The liquidation and rescue provisions within the Companies Act 2019 and the Corporate Insolvency and Restructuring Act 2020 do not apply to all incorporated entities. Companies specially licensed under specific legislation to conduct banking and other specialised deposit-taking business,<sup>2</sup> insurance business<sup>3</sup> and other businesses subject to special legislation are exempted from the application of the Corporate Insolvency and Restructuring Act 2020, except where the special legislation for these entities does not provide for a rescue provision.<sup>4</sup> Ghana's insolvency regulatory system, therefore, adopts a fragmented approach in providing for rules relating to corporate rescue and insolvency.

There is no formal data to firmly establish whether Ghana's insolvency system is regarded as creditor or debtor friendly. A fair anecdotal view of the old insolvency regulatory system under the Bodies Corporate (Official Liquidations) Act 1963 (Act 180) is that it was more creditor than debtor friendly. This is because it was unnecessarily skewed towards liquidation and allowed little room for rescue. The Memorandum to the Corporate Insolvency Bill as presented to the Ghanaian Parliament in 2019 indicated that the bill "seeks to promote private enterprise in Ghana".<sup>5</sup> Statements from advocacy and professional groups in Ghana such as the Business Sector Advocacy Challenge (BUSAC) Fund and the Ghana Association of Restructuring and Insolvency Advisors (GARIA), affiliated as a national organisation to INSOL International, show that they take a generally positive view on the new legal framework. The new law is intended to "facilitate access to timely, efficient and impartial insolvency proceedings either directly or through the creditor's committees".<sup>6</sup> The goal is that "the Act will promote efficient closure and transfer of assets of businesses which are no longer viable, and a proper winding up of businesses where the members for other reasons, decide to cease operations".<sup>7</sup>

In a similar strategy, the Companies Act 2019 balances the rights of the company and its creditors to achieve mutually beneficial corporate reorganisations. The current insolvency framework could, therefore, mark a shift from the liquidation-focused slant of the old framework towards rescue and the continuation of viable but currently distressed businesses. Overall, creditors no longer have the final defining powers they enjoyed in the previous insolvency system supported by the old companies and insolvency legislation. The new structure strikes a fairer balance between creditor and debtor interests.

### **1.1.1 Formal insolvency and rescue procedures under the Companies Act 2019**

There are six formal procedures available under the Companies Act 2019 relevant to insolvency and corporate rescue. These are schemes of arrangement, mergers, compromises, divisions, variations of shareholder and creditor class rights, and liquidation.

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<sup>2</sup> Banks and Specialised Deposit-Taking Institutions Act 2016 (Act 930).

<sup>3</sup> Insurance Act 2021 (Act 1061).

<sup>4</sup> Corporate Insolvency and Restructuring Act 2020 (Act 1015), s 1(3).

<sup>5</sup> Corporate Insolvency Bill 2019, Memorandum.

<sup>6</sup> D M Opoku, "Parliament passes Corporate Insolvency Bill", *Citinewsroom.com* (1 April 2020) available [here](#).

<sup>7</sup> *Ibid.*



A scheme of arrangement under the Companies Act 2019 “includes a reorganisation of the authorised shares of a company by the consolidation of shares of different classes; (b) division of shares into shares of different classes; or (c) combination of the methods ...”.<sup>8</sup> In a compromise, a company agrees with its creditors to cancel all or part of its debt, or to vary the rights of the creditors or the terms of a debt of that company and includes an alteration of the constitution of the company, that affects the ability of the company to pay a debt of the company.<sup>9</sup> A merger<sup>10</sup> may take place in two ways. Firstly, a merger by absorption, “by which the undertaking, property and liabilities of one or more companies, including the company in respect of which a scheme is proposed, are to be transferred to another existing company”.<sup>11</sup> Secondly, a merger by formation of a new company, “by which the undertaking, property and liabilities of two or more companies, including the company in respect of which the scheme is proposed, are to be transferred to a new company and the consideration envisaged for the transfer is shares in the transferee company received by a member of the transferor company with or without any cash payment to that member”.<sup>12</sup>

A division is a “scheme by which the undertaking, property and liabilities of a company, in respect of which a compromise or an arrangement is proposed, are to be divided among and transferred to two or more companies which are either...” existing companies or new companies.<sup>13</sup> The variation of class rights, including shareholder and creditor rights, is one of the formal procedures to achieve a corporate rescue.<sup>14</sup> This variation may be done with or without the sanction of court depending on whether this is expressly provided for in the constitution of the company. The procedure for winding-up under the Companies Act 2019 is only available to solvent companies. Under the old Companies Act 1963, the only formal option available to an insolvent company was liquidation. An insolvent company may now be rescued or liquidated under the successor legislation, the Corporate Insolvency and Restructuring Act 2020.

### **1.1.2 Insolvency and rescue under the Corporate Insolvency and Restructuring Act 2020**

There are two main formal corporate rescue and insolvency resolution procedures available under the Corporate Insolvency and Restructuring Act 2020, namely administration and official liquidation. Under the Corporate Insolvency and Restructuring Act 2020, administration is the “process of enabling the rehabilitation of a company that is financially distressed beginning when an administrator is appointed”.<sup>15</sup> Once triggered, the administration process may lead to the conclusion of a restructuring agreement with the company’s creditors. If the administration ends without the conclusion of a

<sup>8</sup> Companies Act 2019 (Act 992), Sch 1.

<sup>9</sup> *Ibid.*

<sup>10</sup> Referred to as amalgamations under the previous Companies Act 1963 (Act 179).

<sup>11</sup> Companies Act 2019 (Act 992), Sch 1.

<sup>12</sup> *Ibid.*

<sup>13</sup> *Ibid.*

<sup>14</sup> Companies Act 2019 (Act 992), s 50.

<sup>15</sup> Corporate Insolvency and Restructuring Act 2020 (Act 1015), s 169.

restructuring agreement, the company goes on into liquidation. Unlike the Companies Act 2019, in terms of the Corporate Insolvency and Restructuring Act 2020 a company may still be placed into administration rather than liquidation even when it is unable to pay its debts, or it has a negative net worth. Insolvency no longer results in automatic liquidation.

The process of administration is intended to provide “the temporary management of the affairs, business and property of a distressed company”<sup>16</sup> towards “an opportunity for the [distressed] company to as much as possible continue in existence as a going concern.”<sup>17</sup> In this respect, the Corporate Insolvency and Restructuring Act 2020 provides rules which may be used to place a temporary freeze on the rights of creditors and other claimants against a distressed company. This is expected to lead to the development and implementation of a restructuring plan. The basis of this restructuring plan is that it should result “in a better return for the creditors and shareholders of the company than would result from the immediate winding-up of a distressed company”.<sup>18</sup> Where it is clear, either before or after an administration has begun, that a distressed company is incapable of turnaround or is hopelessly insolvent, the only recourse is official liquidation.

### 1.1.3 Stakeholders in the rescue and insolvency management process

There are other stakeholders involved in the rescue and insolvency management process under Ghanaian law beyond the creditors and debtors. Overall regulatory control over insolvency practice and insolvency practitioners is exercised by a division of the Office of the Registrar of Companies known as the Insolvency Services Division.<sup>19</sup> The role of the Insolvency Services Division is to (i) regulate insolvency practice under the Companies Act 2019 and other enactments, (ii) review the law and practice relating to the insolvency of bodies corporate and to oversee the administration, restructuring and insolvency proceedings of companies and other bodies corporate, (iii) receive reports from liquidators and insolvency practitioners on the administration of insolvencies, (iv) receive reports from agents for debenture holders, trustees for security holders and auditors for companies in distress or in insolvent situations, (v) carry out research and commission studies, disseminate information and provide public education in insolvency administration, (vi) establish and maintain communications with international agencies, (vii) advise the Minister responsible for Justice through the Registrar of Companies on matters relating to the law and practice of insolvency and insolvency administration, and (viii) perform other functions required for the attainment of the objects of the Insolvency Services Division.<sup>20</sup>

The Insolvency Services Division was created in terms of the Corporate Insolvency and Restructuring Act 2020, that came into force on 30 April 2020. There is currently no indication of what impact the operational processes of the Insolvency Services Division will

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<sup>16</sup> *Idem*, s 1(1)(b).

<sup>17</sup> *Idem*, s 1(1)(a).

<sup>18</sup> *Idem*, s 1(1)(c).

<sup>19</sup> *Idem*, s 153 (1).

<sup>20</sup> Corporate Insolvency and Restructuring Act 2020 (Act 1015), s 153(3).

have on insolvency practice, as more than a year and a half after its creation, the Insolvency Services Division is yet to be properly set up and a detailed supporting legal and operational framework is also not in place.

The High Court of Ghana also plays a vital role in rescue and insolvency management under both the Companies Act 2019 and the Corporate Insolvency and Restructuring Act 2020. The High Court is at the lowest rung in the hierarchy of the Superior Courts of Judicature in Ghana. Generally, under Ghanaian law, the High Court has original jurisdiction in all matters except interpretation of the Constitution.<sup>21</sup> The High Court is superseded by the Court of Appeal and at the apex of the Superior Courts of Judicature is the Supreme Court of Ghana. Under the Companies Act 2019, the High Court sanctions or facilitates proposals for arrangements, compromises, mergers and divisions of companies especially when there is a dissent between creditors or shareholders.<sup>22</sup> The High Court also has the power to appoint a reporter to investigate the fairness of an arrangement or compromise agreed between a company, its shareholders and its creditors.<sup>23</sup>

Under the Corporate Insolvency and Restructuring Act 2020, the High Court has powers to ensure that the resolution by a meeting of creditors is passed in accordance with the views and interests of those creditors or a class of them.<sup>24</sup> The High Court can intervene to protect the property of a company in the enforcement of charges and the recovery of company property.<sup>25</sup> The High Court may also rule on the validity of a restructuring agreement if there is doubt, on a specific ground, as to whether the agreement complies with the Companies Act 2019.<sup>26</sup> The High Court has power to cancel the variation of a restructuring agreement by creditors<sup>27</sup> and on application by the company, a creditor, a restructuring officer or other interested party, it also terminate a restructuring agreement.<sup>28</sup> The High Court also has a host of other powers including the power to protect creditors during administration and determine the validity of the appointment of an administrator or restructuring officer.<sup>29</sup> One of the means to commence liquidation is by a petition to the High Court.<sup>30</sup>

There may also be appeals to the High Court in respect of a decision of a liquidator in two circumstances only, namely to challenge a liquidator's (i) payment out of the assets of the company to a person who prepares the statement of a company's affairs when the liquidator investigates the affairs of the company,<sup>31</sup> and (ii) a call on contributories to make

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<sup>21</sup> Constitution of the Republic of Ghana 1992, art 140(1); and Courts Act 1993 (Act 459), s 15.

<sup>22</sup> Companies Act 2019 (Act 992), ss 238 to 240.

<sup>23</sup> *Idem*, s 239(3).

<sup>24</sup> Corporate Insolvency and Restructuring Act 2020 (Act 1015), s 25.

<sup>25</sup> *Idem*, ss 30 and 31.

<sup>26</sup> *Idem*, s 54.

<sup>27</sup> *Idem*, s 55.

<sup>28</sup> *Idem*, s 56.

<sup>29</sup> *Idem*, ss 64-71.

<sup>30</sup> *Idem*, s 84.

<sup>31</sup> *Idem*, s 108(4).

payments into a liquidation fund.<sup>32</sup> To avoid protracted legal challenges, the structure within the Corporate Insolvency and Restructuring Act 2020 is such that matters requiring judicial intervention are designed to be resolved in the High Court. Further appeals from a decision of the High Court are not specifically provided for within the current companies and insolvency legislation. District and Circuits Courts, which are courts lower in the hierarchy than the High Court, have no role to play in corporate rescue and insolvency matters.

## 2. Local public entities under Ghanaian law

For an entity to be considered a local public entity within the meaning of this chapter, it must have the following characteristics: it must (i) be a public authority or other entity of a public nature, (ii) be funded partially or totally by taxes or other public levies, and (iii) also provide essential services such as transport, education, healthcare and utilities to the public. These services may be provided at market price or subsidised rates to local communities.

Typical local public entities will include municipalities, cities, districts, councils, provinces and other political sub-divisions of a state or country. There are also “hybrid” local public entities that do not satisfy the characteristics of the “basic” entities mentioned. Hybrid entities are private law entities, publicly or privately owned, that carry out fundamental services or are responsible for the production or distribution of essential goods and operate at a local, territorial or regional level within a country or state. There is no distinct concept of a local public entity under the Ghanaian constitutional architecture and in other law. The term “local public entity” is not currently in use under Ghanaian law. There are however entities within Ghana which will qualify as either local public entities or hybrid local public entities.

### 2.1 The equivalent of a local public entity under Ghanaian law

Ghana is a unitary republican state. It was a British colony until 6 March 1957 and after independence, the British monarch continued to serve as Head of State until the country became a republic on 1 July 1960. Through the colonial influence, English law has had a significant historical and continuing effect on Ghanaian law. This is even more so in company and commercial law (including insolvency law). The current Ghanaian Constitution was approved by referendum in November 1992 and came into effect on 7 January 1993. The Constitution is the supreme law, and every other law must be consistent with the Constitution to be valid.<sup>33</sup>

The Government of Ghana is a recognised legal entity and enters into contracts through Ministries, Departments and Agencies of the Government machinery as represented by a Minister, other political representative or an authorised senior civil servant. Apart from

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<sup>32</sup> *Idem*, s 126(4).

<sup>33</sup> The Constitution of the Republic of Ghana 1992, art 1(2).

Central Government, some of the entities subject to the Public Financial Management Act 2016 (Act 920) (PFMA) most closely accord with the definition of a local public entity adopted within this chapter. These entities that are subject to the PFMA include ministries, departments and agencies of Central Government, local government authorities, autonomous agencies and some statutory bodies (altogether called “covered entities”).<sup>34</sup>

Covered entities typically receive decentralised transfers from constitutional, statutory and donor funds managed by Central Government and may raise their own funds through their activities, or by way of payment for their services (internally generated funds). These covered entities, some of which qualify as local public entities, are subject to public financial management frameworks as those agreed under the yearly Appropriation Acts passed by Parliament, and the PFMA and its associated regulations. Covered entities have the power to borrow funds within specified limits.<sup>35</sup> Of the host of covered entities, districts (and their assemblies) and public utility service providers accord most closely to the concept of local public entities adopted within this chapter.

### 2.1.1 Districts

A district is a territorial sub-division of the Republic for the purpose of decentralised local governance. The President has power, by executive instrument,<sup>36</sup> to create districts for the governance of the country at the local level.<sup>37</sup> These districts are under the management of district assemblies (akin to city or municipal councils), composed of both elected and central government-appointed representatives.<sup>38</sup> A district assembly is the highest political authority in the district.<sup>39</sup> A district assembly has oversight responsibility for, amongst others, physical planning, health, agriculture and building works within their areas of authority.

A district assembly is a body corporate with perpetual succession.<sup>40</sup> Depending on the population within the geographical area, its geographical contiguity, economic viability, infrastructure, amenities and other metrics provided under law, district assemblies are classified into types of assemblies: metropolitan assemblies and municipal assemblies.<sup>41</sup> All districts, of whatever type, have power under the law to raise their own finance through service fees, business and entertainment licences, and investment income, as well as from the collection of property rates and other taxes and levies within their areas of authority. Apart from the metropolitan assemblies, all the district assemblies rely almost entirely on payments received from the Central Government through the District Assemblies

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<sup>34</sup> Public Financial Management Act 2016 (Act 921), s 102.

<sup>35</sup> *Idem*, ss 2, 73-74.

<sup>36</sup> Subsidiary legislation that is created by members of the executive arm of government under a power granted by an act of Parliament; and Constitution of the Republic of Ghana 1992, art 11(1)(b).

<sup>37</sup> Local Governance Act 2016 (Act 936), s 1(1).

<sup>38</sup> *Idem*, s 5.

<sup>39</sup> *Idem*, s 3(2).

<sup>40</sup> *Idem*, s 4(1).

<sup>41</sup> *Idem*, s 4.

Common Fund to fund their activities.<sup>42</sup> The District Assemblies Common Fund receives yearly sums under the national budget statement which is then distributed to the different districts based on a formula that tracks closely with their classification.

### 2.1.2 *Public utility service providers*

In Ghana, public services are usually provided through a state-owned enterprise. A state-owned enterprise is a body corporate whose shares are wholly or partially held or controlled by the Government.<sup>43</sup> Under Ghanaian law, a state-owned enterprise may be incorporated as a statutory corporation under the Statutory Corporations Act 1964 (Act 232) or as a public or private limited liability company under the Companies Act 2019. These public utilities providers have national reach. Their sub-divisions for purposes of business are however not coterminous with those of the prevailing geographical and political sub-divisions of the country. Utilities such as water and electricity are managed by the Electricity Company of Ghana Limited and Ghana Water Company Limited respectively. These national level entities are currently registered as limited liability companies. They were originally incorporated as public corporations (as Electricity Corporation of Ghana and Ghana Water and Sewerage Corporation) but the corporate character of many state-owned enterprises was changed from statutory corporations to companies limited by shares following the passage of the Statutory Corporations (Conversions to Companies) Act 1993 (Act 461).<sup>44</sup> The schedule of this 1993 law listed 32 companies which were converted to limited liability companies. In 1996, another 19 public corporations were converted under that law. The range of corporations that were thus converted include those in postal services, railway transport, logistics, agriculture, regional development, banking, electricity, food distribution, publishing, newspapers, telecommunications and trading.

The policy basis for this shift in the corporate character of these entities from statutory corporations to companies limited by shares is unclear. What is however clear is that no new companies have since been incorporated as statutory corporations, and there appears to be no further indication of an intention to do so.<sup>45</sup> The Statutory Corporations Act 1964 (Act 232) has therefore effectively fallen into desuetude. State-owned enterprises are now typically registered as companies limited by shares and are thus subject to traditional rules of company and insolvency law.

## 2.2 **The treatment of debts of local public entities**

State-owned utility companies and district assemblies are distinct legal entities separate from Central Government. Under the PFMA, "a local government authority, public corporation or state-owned enterprise is liable for the debt and other obligations of that

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<sup>42</sup> Constitution of the Republic of Ghana 1992, art 125; and Local Governance Act 2016 (Act 936), s 125.

<sup>43</sup> Public Financial Management Act 2016 (Act 921), s 102.

<sup>44</sup> Statutory Corporations (Conversions to Companies) Act 1993 (Act 461).

<sup>45</sup> K Ghartey, "The Death of the Statutory Corporation", *Ghana Law Journal* 1(1) 144 at 146.

local government authority, public corporation or state-owned enterprise without recourse to Government, unless otherwise explicitly guaranteed by Government in accordance with [the] Act".<sup>46</sup>

Borrowing by local government authorities (metropolitan, municipal and district assemblies) is restricted to funds from within Ghana and only up to a limit determined by the Minister for Finance in consultation with the Minister responsible for Local Government in line with Government's medium-term debt strategy and annual borrowing and recovery plan.<sup>47</sup> A local government authority has to obtain prior written approval from the Minister for Finance for the issuance of debt securities to the public, or for the borrowing of amounts above the limit.<sup>48</sup> State-owned enterprises, some of which qualify as local public entities, are subject to the same borrowing and financial prudence restrictions as is the case for local government authorities.<sup>49</sup> Public corporations and state-owned enterprises are however not restricted to borrowing in the local Ghanaian market. They may borrow in foreign markets, that is, from entities domiciled outside Ghana.<sup>50</sup> The Minister for Finance may also issue a guarantee on behalf of the Ghanaian Government in respect of the obligation of a local government authority, public corporation or other entity. The Minister may do so if satisfied that it is in the public interest to issue the guarantee and the entity has the ability to fulfil the obligations under the underlying loan and related agreements.<sup>51</sup> Government may also borrow monies for on-lending to local government authorities and state-owned enterprises as approved by Parliament.<sup>52</sup>

In theory state-owned enterprises are, by their character, subject to ordinary insolvency law just as other ordinary companies. In this way, their treatment in formal insolvency proceedings should be different from local government authorities which are an appendage of government. In practice, however, local government authorities and state-owned entities tend to fall back on Central Government to defray debts incurred where they are unable to do so themselves. A strong case has not been made for the liquidation of ailing state-owned utility companies during their decades-long financial distress. The liquidation of the national airline, Ghana Airways, that began in 2005 and formally ended in 2015, stands out in this respect. This is perhaps because Ghana Airways had creditors outside of Ghana whose seizure of aircraft in London, and other threats to seize aircraft belonging to the airline elsewhere, created an inevitable situation:<sup>53</sup> the Ghanaian Government was forced to allow the liquidation of Ghana Airways to contain the situation. On the other hand, it is impossible to liquidate a district assembly purely for the reason of

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<sup>46</sup> Public Financial Management Act 2016 (Act 921), s 73(3).

<sup>47</sup> *Idem*, s 74.

<sup>48</sup> *Idem*, s 75.

<sup>49</sup> *Idem*, ss 76-77.

<sup>50</sup> *Idem*, s 76.

<sup>51</sup> *Idem*, s 66(1).

<sup>52</sup> *Idem*, s 57(1)(c).

<sup>53</sup> E Simpkins, "Plane seized at Heathrow over debts of £4m", *The Daily Telegraph* (2 June 2002) available [here](#).

its insolvency. A change to the character or the area of geographical authority of a district is by amendment of the law creating the district. This falls outside of insolvency law.

### **3. Dealing with local public entities in distress - the Ghanaian legal framework**

There is currently no legal framework that specifically provides mechanisms for the resolution of the financial distress of local public entities. A look at Ghana's Constitution does not suggest that sub-divisions of Central Government (Ministries and Agencies) may be treated separately from Central Government for purposes of insolvency. Districts and the relevant district assemblies are also treated as an appendage of Central Government for many purposes. Cities, towns and municipal areas (in geographical terms) do not have legal personality separate from a metropolitan, municipal or district assembly that has oversight over that city, town or municipal area. The debt of a city is the debt of the relevant local government authority.

#### **3.1 Liquidation of local public entities under Ghanaian law**

Public utility companies and district assemblies are the focus of this enquiry into the financial distress of local public entities.

A district assembly, upon creation, is a body corporate with perpetual succession.<sup>54</sup> For the performance of its functions, a district assembly may acquire and hold movable and immovable property, dispose of property and enter into contracts or other transactions. A review of the Local Governance Act 2016 (Act 936), the primary legislative framework for Ghana's local governance system, does not even vaguely suggest that a district assembly as a local sub-division of Government is capable of being liquidated as an entity. The debts or operating losses of metropolitan, municipal or district assemblies are, in practice, eventually borne by Central Government. Metropolitan, municipal and district assemblies are known for long delays in payment of contractual sums for works and services. It is not possible that a district may be formally declared insolvent and thus be subject to the rescue processes under the Corporate Insolvency and Restructuring Act 2020. Both the Constitution and the Local Governance Act 2016 are silent in this respect. There has been a suggestion however that district assemblies are excluded from the ambit of the Corporate Insolvency and Restructuring Act 2020.<sup>55</sup> This view accords with the tenor of the Corporate Insolvency and Restructuring Act 2020, read as a whole, and the purpose of its enactment.

Many profit-making state-owned companies have frequently fallen into long-term debt servicing difficulties. Whilst these enterprises are distinct legal entities, Central Government typically provides funds to clear these debts or to overcome an imminent

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<sup>54</sup> Local Governance Act 2016 (Act 936), s 4(1).

<sup>55</sup> Views expressed by Felix Addo, former Country Senior Partner for PriceWaterhouseCoopers (PWC) in Ghana and Founding President of the Ghana Association of Restructuring and Insolvency Advisors at a Virtual Public Education Workshop on "Restructuring Distressed Businesses in an evolving Economy", 29 September 2021.



shutdown. State-owned enterprises which have received such assistance include publicly owned electric power generation companies, the national oil refinery, the national petroleum corporation and the publicly owned power distribution companies.

Notionally, state-owned enterprises either registered as statutory corporations or companies limited by shares, are not legally distinguishable from other bodies corporate subject to the Corporate Insolvency and Restructuring Act 2020. Since these state-owned enterprises are now generally registered as companies limited by shares, they should thus be subject to the ordinarily applicable rules for the treatment of financially distressed entities. Where the Government is minded, therefore, a state-owned enterprise qualifying as a local public entity and registered as a company limited by shares, can be the subject of an administration, restructuring or liquidation process under the Corporate Insolvency and Restructuring Act 2020. A qualified insolvency practitioner will then be appointed to manage the administration process. Within this process, the administrator works with the creditors of the state-owned enterprise to negotiate a binding restructuring agreement.

The terms of a restructuring agreement will include stays on the exercise of foreclosure and other rights by the entity's creditors. Where a restructuring agreement is not reached or the creditors vote to discontinue the administration proceedings, the company becomes subject to ordinary liquidation proceedings.<sup>56</sup> In the usual way, the creditors are identified and ranked according to the priority rules. Thereafter, the assets of the distressed entity are identified, collected and liquidated to satisfy the claims of the creditors according to the priority-ranking determined by the liquidator. Any pre-commencement financing offered to a distressed entity in a bid to turn around the entity ranks in priority to all other debt, secured or unsecured, incurred before the official declaration of insolvency and the attendant liquidation.<sup>57</sup>

The financial distress of state-owned enterprises which qualify as local public entities is treated very differently in practice from the insolvency of other entities, especially those which are privately-owned. Even severely distressed state-owned enterprises are seldom liquidated. There is no example in the last 30 years, at least, of the liquidation of a state-owned utility provider.

### **3.2 Resolving financial distress of local public entities**

Since districts cannot be liquidated and companies with state ownership are very seldom liquidated in Ghana, how is the financial distress of local public entities resolved in practice?

District assemblies and public utility services providers are both subject to public financial management regulation in Ghana. Both district assemblies and public utility service providers face perennial financial distress. For a myriad of reasons, however, Government

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<sup>56</sup> Corporate Insolvency and Restructuring Act 2020 (Act 1015), s 28 (1).

<sup>57</sup> *Idem*, s 107(3).

will typically only in very limited circumstances permit the formal liquidation of state-owned enterprises. Governments will generally intervene to prevent the seizure of assets of metropolitan, municipal and district assemblies by creditors. The reality is that for both public utility service providers and local government authorities, creditors are very hesitant to proceed against the assets of such entities. This even includes judgement creditors who try to negotiate with government agencies and other political appointees for alternative payment plans. This can be attributed to several reasons, including fear by creditors of the loss of future government business and the long and expensive judicial process to recover debts otherwise than by declaration of insolvency and thereafter, liquidation.

### 3.2.1 *Resolving the financial distress of public utility companies in Ghana*

The resolution of the financial distress of public utility companies must be properly situated within the context of state ownership of these companies. After independence, Ghana chose a state-centred developmental model. The State invested heavily in industry and provided an overwhelming number of formal jobs in many sectors. This model became inefficient and stagnated economic growth. By 1983, the then military government recognised the need for serious reforms. It agreed for the country to undergo the Economic Recovery Programme which entailed substantial fiscal adjustment, tightening monetary policy and exchange rate reform.<sup>58</sup> In 1988 under the Economic Recovery Programme, a major effort was made to divest the State of some of its interests in the mining, banking, telecommunications and manufacturing sectors. The Divestiture Implementation Committee was set up in 1988 and formalised by law in 1993 to achieve this objective. The Government sold its stakes in these entities through the Divestiture Implementation Committee.<sup>59</sup> From a slow-start from 1989 to 1992, by 1999 208 entities with State ownership had been divested of that ownership.<sup>60</sup>

In the process of divestiture, the public utility companies supplying water and electricity were noticeably missing. An ultimately unsuccessful attempt was made to privatise water distribution for southern Ghana in 2000. A management contract granted between June 2006 and June 2011 for water distribution by an international consortium of Dutch and South African private operators was not extended after the first run of five years.<sup>61</sup> After this episode, public water was administered once again by public hands. Public utilities have, therefore, fully remained within Government control through these state-owned entities, and they continue to be sources of perennial financial distress.

The resolution of the financial distress of these entities happen outside of the formal insolvency framework and often by means of bailouts by Central Government, and this has been previously achieved by the imposition of a sector-specific levy or tax. The Ghanaian energy and roads sectors provide vivid examples of how these bailouts work. Energy

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<sup>58</sup> S P Leite, A Pellechio, L Zanforlin, G Begashaw, S Fabrizio and J Harnack, *Ghana: Economic Development in a Democratic Environment* (International Monetary Fund, Washington, 2000) at 30.

<sup>59</sup> *Idem*, at 48.

<sup>60</sup> *Idem*, Table 7.1 (Divestiture of State Enterprises) at 50.

<sup>61</sup> L Shang-Quartey, *Post Privatisation Challenges of Public Water in Ghana* (23 June 2014) available [here](#).

sector levies were formalised under the Energy Sector Levies Act 2015 (Act 899), mainly for the clearance of legacy debts of energy-related state-owned enterprises, power generation and support power sector infrastructure, subsidies for pre-mix fuels and the stabilisation of petroleum prices.<sup>62</sup> The bulk of the energy debt servicing from the levies collected under the Energy Sector Levies Act 2015 has been dedicated to these legacy debts owned by the state-owned Tema Oil Refinery.<sup>63</sup> The Road Fund was created under the Road Fund Act 1997 (Act 536) to finance routine, periodic maintenance and rehabilitation of public roads in the country. The Road Fund Act 1997 also provides that the Road Fund “shall also be used to assist the Metropolitan, Municipal and District Assemblies in the exercise of their functions relevant to public roads under any enactment”.<sup>64</sup> Public maintenance of roads and other public carriageways is a substantial budget line item for many district assemblies across Ghana. Contractors who have provided construction or maintenance services for public roads are often owed monies for years by both Central Government and sub-national government authorities like the district assemblies. Although the Road Fund was expected to provide funds to avoid this source of financial distress, the debt situation relating to road construction and maintenance has not changed. Originally, the Road Fund was made up of government levies on petrol, diesel and refined fuel oil as well as bridge, ferry and road tolls, vehicle licence and inspection fees, international transit fees collected from foreign vehicles entering Ghana and other monies approved by Parliament.<sup>65</sup> Strangely, a 2016 amendment<sup>66</sup> to the Road Fund Act 1997 now provides for monies borrowed by the Road Fund from banks and other institutions as part of the sources of funding for the Road Fund. It is interesting to consider why a tool intended for tackling perennial debts in the Ghanaian roads and highways sector has itself become a new source of Government debt.

### 3.2.2 *Resolving the financial distress of district assemblies in Ghana*

The perennial financial distress of local government authorities in Ghana is partly attributable to constitutional design and the power relations between local government and Central Government authorities. The fiscal architecture in Ghana creates an imbalance of power and resources between sub-national governance entities like metropolitan, municipal and district assemblies and the national Government. District assemblies have been entrusted with expenditure functions than can be financed from the revenues available to them.<sup>67</sup> This imbalance of power continues in favour of the Central Government after over three decades of growing decentralisation of government services. Central Government continues to be the primary recipient and beneficiary of taxation and other revenue. The scope of payments that are made to local government authorities are

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<sup>62</sup> Ministry of Finance - Republic of Ghana, *Annual Report on the Management of the Energy Sector Levies and Accounts for the Year 2016*, para 27.

<sup>63</sup> *Idem*, Section 7: Appendices, Table C.

<sup>64</sup> Road Fund Act 1997 (Act 536), s 2(2).

<sup>65</sup> *Idem*, s 3.

<sup>66</sup> Road Fund (Amendment) Act 2016 (Act 909), s 2.

<sup>67</sup> J R A Ayee, “Financing Sub-national Governments in Ghana: the District Assemblies’ Common Fund”, *Regional and Federal Studies* (1995) 5(3) 292 at 292.

comparatively limited and do not provide substantial funds. District assemblies also lack logistical and managerial capacity to effectively collect statutory payments and other funds due them under relevant laws. District assemblies, therefore, depend heavily on transfer from Central Government to fund statutory responsibilities and administrative expenses. Central Government very often competes with local government for the provision of projects and services at local level, and this is often tied to short-term electoral objectives.

The debts of a local government authority are its debts and not those of the Central Government. Since these local government authorities have capacity to sue and be sued, it is possible for a court to declare a seizure of their assets in execution of a debt owed by them. The threat or actual success of a suit can however influence the supervising Ministry to take necessary steps to compromise or negotiate the debt. It is not unusual for Central Government, especially in the face of a judgment debt, to transfer funds to the local government authority to defray the debt. In many instances, there are no viable assets that may be attached in execution of a district assembly's debt. Many district assemblies, apart from the largest metropolitan ones, tend to own very little beyond their own offices, land and equipment. The main practical way to resolve the financial distress of a district assembly is for Central Government to intervene and pay off the debt or negotiate a compromise. This is, therefore, external to the formal insolvency framework.

#### **4. Dealing with local public entities in distress in practice**

This part considers the approach taken with respect of the publicised financial distress of three qualifying local public entities in Ghana. The examples discussed within this part show that law or formal legal techniques are not the primary tools for the resolution of local public entities' financial distress.

##### **4.1 Accra Metropolitan Assembly**

The Accra Metropolitan Assembly is the local government authority with jurisdiction over the core parts of Accra, Ghana's capital. In 1997, the Accra Metropolitan Assembly and City and Country Waste Limited entered into a waste management contract. In July 2001, this contract was abruptly abrogated by a new local government which took office earlier that year alleging the high cost of the contract and the failure of the company to rid the city of refuse.<sup>68</sup>

City and Country Waste Limited sued the Accra Metropolitan Assembly in 2002. The case had a long and chequered history in the Ghanaian courts until it was resolved by the Ghanaian Supreme Court in February 2008.<sup>69</sup> The Supreme Court ordered the Accra Metropolitan Assembly to pay the judgment debt with interest in 2012. In that same year,

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<sup>68</sup> See <https://www.ghanaweb.com/GhanaHomePage/business/AMA-abrogates-contract-with-City-and-Country-Waste-Limited-16570> in this regard.

<sup>69</sup> *City and Country Waste Limited v Accra Metropolitan Assembly (2007-2008)* Supreme Court of Ghana Law Reports 409.

City and Country Waste Limited obtained a High Court order to attach seven properties of the Accra Metropolitan Assembly (offices and residences) in prime areas of Accra for auction in execution of the debt. Faced with the possibility of its entire operations grinding to a halt, the Accra Metropolitan Assembly passed a resolution appealing to Central Government through the Attorney-General's Department, to "pay the \$6,575,928.52 judgement debt that the AMA owes City and Country Waste Limited on its behalf to enable the assembly to have respite to concentrate on its better Ghana development activities".<sup>70</sup>

Representatives of City and Country Waste Limited seized some vehicles belonging to the Accra Metropolitan Assembly in a threatened start to the execution processes. It was thereafter reported in November 2013 that meetings were being held with the Ministry of Finance and Economic Planning, the Attorney-General's Department and the auctioneers appointed to auction off the Accra Metropolitan Assembly's properties and assets. Not much else was publicly reported about the legal tussle between City and Country Waste Limited and the Accra Metropolitan Assembly. It will have been politically embarrassing to have the head office of the nation's pre-eminent local government authority seized and sold. It appears that Central Government negotiated and paid off or compromised the debt owed. This episode was before the passage of the PFMA. Nonetheless, it is clear that a very similar approach will be considered by Central Government despite the clear delineation between debts by local government authorities and debts of Central Government within the PFMA.

## 4.2 Kumasi Metropolitan Assembly

Kumasi is the second largest city in Ghana and capital of the Ashanti region, the second most populous region of Ghana. The Kumasi Metropolitan Assembly has local governance oversight over the Kumasi metropolis. The Kumasi Metropolitan Assembly had been in a long running legal battle with a company called FREKO FD Enterprise Limited, a sub-contractor to the Kumasi Metropolitan Assembly, over a judgment debt of GHS 5 million (approximately USD 830,000).<sup>71</sup> In 2016, FREKO FD Enterprise Limited obtained an order to attach three vehicles of the Kumasi Metropolitan Assembly to defray the debts. In 2017, it secured a similar court order to attach three buildings of the Kumasi Metropolitan Assembly including the mayor's official residence. On 28 September 2021, FREKO FD Enterprise Limited obtained another order to attach the main office building of the Kumasi Metropolitan Assembly. The Presiding Member of the Kumasi Metropolitan Assembly, the highest-ranking elected member of the Kumasi Metropolitan Assembly, acknowledged in a radio interview that "[a]s I speak, we are in financial distress and if care is not taken, we shall fall into the abyss of insolvency".<sup>72</sup> The Kumasi Metropolitan Assembly is estimated as owing debts close to GHS 50 million (approximately USD 8,300,000). It is unclear how the matter will finally be resolved. The Kumasi Metropolitan Assembly has made formal

<sup>70</sup> See <https://www.ghanabusinessnews.com/2012/07/10/amas-properties-to-be-sold-to-settle-judgement-debt/> in this regard.

<sup>71</sup> *Freko F D Enterprise Ltd v Kumasi Metropolitan Assembly*, High Court (Commercial Division), Suit No OCC/47/14.

<sup>72</sup> See <https://3news.com/judgement-debt-court-orders-kma-office-complex-to-be-sold/> in this regard.

requests to the Central Government for a bailout. It confirms the view that local government authorities expect that Central Government will pay off debts that the assemblies owe to their general creditors and judgement creditors. Without Central Government intervention, the path leads to the attachment of all properties of an assembly which will then bring local governance over their jurisdiction to an effective and embarrassing halt.

### **4.3 Electricity Company of Ghana Limited**

The major electric power distribution company, the Electricity Company of Ghana Limited, has also faced continuing losses for years. It has been the subject of sustained public discussion, especially between 2013 and 2016, when the country experienced severe electric power disruptions and rationing. In the case of the Electricity Company of Ghana Limited, an attempt was made to restructure the operations of the company through a takeover of the company's assets via a concession agreement with a Filipino entity called Meralco. To satisfy local content and participation requirements, a special purpose vehicle, Power Distribution Services Ghana Limited (a joint venture between Meralco and Ghanaian investors), was incorporated to be the operator of the concession agreement. The objective of this deal was to promote growing private sector participation in the energy sector. The deal was from the outset mired in allegations of corruption and nepotistic dealing.<sup>73</sup> Ultimately the concession agreement was abrogated by the Government of Ghana, officially stating that it was due to the lack of eligible demand guarantees to secure the transfer of assets from the Electricity Company of Ghana Limited to Power Distribution Services Ghana Limited. Power Distribution Services Ghana Limited is no longer in charge of the assets which are still currently operated by Electricity Company of Ghana Limited. It is expected that Central Government will write off some debts currently owed to the Electricity Company of Ghana Limited and negotiate the large sums owed to its creditors, including local banks. Ironically the greatest source of indebtedness to Electricity Company of Ghana Limited is by government ministries, departments, agencies and districts.

## **5. Conclusion**

The discussion within this chapter shows that Ghana's current formal insolvency and restructuring regime is inapplicable to the main form of local public entity - the district assembly. However, while state-owned enterprises that qualify as local public entities are theoretically subject to formal insolvency processes of financial distress resolution, in practice the approach taken to the resolution of their financial distress is mainly outside of formal procedures provided under law. There is an overwhelming use of bailouts, negotiations and, in limited cases, high-level interventions to creditors to achieve the resolution of the financial distress of local public entities in Ghana.

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<sup>73</sup> See <https://www.ghanabusinessnews.com/2020/08/25/we-will-investigate-pds-and-agyapa-deals-maha-ma/> in this regard.

## Local public entities in distress - a critical analysis of the Italian approach

By Rolandino Guidotti\*

### 1. General context of insolvency law

#### 1.1 The Bankruptcy Law

Italian bankruptcy law (in its current form) dates back to 1942. Currently, Italy's bankruptcy law is contained in Royal Decree number 267 of 16 March 1942 (Bankruptcy Law).

The goal of the bankruptcy procedure under Italian law is merely to liquidate a company's assets (bankruptcy is a liquidation and compulsory winding-up procedure). The main objective of bankruptcy is to protect the rights of creditors and to maximise their returns rather than to facilitate individual ordinary enforcement proceedings.

Since 2005, the original provisions of the Bankruptcy Law have been significantly altered to facilitate the restructuring of distressed but viable entities. In particular, the post - 2005 rules improved the procedures known as arrangement or composition with creditors, the structures of which are inspired by the United States Bankruptcy Code's Chapter 11 procedure. Both of these procedures seek to allow business continuity.

Italy's bankruptcy framework, as amended in 2005,<sup>1</sup> 2006,<sup>2</sup> and 2007,<sup>3</sup> thus contains many elements of discontinuity when compared to the earlier, original Bankruptcy Law (from 1942).<sup>4</sup> Furthermore, it is worth discussing the introduction of the arrangement with creditors in the business continuity procedure<sup>5</sup> that took place in 2012,<sup>6</sup> alongside the new rules that mean that debtors can file a petition for an arrangement (a so-called "blank" or "incomplete" petition) whilst reserving the right to lodge a proposal and a plan at a later stage.<sup>7</sup>

In 2015 the Bankruptcy Law was amended to revise the provisions on arrangements with creditors, due to some concerns regarding the abusive use of these mechanisms. That year marked the introduction of new eligibility requirements to utilise arrangements with creditors based on liquidation. Currently, in order to utilise a procedure in accordance

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<sup>1</sup> By Decree no 35 of 14 March 2005, transposed into Law no 80 of 14 May 2005.

<sup>2</sup> By Legislative Decree no 5 of 9 January 2006.

<sup>3</sup> By Legislative Decree no 169 of 12 September 2007.

<sup>4</sup> The term "bankruptcy law" is used with reference to Royal Decree no 267 of 16 March 1942, if not otherwise specified.

<sup>5</sup> Bankruptcy Law, art 186(2).

<sup>6</sup> Decree no 83 of 22 June 2012, transposed into Law no 134 of 7 August 2012.

<sup>7</sup> Bankruptcy Law, art 161(6).

with the Bankruptcy Law, a debtor must guarantee that it can repay 100% of its senior / preferential debts and 20% of its unsecured debts.<sup>8</sup>

At present, ailing companies can choose between a wide variety of procedures to liquidate or turn around their businesses. These include, *inter alia*:

- (a) extrajudicial settlements with creditors;<sup>9</sup>
- (b) certified restructuring plans;<sup>10</sup>
- (c) debt restructuring agreements<sup>11</sup> (under the Italian system, agricultural enterprises may not be subject to the same bankruptcy or other insolvency procedures as those that apply to commercial entrepreneurs.<sup>12</sup> There is however an exception regarding debt restructuring agreements,<sup>13</sup> as agricultural entrepreneurs may access over-indebtedness procedures, dictated by Law number 3 of 27 January 2012, that are applicable to entities that are not subject to bankruptcy);
- (d) debt restructuring agreements involving financial entities;<sup>14</sup>
- (e) agreements with tax authorities (tax settlements);<sup>15</sup>
- (f) arrangements with creditors in both models, based on liquidation and with business continuity;<sup>16</sup>
- (g) extraordinary administrations for large undertakings in a state of insolvency;<sup>17</sup>

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<sup>8</sup> Creditors are given the right to submit competing plans and competing bids, and such proposals overlap those already lodged by a debtor. Competing plans and competing bids envisage the possibility of modifying a debtor's proposal, in and this case, competition regarding the arrangement with creditors procedure is facilitated by the possibility of modifying a debtor's proposal. These two instruments (competing plans and competing bids) differ in nature and, after their introduction in 2015, were maintained in the new Business Crisis and Insolvency Code, which entered into force on 15 July 2022. This code contains the rules of the arrangement (composition) with creditors procedure, which is a procedure (the most important one) through which a crisis situation can be overcome. The two instruments (competing plans and competing bids) both increase the complexity of the arrangement with creditors procedure and extend its duration. On this topic, see R Guidotti, "Arrangement with Creditors, Competing Plans and Competing Bids", *International Company and Commercial Law Review* (2021) 32(2) at 80.

<sup>9</sup> Bankruptcy Law, art 67, para 3, letter (d).

<sup>10</sup> *Ibid.*

<sup>11</sup> *Idem*, art 182(2).

<sup>12</sup> Civil Code, art 2221.

<sup>13</sup> Decree Law no 98 of 6 July 2011, art 23, para 43; transposed by Law no 111 of 15 July 2011.

<sup>14</sup> Bankruptcy Law, art 182(7).

<sup>15</sup> *Idem*, art 182(3).

<sup>16</sup> *Idem*, arts 160 ff.

<sup>17</sup> Legislative Decree no 270 of 8 July 1999.



(h) bankruptcy; and<sup>18</sup>

(i) enforced judicial liquidations.<sup>19</sup>

Some of these procedures can be considered formal insolvency procedures according to the definition adopted by the European Union (EU).

## 1.2 The new Business Crisis and Insolvency Code

On 11 October 2017, the Italian Parliament approved Law number 155 (published in the Official Journal of the Italian Republic on 19 October 2017), which delegated the Italian Government as the legislator for a global reform covering business crises and insolvency.<sup>20</sup>

Law number 155/2017 was produced from work by the Rordorf Commission, which was established by the Minister of Justice. The reform is known as the Rordorf Reform, as it was named after the President of the Rordorf Commission, Renato Rordorf.

The legislation that delegated the authority to reform Italy's insolvency law to the Government (Law number 155/2017) allows the Government to create new legislation that: (i) gives priority to proposals intended to overcome financial crises and guarantee business continuity, even by means of a different entrepreneur, as long a proposal ensures that creditors' interests are upheld maximally, or (ii) concerns judicial winding-up, which should replace the bankruptcy procedure<sup>21</sup> as a last resort mechanism.

Following the implementation of Law number 155/2017, Legislative Decree number 14 of 12 January 2019 introduced a new Business Crisis and Insolvency Code (the New Code) into Italy's insolvency law framework. It includes a complex reform that is aimed at considering insolvency procedures in terms of a procedure aimed at preserving the value of distressed enterprises, rather than from a liquidation or sanctioning perspective.

Almost all of the new rules came into force on 15 July 2022. Therefore, two different systems concerning business crises will co-exist in Italy for some time. The criterion

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<sup>18</sup> Bankruptcy Law, arts 1 ff.

<sup>19</sup> *Idem*, arts 194 ff.

<sup>20</sup> On this topic, see F Pasquariello, "Italian Bankruptcy Code moving Towards a Reform Era", *Il diritto fallimentare e delle società commerciali* (2016) II at 347; and A Benocci, "Reforming Italian Insolvency Law: Bankruptcy vs. Judicial Liquidation", *European Business Law Review*, (2018) 29(2) at 291.

<sup>21</sup> The term bankruptcy describes liquidation proceedings, which can be invoked by a large number of creditors, including companies. The reason for using this term rather than liquidation is because it is used under current Italian law with reference to liquidation proceedings. Bankruptcies can be declared by both individuals and companies (or, rather, natural persons, legal persons or other entities that may be subject to bankruptcy whilst carrying out commercial activity). However, it is acknowledged that in most other jurisdictions the term bankruptcy refers to liquidation proceedings involving individuals. The Italian term *fallimento* cannot be directly translated using the English notions of insolvency or insolvency procedure, as *fallimento* is based on different eligibility criteria and specific characteristics.

adopted by the transitional rules envisaged by the New Code<sup>22</sup> is the filing date. All petitions filed after 15 July 2022 will be subject to the New Code; but petitions filed prior to this date will be subject to the *Bakruptcy Law*, as amended in recent years.

### 1.3 The negotiated crisis settlement procedure

Decree number 118 of 24 August 2021 – converted into Law number 147 of 21 October 2021 – introduces an entirely new process for distressed enterprises known as the negotiated crisis settlement procedure.<sup>23</sup> This new settlement procedure aligns with EU Directive number 1023/2019.<sup>24</sup> This new regime is suggested as an option for any business that finds itself in a situation of distress, but is able to continue carrying on its business either directly or indirectly.<sup>25</sup> Direct continuity is characterised by entrepreneurs personally continuing to run their businesses, and indirect continuity involves business being managed or their activities being continued by entities other than the debtors themselves.

The negotiated crisis settlement procedure is an extrajudicial procedure that is confidential and may only be initiated voluntarily. It aims to allow the recovery of insolvent entities or entities in distress that have “the potential to remain a going concern, including through the sale of [its] business or a branch of it”.<sup>26</sup>

A debtor may request the appointment of an independent expert – a third party selected by an *ad hoc* committee organised by the local Chamber of Commerce. An independent expert is asked to examine any restructuring plan submitted by the company to which they are appointed and facilitate the relationship between that company, its creditors, and any other interested parties. Once a suitable solution for overcoming a debtor’s crisis has been identified, the parties may, alternatively, enter into a contract or follow one of the proceedings regulated by the law.

If the expert considers that there are no actual prospects for recovery, he may, at any time, promptly notify the relevant Chamber of Commerce and put an end to the negotiated crisis settlement process.

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<sup>22</sup> New Code, art 390.

<sup>23</sup> R Guidotti, “La crisi d’impresa nell’era Draghi: la composizione negoziata e il concordato semplificato”, *ristrutturazionaziendali.ilcaso.it* (8 September 2021) available [here](#).

<sup>24</sup> In this regard, see G McCormack, *The European Restructuring Directive* (Edward Elgar Publishing, Cheltenham, 2021); and C G Paulus and R Dammann (eds), *European Preventive Restructuring – Article by Article Commentary* (Beck / Hart / Nomos, Munich, 2021).

<sup>25</sup> See R Guidotti, “La composizione negoziata e la direttiva Insolvency: prime note”, *dirittodellacrisi.it* (2 February 2022) available [here](#); S Bonfatti and R Guidotti (eds), *Il ruolo dell’esperto nella composizione negoziata per la soluzione della crisi dell’impresa* (Giappichelli Editore, Turin, 2022); and M Irrera, S A Cerrato and F Pasquariello (eds), *La crisi d’impresa e le nuove misure di risanamento* (Zanichelli Editore, Bologna, 2022).

<sup>26</sup> See the Explanatory Report to the Decree.

The rules came into force on 15 November 2021 and apply to all businesses or companies registered by a chamber of commerce in Italy.

#### 1.4 Over-indebtedness procedures

In Italy, the over-indebtedness procedures, dictated by Law number 3 of 27 January 2012, which apply to entities not subject to bankruptcy, were recently modified by Law number 176 of 18 December 2020.<sup>27</sup> It should be noted that this law does not apply to local public entities (LPEs) in distress, neither directly nor indirectly, in the absence of rules that permit its application to LPEs.

## 2. Local public entities

### 2.1 General definition

In the Italian legal system, there is no unitary definition of public entity, and there are no definitive regulatory parameters through which to establish one. The idea of achieving a clear definition may be somewhat utopian, given that the public sphere has developed extremely varied organisational models in recent years.<sup>28</sup>

This aspect is further complicated by the trend in recent decades toward merging legal forms. This may explain why, on the one hand, public entities use many private law instruments whilst, on the other hand, private entities are increasingly becoming public.<sup>29</sup>

The only certainty in the definition of public entities concerns LPEs, which are clearly identified by an express regulatory provision. Article 2 of Legislative Decree number 267 of 18 August 2000 (TUEL)<sup>30</sup> defines the scope of LPEs, establishing that, for the purposes of the decree, "municipalities", "metropolitan cities", "mountain communities", "island communities" and "unions of municipalities" are to be classified as local entities. The above rule is a specification of article 114 of the Constitution of the Italian Republic<sup>31</sup> according to which:

<sup>27</sup> M Ranieli, "Requisito soggettivo per l'accesso alle procedure e presupposti di ammissione", in M Irrera, S A Cerrato and F Pasquariello (eds), *La nuova disciplina del sovraindebitamento* (Zanichelli Editore, Bologna, 2021) at 38, and 47-48.

<sup>28</sup> See V Cerulli Irelli, "'Ente pubblico': problemi di identificazione e disciplina applicabile", in *Scritti in onore di Alberto Predieri I*, (Giuffrè, Milan, 1996) at 504; G Rossi, "Ente pubblico", in *Enc Giur Treccani XII*, (Treccani Editore, Rome, 1989) at 19; and LE Fiorani, "Società "pubbliche" e fallimento", *Giur comm* (2012) I at 536.

<sup>29</sup> S Cimini, "L'attualità della nozione di ente pubblico", *federalismi.it* (2015) 24 at 6; F Fimmanò and M Coppola, "Sovraindebitamento ed enti pubblici. Spunti di riflessione", *Diritto fallimentare e delle società commerciali* (2018) 87; and F T Banfi, *Lezioni di diritto pubblico dell'economia* (Giappichelli Editore, Turin, 2016) at 189 ff.

<sup>30</sup> *Testo Unico delle leggi sull'ordinamento degli enti locali* (also known in Italy by its abbreviation, TUEL).

<sup>31</sup> "Consortia in which local bodies participate" may also be classified as local authorities, with the exception of those that manage economic and entrepreneurial activities. See G C De Martin, "Enti pubblici territoriali", in *Digesto - Discipline pubblicistiche* (Giappichelli Editore, Turin, 2011) in this regard.

“[t]he Republic shall be composed of municipalities, provinces, metropolitan cities, regions and the State. Municipalities, provinces, metropolitan cities and regions shall be autonomous entities having their own statutes, powers and functions in accordance with the principles laid down in the Constitution.”<sup>32</sup>

The mission of LPEs, as stated by the law, is to represent the community that it oversees, protect its interests, and promote its development. The greatest difficulties concern non-territorial entities for which there is no direct classification in law.

However, the regions are not technically local entities, as they represent both the regulatory power and the legislative power.

The greatest difficulties in classification arise with regard to non-territorial entities for which no publicity qualification has been stated by the legislator. To address these problems, scholars have developed multiple theories, namely the:<sup>33</sup>

- (i) theory of purpose, which involves verifying the pursuit of a purpose of State;
- (ii) theory of *imperium*, which involves verifying the existence of authoritative powers conferred on these entities in question by the State;
- (iii) service relationship theory, which verifies the existence of a particular organisational relationship with the State;
- (iv) control theory, which verifies any control by the State; and
- (v) theory of financing, which investigates whether or not funding is provided by the State budget.

In order to distinguish between public and private entities, courts have typically adopted a quantitative criterion to identify the public elements of the rules applicable to the body being assessed.<sup>34</sup>

## 2.2 The mission of local public entities

LPEs have purposes established by law and, more specifically, by the TUEL.<sup>35</sup> For instance, the purpose of an LPE is to represent its community, protect the community's interests,

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<sup>32</sup> Rome shall be the capital of the Republic, and its status shall be regulated by State Law. Also see Civil Code, art 11.

<sup>33</sup> G Rossi, *Gli enti pubblici* (Zanichelli Editore, Bologna, 1991) at 259 ff.

<sup>34</sup> F Pantaleo Gabrieli, “Indici rivelatori del carattere pubblico degli enti”, *Foro it* (1940) II at 184.

<sup>35</sup> TUEL, art 3.

and promote the community's development. These entities have their own functions and those conferred on it by the State or regional law.

The TUEL permits the establishment of a consortium between LPEs, also known as municipalities.<sup>36</sup> In this regard it is of interest to examine a judgment of the Turin Court of Appeal,<sup>37</sup> where the court confirmed the principle that a consortium may be subjected to extraordinary administration proceedings for large undertakings in a state of insolvency<sup>38</sup> insofar as it is a commercial entrepreneur. However, the adoption of a procedure must not cause the adopting body's structure to be altered from a private association model, and the activity actually carried out by the entity must predominantly take place on the free market.

### 3. Dealing with local public entities in distress – the legal framework

#### 3.1 Principles and framework

The rules relevant to the insolvencies of LPEs are contained in the TUEL, which (transposing the rules contained in the previous Legislative Decree number 504 of 1992) envisages *ad hoc* recovery procedures for LPEs.<sup>39</sup>

A range of remedies has been established based on the severity of the situation affecting an entity's economic and financial management.

TUEL regulates entities in financial difficulty.<sup>40</sup> Financial distress<sup>41</sup> can only be declared by a distressed local authority. This opposes the condition of "guided failure", which can be ascertained by the regional section of the Court of Auditors and by a prefect. Should an LPE declare itself in a situation of financial distress, a municipal public entity will take the initiative with a resolution adopted by the Council of the LPE.<sup>42</sup>

Pursuant to TUEL,<sup>43</sup> a state of financial distress occurs if (i) an entity cannot guarantee the fulfilment of its necessary functions and services, or (ii) the liquid and collectable credits claimed by third parties from the entity cannot be paid in the ordinary course of business. It should be noted that in order to declare a municipality to be in financial distress, these two conditions may be independent of each other, as there is no need for them to exist simultaneously.<sup>44</sup>

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<sup>36</sup> *Idem*, art 31.

<sup>37</sup> Turin Court of Appeal, 15 February 2010, in *Società* (2010) 643.

<sup>38</sup> See para 1.1 above in this regard.

<sup>39</sup> These procedures were not envisaged by the original Royal Decree no 383 of 1934 (*Testo Unico della legge comunale e provinciale*)

<sup>40</sup> TUEL, art 244.

<sup>41</sup> *Dissesto* in Italian.

<sup>42</sup> TUEL, art 246.

<sup>43</sup> *Idem*, art 244(1).

<sup>44</sup> Rome Administrative Court no 32825 of 14 October 2010.

It should be noted that TUEL dictates that the rules on the rehabilitation of local entities apply only to municipalities and provinces.<sup>45</sup>

Note that the notion of insolvency<sup>46</sup> applicable to traditional bankruptcy proceedings is almost identical to financial distress. The chief difference between the two notions relates to the requirement of it being impossible for an entity to carry out its essential functions and services in order to be considered in financial distress. Additionally, the first part of the definition of financial distress<sup>47</sup> is different to insolvency, as the requirement of not being able to fulfil essential functions and services does not apply to general enterprises.

This highlights, on the one hand, the indispensable functions and services performed by LPEs and, on the other, the specific aspects of these entities in undergoing insolvency proceedings. This is not merely limited to the payment of creditors, like other debtors, but involves guaranteeing the continuity of its services and functions.<sup>48</sup>

### 3.2 Financial distress *versus* bankruptcy

It must be clarified that the financial distress procedure<sup>49</sup> is not a bankruptcy procedure such as bankruptcy<sup>50</sup> and arrangement with creditors.<sup>51</sup> It is only on a *prima facie* basis that it seems possible to identify therein the principles of bankruptcy proceedings. The financial distress procedure applicable to LPEs is a completely original and different procedure from those outlined in the Bankruptcy Law.

According to article 246 of TUEL, a financial distress resolution is adopted by the Council of an LPE<sup>52</sup> after the causes that led to the failure are evaluated. Such a resolution cannot

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<sup>45</sup> *Idem*, art 244(2).

<sup>46</sup> Bankruptcy Law, art 5 provides that: “[a]n enterprise that finds itself in [a] state of insolvency is declared bankrupt. A state of insolvency occurs through non-fulfilment or through other external facts [that] demonstrate that [a] debtor is no longer capable of duly fulfilling its obligations”.

<sup>47</sup> TUEL, art 244.

<sup>48</sup> Case law provides that school assistance services cannot be considered indispensable for the purposes of declaring the state of collapse referred to in art 244 of TUEL, given that Ministerial Decree 28 May 1993 only considers primary and secondary education services to be indispensable, involving the provision of what is necessary for school attendance to students. Alternatively, the related school assistance services involve providing what is deemed most appropriate to guarantee greater convenience in using the same school despite not being indispensable for educational purposes (Latina Regional Administrative Court, no 239 of 12 February 2005).

<sup>49</sup> TUEL, art 244.

<sup>50</sup> Bankruptcy Law, art 9. Bankruptcy is declared by courts to be based in the location where an enterprise has its head office.

<sup>51</sup> *Idem*, art 161. An application for admission to the arrangement with creditors procedure is submitted in the form of a petition signed by a debtor to a court based in the location in which the enterprise has its head office.

<sup>52</sup> *Consiglio dell’ente locale*.

be revoked,<sup>53</sup> and a detailed report by the economic and financial auditing body that analyses the causes that determined the distress must be attached to it.

The entities involved in a recovery procedure are the extraordinary liquidation body<sup>54</sup> and the institutional bodies of a distressed entity.<sup>55</sup> Each of them has clearly identified tasks, duties, and obligations in the procedure. The extraordinary liquidation body settles existing debts by using the insolvency assets<sup>56</sup> by the means permitted by law. The institutional bodies of a distressed entity guarantee the stabilisation of a debtor's financial conditions by removing the structural causes that led to its distress. Subsequently, the extraordinary liquidation body restructures the institutional body, which continues to carry out the tasks and functions it is obliged to perform by law.

An extraordinary liquidation body may attempt to settle a distressed entity's debts by liquidating the entity's assets that are subject to the insolvency procedure, and acquiring and managing an entity's available finances to attempt a recovery.<sup>57</sup>

The financial distress procedure applicable to local entities shares many characteristics with "traditional" insolvency procedures. For both, a debtor or its representative will have to ascertain the creditors' claims and liquidate the assets to pay the creditors. Additionally, for both, an automatic stay on enforcement actions will be enforced to promote a collective procedure.

The plan for paying liabilities becomes enforceable upon being filed at the Ministry of the Interior. When filing a plan, the extraordinary liquidation body requests authorisation to obtain a loan in the amount necessary to finance the liabilities.<sup>58</sup> Within 30 days from a loan disbursement, the extraordinary liquidation body makes advance payments in equal proportion for all of the liabilities included in a plan. A plan assumes that all creditors will be paid in full, even if those payments are deferred over time.<sup>59</sup>

### 3.3 Financial crisis

With regard to the possibility of rescuing local entities and thus restructuring their debt, there are "crisis" procedures that do not always anticipate an entity's insolvency, but sometimes preclude it. It would, therefore, be incorrect to consider that there is no

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<sup>53</sup> In contrast to Bankruptcy Law, art 18, which provides that an appeal against the bankruptcy order may be made by the debtor and by any interested party in a petition to be filed at the Court of Appeal within a period of 30 days.

<sup>54</sup> *Organo straordinario di liquidazione.*

<sup>55</sup> *Organi istituzionali dell'ente.*

<sup>56</sup> *Massa passiva.*

<sup>57</sup> TUEL, art 252(4).

<sup>58</sup> *Idem*, art 256.

<sup>59</sup> On this topic, see *ex pluribus*, L D'Orazio and L Monteferrante (eds), *Procedure concorsuali e diritto pubblico. Insolvenza, imprese pubbliche, contratti pubblici, titoli autorizzatori* (Giuffr , Milan, 2017) at 184 ff.

connection and no common pre-alarm situation between the two situations: the less serious “crisis” and the more serious distress situation.

TUEL provides the technical notion of local authorities in conditions of “crisis”.<sup>60</sup> These procedures of “pre-distress” are essentially the (i) “guided crisis” (*dissesto guidato*) referred to in Legislative Decree number 149 of 2011, and (ii) multi-year financial rebalancing procedure (*procedura di riequilibrio finanziario pluriennale*) according to Decree Law number 174 of 2012, which was converted into Law number 213 of 2012.<sup>61</sup>

The most important innovation is the simplified procedure under TUEL,<sup>62</sup> which introduced a process similar to that of the arrangement with creditors. During this simplified procedure, the extraordinary liquidation body has the power to settle an entity’s credit claims by offering a payment of between 40% and 60% of the entire debt.

### 3.4 Functions and aims of the legislative frameworks

The procedures that may be utilised by distressed LPEs have been developed to allow protection to the creditors of the entities that use them. They are also crucial for guaranteeing business continuity despite an entity facing a financial crisis, as the imbalances in economic and financial conditions that caused the crisis must not lead to the forced closure of the entity’s business.

A declaration of distress<sup>63</sup> leads to a fracture between the past and the future. However, it does allow LPEs to continue free from debt, though also devoid of credits and assets (if they have been sold for liquidation purposes). All of this is explained by considering the utility of protecting local entities, together with the fact that they cannot cease to exist as they are not indispensable, unlike standard companies.

Finally, it should be noted that the discussed legislation aims to allow entities to overcome insolvency issues. In order to fulfil its aim, the legislation is able to influence the rights of creditors (albeit with some limitations), which creditors, following the declaration of insolvency, will be unable to lodge individual enforcement actions to make judicially-ascertained claims.

In short, it can be said that the legislation and the consequent necessary recovery procedure aimed at financial normalisation pursue the dual purpose of:

- (i) guaranteeing the general interest in continuing the functions of the entity utilising the procedure, ensuring that essential services are still provided; and

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<sup>60</sup> TUEL, arts 242 and 243.

<sup>61</sup> *Idem*, arts 243(2)-(4).

<sup>62</sup> *Idem*, art 258.

<sup>63</sup> *Idem*, art 246.



- (ii) protecting creditors by satisfying their claims in compliance with the principle of *par condicio creditorum*, subject to the prohibition on individual enforcement actions.<sup>64</sup>

### 3.5 Automatic stay

TUEL regulates the consequences of a declaration of distress.<sup>65</sup> From the date of a declaration of distress and until a report made in alignment with TUEL (the management report of the extraordinary liquidation body) is approved,<sup>66</sup> no executive actions can be taken or continued against a declaring entity for debts falling under the remit of the extraordinary liquidation body.

This prohibition has been the subject of some fundamental decisions of the European Court of Human Rights<sup>67</sup> concerning the problem of non-payment (or, more specifically, the excessive delay in payment of debts by local authorities in a state of financial distress). In the cases mentioned in the footnotes, the applicants claimed that the state of financial instability declared by the local entity (the municipality of Benevento) in 1993 prevented the execution of their claims ascertained by a final judgment which claims were, therefore, characterised as certain, liquid and collectable. The European Court of Human Rights ruled that the right to a fair trial is compromised if the legal system of a EU member state allows that a final and enforceable judgment cannot be executed to the detriment of an unsuccessful party, as the execution of a conviction ruling pronounced by a court is an integral part of the judicial process.<sup>68</sup>

### 3.6 Powers of creditors and jurisdiction

As discussed above, the extraordinary liquidation body carries out the financial distress procedure of LPEs. Creditors are not separated into classes, as the procedure aims to facilitate the full payment of an entity's liabilities.<sup>69</sup> This means that creditors do not need to vote on a restructuring plan, as they are not impaired by the procedure. A cramdown mechanism may only be utilised in a simplified procedure.<sup>70</sup>

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<sup>64</sup> This dual purpose, which is inherent in the rules on the financial recovery of municipalities and provinces, has been recognised since the 1990s in a judgment by the Constitutional Court (no 155 of 21 April 1994). Also see Constitutional Court no 269 of 17 July 1998. The Judge highlighted that the ultimate aim of the entire procedure is to return the institution to a position in which it is able to fulfil its institutional functions in a situation of financial equilibrium.

<sup>65</sup> TUEL, art 248.

<sup>66</sup> *Idem*, art 256.

<sup>67</sup> See the "twin" cases of the European Court of Human Rights, *De Luca v Italy* (app no 43870/2004) and *Pennino v Italy* (app no 43892/2004) of 24 September 2013, with comment by L Mercati, "Il dissesto degli enti locali dinanzi alla Corte europea dei diritti umani", *Giur it* (2014) at 373.

<sup>68</sup> The European Court of Human Rights specifically stated that the financial needs of the public administration could not justify a serious compromise of the right to have its claims recognised if they derive from a final judgment. In fact, the requirements of a fair trial concern both the assessment phase and the execution phase.

<sup>69</sup> TUEL, art 256(5).

<sup>70</sup> *Idem*, art 258.

As discussed, the bodies involved in a financial distress procedure are essentially administrative and not jurisdictional. A court is not in charge of the proceedings for LPEs in distress. In particular, the appointment of an extraordinary liquidation body is ordered by a decree of the President of the Republic at the proposal of the Ministry of the Interior. Despite an entity's rescue, the parties responsible for its distress can still be held accountable for damages to the Treasury. Any disputes regarding the interpretation and practical application of the provisions of the TUEL are referred to administrative courts.

### 3.7 Parties

With regard to the distress procedure affecting LPEs, the extraordinary liquidation body appointed by decree of the President of the Republic will present a repayment plan for approval by the Ministry of the Interior, through which the situation that created the bankruptcy can be removed.

With regard to "crisis" procedures, it should be noted that a resolution to appeal the multi-year financial rebalancing procedure must be sent, within a short period from the date of execution, to the competent regional section of the Court of Auditors and to the Ministry of the Interior.

Within 10 days from the date of the resolution indicated by TUEL,<sup>71</sup> a multi-year financial rebalancing plan must be sent to a competent regional control section of the Court of Auditors and the commission identified in article 155. Within 60 days from submission, this commission will carry out the necessary preliminary investigation based on the guidelines approved by the special section of the Court of Auditors.

Within 30 days from receiving the necessary documentation, the regional control section of the Court of Auditors decides whether to approve or reject a plan by assessing its appropriateness for financial rebalancing purposes. If a plan is approved, the Court of Auditors supervises its execution. A decision to accept or deny approval of a multi-year financial rebalancing plan is communicated to the Ministry of the Interior.

LPEs are prohibited from taking new mortgages after their financial distress has been resolved, except those intended to cover ordinary expenses.<sup>72</sup> It is evident that, in this situation, the only way to guarantee for an entity to truly balance its budget is by adopting measures regarding personnel and local taxes, which are considered extremely penalising. In fact, this aspect means that institutions often only declare bankruptcy when, following the enforcement actions of creditors seizing sums of cash, they can no longer pay salaries to their employees.

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<sup>71</sup> *Idem*, art 243(2), para 5.

<sup>72</sup> *Idem*, art 249.

### 3.8 Publicly-owned companies

For the sake of completeness, it should be noted that the nature of publicly-owned companies in the Italian legal system has long been discussed. The debate has focused on the fact that these companies can be classified as public bodies and thus benefit from a consequent exemption from bankruptcy proceedings. This problem appears to have been resolved by the New Code, which has also extended its subjective scope of application to public companies, thus clarifying that public bodies cannot benefit from the aforementioned exemption. It should be considered that Royal Decree of 18 June 1931 (TUSP)<sup>73</sup> had previously also declared that publicly-owned companies should be subject to bankruptcy proceedings and arrangements with creditors.<sup>74</sup>

## 4. Dealing with local public entities in distress

### 4.1 Significant cases of local public entities in distress

The focus now turns to the case concerning the municipality of Catania.

In 2013, the municipality of Catania resorted to using a financial rebalancing procedure, but it was unsuccessful. Consequently, the municipality required that the local authority declares its financial distress.

The municipality of Catania adhered to the multi-year economic-financial rebalancing plan made in 2013 by resolution of the Court of Auditors.<sup>75</sup> This plan had been assessed positively by the Court of Auditors, but was subsequently modified by the Council of the municipality on several occasions.<sup>76</sup> The plan proved to be ineffective, not only in light of the results achieved directly but also by virtue of the substantial legislative changes that occurred between the initial formulation of the plan and its conclusion in late 2018.

Catania has not been the only municipality to experience financial distress in recent times. Another notable case is the municipality of Alessandria. This can be studied in depth by

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<sup>73</sup> *Testo Unico delle Leggi di Pubblica Sicurezza*, art 14 (also known in Italy by its abbreviation, TUSP).

<sup>74</sup> See in this regard a recent ruling by the Court of Cassation: Cass no 13160 of 30 June 2020, which ratified that a capital company that is wholly or partly owned by public bodies is always subject to bankruptcy pursuant to the Bankruptcy Law, art 1(1). Should a public entity hold a company's shares, it will only have rights in connection with its position as a shareholder, and it will not be allowed to influence the functioning of a company using its public powers.

<sup>75</sup> No 269 of 2013.

<sup>76</sup> In the rebalancing plan approved by the municipality of Catania, its main objectives (ie, the main causes of imbalance to be resolved through the plan) were to remedy (i) the municipality's persistent difficulty in collecting its own income, (ii) its tendency to rely on treasury advances, which revealed the structural inability of the entity to cover its normal payments, (iii) the maintenance of a large number of burdensome receivables over five years old that were of doubtful due date and had a crucial impact on its financial results, (iv) issues regarding its municipal shareholdings and financial relationships with them, and (v) the improper use of services on behalf of third parties for cases not envisaged by the regulations and accounting principles for local authorities.

analysing the judgments and orders issued by the regional section of the Court of Auditors for Piedmont.<sup>77</sup> These orders and judgments describe in detail the process of the procedure and clearly identify the financial conditions that can result from such procedure. The judgment of the Court of Auditors is very complex and articulated but section VI thereof is particularly relevant for this research.<sup>78</sup> In this section, the Court of Auditors defines “financial distress” as the situation in which either the LPE is no longer able to guarantee the performance of its essential functions and services, or when there are liquid and payable claims that the LPE is not able to pay within the ordinary course of business.

The procedures outlined in this chapter have been used by many more municipalities, including Caserta and Naples. This shows that, despite the administrative support provided by these procedures, more should be done to strengthen the system of early warning and the accountability of local managers.

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<sup>77</sup> Court of Auditors, *Regional Audit Section of Piedmont, resolution no 260 of 12 June 2012*, available [here](#).

<sup>78</sup> *Idem*, p 63 ff.

## Local public entities in distress – a critical analysis of the Japanese approach

By Keisuke Imamoto\*

This paper discusses the structure of Japan's bankruptcy legislation and the insolvency legislation of local governments. The term "local public entity" is provided in Japan's Constitution, but in this paper, it means the municipality and public enterprises covered by the Act on Assurance of Sound Financial Status of Local Governments.<sup>1</sup>

### 1. Overview of Japan's bankruptcy legislation

#### 1.1 Characteristics of Japan's bankruptcy legislation

Japan's bankruptcy legislation includes liquidation procedures equivalent to Chapter 7 of the Federal Bankruptcy Code of the United States and procedures equivalent to Chapter 11 of the same code. Japan generally takes a fragmented approach to liquidation in which the debtor or creditor can choose either procedure.

##### 1.1.1 Liquidation procedures

To implement liquidation, corporations follow bankruptcy proceedings and special liquidation procedures as described below.

###### 1.1.1.1 Bankruptcy proceedings

Bankruptcy proceedings apply to all individuals and corporations. Although it is not expressed in the Bankruptcy Act,<sup>2</sup> it is considered that bankruptcy declarations made by local governments should be denied as the dissolution of a local government's legal personality is not recognised by a legal order.<sup>3</sup> Specifically, local governments are unable to liquidate the property that is the basis of their activities through bankruptcy proceedings. Therefore, local governments are excluded from utilising the Bankruptcy Act.<sup>4</sup>

Bankruptcy proceedings are commenced by a petition made to a court by a creditor or debtor due to a debtor's insolvency and excess debt. Upon commencement of bankruptcy proceedings, the debtor's property is managed by a bankruptcy trustee appointed by a court.

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<sup>1</sup> Act No 94 of 2007, the English translation contained in the Japanese Law Translation Database System (JLT DS), available [here](#).

<sup>2</sup> Act No 75 of 2004, English translation in the JLT DS.

<sup>3</sup> M Ito, *Bankruptcy and Civil Rehabilitation Act* (5<sup>th</sup> ed, Yuhikaku, Tokyo, 2022) at 90.

<sup>4</sup> *Ibid.*

All bankruptcy creditors must participate in bankruptcy proceedings in order to exercise their rights. In principle, creditors are paid equal dividends, but security rights such as mortgages are excluded. The right of exchange is exercised outside of bankruptcy proceedings, and priority payment rights are possible. In principle, upon commencement of bankruptcy proceedings, bankruptcy claims can be made. Receivables can offset the debts borne by a creditor to a bankrupt entity. However, the right to offset is denied if doing so will contradict the creditors' equality. The security right as a right of exclusion may be redeemed by compulsory execution procedures, and an exclusion rights holder cannot refuse it.

Upon filing for bankruptcy, a petition for a grant of discharge is also deemed to be filed. When discharge proceedings are established, an individual debtor can file a petition for a grant of discharge. When an order for a grant of discharge becomes final and binding, an individual debtor is discharged from his liabilities associated with any bankruptcy claims. Given that the Bankruptcy Act is for "securing the opportunity for rehabilitation of [the] economic life [of companies]",<sup>5</sup> bankruptcy proceedings are considered debtor-friendly.

#### 1.1.1.2 *Special liquidation procedures*

Special liquidation proceedings are applicable to a stock company in liquidation when circumstances prevent the execution of the liquidation or when debt overrun is suspected. These proceedings commence with a court order. Unlike in a bankruptcy proceeding where the bankruptcy trustee implements the liquidation, in a special liquidation this function is assumed by liquidators (for example, directors). Moreover, unlike in bankruptcy proceedings, creditors' payments require a special majority decision on a proposal made by the liquidator to be passed and subsequent court approval. This makes special liquidations creditor-friendly.

### 1.1.2 **Rehabilitation procedures**

Rehabilitation procedures include civil rehabilitation and corporate reorganisation proceedings.

#### 1.1.2.1 *Civil rehabilitation proceedings*

Civil rehabilitation proceedings are filed prior to bankruptcy. Petitions are filed "when there is [a] risk that a fact constituting the grounds to commence bankruptcy proceedings [is faced by] a debtor"<sup>6</sup> or "when a debtor is unable to pay debts that are due without causing significant hindrance to business continuation".<sup>7</sup> Civil rehabilitation proceedings apply to individuals and corporations in general, but there are no clearly written

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<sup>5</sup> Bankruptcy Act, art 1, English translation in the JLT DS.

<sup>6</sup> Civil Rehabilitation Act, Act No 225 of 1999, art 21, para 1, English translation in the JLT DS.

<sup>7</sup> *Ibid.*

procedures contained in statute. It is understood that local governments do not have the ability to rehabilitate for the same reason applicable to bankruptcy proceedings.<sup>8</sup>

In civil rehabilitation proceedings, a debtor has the right to dispose of property and the right to carry on business, and trustees are only appointed if it is deemed necessary for a business' rehabilitation. A person who holds a security interest in a debtor's property is considered to have an exclusion right, which right may be exercised in the absence of civil rehabilitation proceedings. A creditor who has priority claims, such as liens, will receive payments at any time, even without civil rehabilitation proceedings having been initiated. Therefore, in civil rehabilitation proceedings, the rehabilitation plan is intended only for general creditors; as such, the procedures are simplified and accelerated. However, if a court finds that the rehabilitation conforms to the general interests of a creditor and is not likely to cause unreasonable damage to an auctioneer, it may order the suspension of a procedure to allow the security interest to be executed. Moreover, if a debtor's encumbered property is indispensable as it is needed for the continuation of its business, a debtor may file a petition for permission to extinguish the security interest. Evidently, restrictions on the execution of security rights in the process of continuing the business are permitted.

In the procedures for civil rehabilitation and corporate reorganisation, general provisions concerning rights changes are required in the rehabilitation plan to reduce the debt burden for the rehabilitation of a debtor's business. Although the change of rights is effective by virtue of a resolution of a creditors' meeting and the approval of the court, it is characterised by a simple procedure that is initiated in a manner that is dissimilar to the corporate reorganisation procedure.

### 1.1.2.2 *Corporate reorganisation procedures*

Corporate reorganisation procedures may only be utilised by stock companies. A petition is granted "where there is [a] risk that a fact constituting the grounds for commencement of bankruptcy proceedings [could] occur"<sup>9</sup> or "where the stock company is likely to experience significant hindrance to the continuation of its business if it pays its debts that are due".<sup>10</sup> As with civil rehabilitation procedures, corporate reorganisation is recognised prior to bankruptcy.

During a corporate reorganisation procedure, the right to manage and dispose of a debtor's property is exclusive to a rehabilitation trustee. However, since the purpose of this procedure is to reorganise a debtor's business, the rehabilitation trustee manages both the property disposition and the business.

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<sup>8</sup> M Ito, *Bankruptcy and Civil Rehabilitation Act* (5<sup>th</sup> ed, Yuhikaku, Tokyo, 2022) at 843.

<sup>9</sup> Corporate Reorganisation Act, Act No 154 of 2002, art 17, para 1, English translation in the JLT DS.

<sup>10</sup> *Ibid.*

When a debtor is subject to a corporate reorganisation, it is necessary for all rehabilitation creditors, including those with security interests, to participate in the procedure. It is not possible for a company to make payments outside of a procedure or for creditors to file a petition for a compulsory liquidation of a company's property. Moreover, unlike in relation to bankruptcy proceedings, creditors with various rights (for example, rehabilitation claims, rehabilitation security rights and shares) vote on the resolution separately in their respective classes. When a rehabilitation plan proposal is passed and approved by a court, a rehabilitation trustee carries out the rehabilitation plan.

As described above, corporate reorganisation procedures are more integrated methods of business revitalisation than civil rehabilitation proceedings.<sup>11</sup> However, corporate reorganisation procedures are less often used for civil rehabilitation as the management rights are transferred to the rehabilitation trustee, and the former shareholders' rights are also extinguished via 100% capital reduction and the issuance of new shares.<sup>12</sup>

Since the realisation of continuing business value takes precedence over the realisation of liquidation value, civil rehabilitation and corporate reorganisation proceedings are prioritised over bankruptcy proceedings. However, if they do not achieve their purpose, a court may commence bankruptcy proceedings.

## 1.2 Reform of Japan's bankruptcy legislation

Japan's bankruptcy legislation takes multiple procedural forms, and the debtor or creditor decides which one to initiate. Building on the review of bankruptcy legislation since 1996, the bankruptcy law in the Corporation Act of 2005<sup>13</sup> now provides for special liquidation. Additionally, the Civil Rehabilitation Act<sup>14</sup> came into effect in 2000, whilst the Corporate Reorganisation Act<sup>15</sup> became operational in 2003. However, some specialists in civil procedures in Japan point out several issues, especially with regard to the structure of the entire bankruptcy system.<sup>16</sup>

### 1.2.1 Adoption of a single procedural approach

Currently, upon the finding of financial distress, a choice must be made regarding whether to utilise a liquidation or rehabilitation procedure. However, as seen in managed civil rehabilitation and debtor-in-possession type corporate reorganisation, the difference between rehabilitation-type procedures is becoming negligible. Therefore, it is strongly advised that a bankruptcy proceeding should be started as a single procedure, and it should be examined whether to continue or liquidate the business, and whether to

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<sup>11</sup> M Ito, *Bankruptcy and Civil Rehabilitation Act* (5<sup>th</sup> ed, Yuhikaku, Tokyo, 2022) at 46.

<sup>12</sup> *Ibid.*

<sup>13</sup> Act No 86 of 2005.

<sup>14</sup> Act No 225 of 1999.

<sup>15</sup> Act No 154 of 2002.

<sup>16</sup> See M Ito, *Bankruptcy and Civil Rehabilitation Act* (5<sup>th</sup> ed, Yuhikaku, Tokyo, 2022) at 81.



provide property disposal or business management rights to an external third party or a debtor.

### **1.2.2 Relationship with extrajudicial proceedings**

Whilst private arrangements for business rehabilitation have been carried out frequently, it has been noticed that it is necessary to examine how to position private arrangements in rehabilitation procedures.

### **1.3 Reforms related to the discipline of local governments in the event of financial distress**

In Japan, local governments are denied the ability to petition for bankruptcy because of their inability to get approval by legal order to liquidate the property on which their activities are based, as the legal personality of the local governments would dissolve.<sup>17</sup> Other public corporations are able to petition for bankruptcy, but may be denied bankruptcy through the establishment of special liquidation proceedings, as per legislative policies.<sup>18</sup>

Regarding local governments, the former Act on the Special Measures to Promote Local Public Financial Reconstruction<sup>19</sup> was promulgated to encourage local governments that have failed in their financial policy to improve their financial discipline. It also provided that a local government facing financial distress had to seek a turnaround under the national government's supervision. However, this Act was criticised because the procedure began when the entity fell in distress. As a result, a financially distressed local government needed to seek financial reconstruction under the national government's strong supervision soon after becoming financially distressed. Moreover, under this act, the necessity of financial reconstruction was judged only by the general accounts of local governments. Hence, there was a risk that the financial collapse of a semi-public joint venture company, (called "a third sector" company in Japan) funded by private sectors and local governments, would be overlooked. Therefore, in 2007, the Act on Assurance of Sound Financial Status of Local Governments (the Local Financial Soundness Act)<sup>20</sup> was enacted. Under this Act, early financial soundness must be established before undertaking financial reconstruction under strong national supervision. This must be evidenced through an earlier fiscal soundness of special accounts, public enterprise accounting, semi-public joint venture company (third sector) accounting, as well as the local government's general account.<sup>21</sup>

Although local governments have cash-based accounting records, accrual-based records have been proposed to gain a clearer picture of their financial situation. In 2014, the Ministry of Internal Affairs and Communications asked local governments to prepare financial documents using uniform accounting standards on an accrual basis.

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<sup>17</sup> *Idem*, at 90.

<sup>18</sup> *Idem*, at 91.

<sup>19</sup> Act No 195 of 1955 (abolished in 2007).

<sup>20</sup> Act No 94 of 2007.

<sup>21</sup> See the discussion in this regard below.

## 2. Local governments in Japan

### 2.1 Types of local governments in Japan

In Japan, the term local government is not constitutionally or legally defined. However, Japan's Constitution provides that regulations concerning organisations and operations of local public entities shall be fixed by law in accordance with the principle of local autonomy.<sup>22</sup> Specifically, the Local Autonomy Act<sup>23</sup> deals with matters concerning the classification, organisation and operation of local governments. Moreover, assemblies serve as the Constitution's deliberative organs. Japan's Constitution provides that the chief executive officers of all local public entities, the members of their assemblies, and such other local officials as may be determined by law shall be elected by direct popular vote within their respective communities.<sup>24</sup> Therefore, local governments have called for the establishment of a uniformly democratic organisation and for the head of local governments to be elected by residents from their communities to avoid diversity of the organisation.

The Local Autonomy Act treats local governments as corporations,<sup>25</sup> divides local governments into ordinary and special local public bodies,<sup>26</sup> and provides for the voluntary and comprehensive implementation of local administration as a basis for promoting the welfare of residents as part of a local government's role.<sup>27</sup> Ordinary local public entities include municipalities (cities, towns and villages), which are basic local governments; as well as prefectures, which are regional governments in a wider area. It is recognised that municipalities generally handle local affairs, except for those handled by prefectures.<sup>28</sup> Prefectures handle (i) affairs in regions that span a large territory, (ii) liaison and co-ordination amongst municipalities, and (iii) affairs that are deemed inappropriate to be handled by general municipalities because of their size or nature.<sup>29</sup> In Japan, except for the Tokyo special wards, all areas of the country belong to municipalities (which are basic local governments) and prefectures (which are regional governments that cover a wider geographical area). In January 2022, there were 1,718 municipalities and 47 prefectures.

Special local governments include special wards, associations and property districts. Special wards are equivalent to cities and handle affairs generally handled by municipalities, except for those that are handled integrally by the prefecture in areas

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<sup>22</sup> Constitution of Japan, art 92.

<sup>23</sup> Act No 67 of 1947.

<sup>24</sup> Constitution, art 93, para 1.

<sup>25</sup> Local Autonomy Act, art 2.

<sup>26</sup> *Idem*, arts 1-3.

<sup>27</sup> *Idem*, arts 1 and 2.

<sup>28</sup> *Idem*, art 2, para 3.

<sup>29</sup> *Idem*, art 2, para 5.

where special wards exist.<sup>30</sup> Tokyo is the only prefecture in which special wards currently operate.<sup>31</sup>

There are some partial-affairs associations and wide-area associations. Partial-affairs associations are established by multiple local governments to jointly manage part of the affairs pertaining to local government,<sup>32</sup> whereas wide-area associations are established to handle a wide range of affairs comprehensively and systematically by creating a wide area plan and making necessary communication adjustments.<sup>33</sup> Partial-affairs associations are used for waste disposal, firefighting, hospital affairs, and similar services. Wide-area associations not only jointly manage the affairs pertaining to local government, but are also recipients of the transfer of authority from the national government.<sup>34</sup> There were 1,303 partial-affairs associations on 31 March 2018,<sup>35</sup> whilst there were 116 wide-area associations on 1 April 2022.<sup>36</sup>

Property districts are special local governments that are authorised to manage and dispose of property or public facilities in municipalities. In property wards, the municipal assembly and the executive body of municipalities and special wards shall manage and dispose of property in the property wards, but the property ward must be accounted for separately.<sup>37</sup> There are 3,940 property wards in 429 municipalities on 1 April 2021.<sup>38</sup>

## 2.2 The Act on Assurance of Sound Financial Status of Local Governments, and local public entities

The Local Financial Soundness Act deals with prefectures, municipalities, special wards and public enterprises managed by local governments. Water supply, industrial water supply, track, automobile transportation, railway, electricity, gas, port improvement, hospitals, markets, livestock, tourism, housing and public sewerage businesses are typically operated through public enterprises. Alternatively, these businesses may be run through semi-public joint venture companies, which are also funded by local

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<sup>30</sup> *Idem*, art 281-12, para 2.

<sup>31</sup> Currently, special wards are only established in Tokyo. However, under the Act on the Establishment of Special Wards in Large Metropolitan Areas, Act No 80 of 2012, (i) ordinance-designated cities that have a population of more than 2 million or (ii) an ordinance-designated city and the area of the same prefecture adjacent to that city that have more than 2 million residents, can abolish municipalities and establish special wards in that area. To abolish municipalities and establish new special wards, relevant municipalities and related prefectures shall consult and prepare a special ward establishment agreement. After approval by the assemblies of the interested municipalities and prefectures, it is necessary to have the approval of the majority of the population in the relevant municipalities. The abolition of prefectures and the establishment of special wards were considered in Osaka City in 2016 and 2020, but neither was rejected by a referendum and both realised.

<sup>32</sup> Local Autonomy Act, art 284, para 2.

<sup>33</sup> *Idem*, art 284, para 3.

<sup>34</sup> *Idem*, art 291.2, para 1 and 2.

<sup>35</sup> According to a survey by the Ministry of Internal Affairs and Communications. In this regard, see [here](#).

<sup>36</sup> According to a survey by the Ministry of Internal Affairs and Communications. In this regard, see [here](#).

<sup>37</sup> Local Autonomy Act, art 294, para 3.

<sup>38</sup> According to a survey by the Ministry of Internal Affairs and Communications. In this regard, see [here](#).

governments. However, the Local Financial Soundness Act does not apply to semi-public joint venture companies. Thus, if such a company goes bankrupt, it will be dealt with under normal bankruptcy law procedures. Public schools are operated by local governments through their boards of education, and public schools themselves thus do not face insolvency issues. Some hospital businesses and research institutes are operated by local independent administrative agencies, and some public universities are operated by public university agencies that are classified as local independent administrative agencies. Local independent administrative agencies are however not subject to the Local Financial Soundness Act. For local independent administrative agencies, local government grants are their main source of funds.<sup>39</sup> Since a local independent administrative agency must prepare a medium-term plan based on medium-term targets set by the heads of local governments,<sup>40</sup> and since the approval of the head of the local public entity is required for the medium-term plan,<sup>41</sup> there is no bankruptcy procedure for local independent administrative agencies.<sup>42</sup>

### 3. Legal system for financially distressed local governments: framework of the Local Financial Soundness Act

#### 3.1 The former Local Fiscal Reconstruction Act

The former Local Fiscal Reconstruction Act of 1955 was first enacted as a system for addressing financial distress amongst local governments.<sup>43</sup> It was passed to respond to the country's poor financial situation in the late 1940s and 1950s.<sup>44</sup> Mainly, it sought to establish a reconstruction system for the ordinary accounting of local public bodies and for public enterprises to which the Local Public Enterprise Act<sup>45</sup> applies. The former Local Fiscal Reconstruction Act was a special-measures law centred on procedures for financial reconstruction of financially distressed bodies and public enterprises. Under this system, a "financial reconstruction body" would formulate a financial reconstruction plan to submit to the Commissioner of the Self-Governing Bodies for approval. Such a financial reconstruction plan would seek to improve a company's financial conditions. Financial reconstruction bodies made plan applications under this system from 1955 by using a quasi-reconstruction procedure. According to the former Local Fiscal Reconstruction Act, 588 bodies (18 prefectures and 570 municipalities) were approved as reconstruction bodies and 296 organisations (two prefectures and 294 municipalities) were approved as quasi-reconstruction organisations. Building on these provisions, a procedure for the financial reconstruction of financially distressed public enterprises was established in

<sup>39</sup> Local Independent Administrative Agency Act, Act No 118 of 2003, art 42, para 1.

<sup>40</sup> *Idem*, arts 25, para 1 and 26, para 1.

<sup>41</sup> *Idem*, art 26, para 1,

<sup>42</sup> *Idem*, arts 88-105 also provide the procedure of dissolution and liquidation.

<sup>43</sup> Act No 195 of 1955 (abolished in 2007).

<sup>44</sup> Approximately 80% of the prefectures and about a third of municipalities had posted a real loss at that time. T Kondo, "Establishment of a New Rehabilitation System for Local Finance - Bill on Financial Soundness of Local Governments", *Legislation and Investigation* 3 (2007) at 268.

<sup>45</sup> Act No 292 of 1947.

1965, and, from 1966, distressed public enterprises were reconstructed using these provisions. So far, 155 public enterprises (one in prefecture and 154 in municipalities) have utilised the provisions, and 25 public enterprises (one in prefecture and 24 in municipalities) have been approved for quasi-reconstruction.

According to the former Local Fiscal Reconstruction Act, local governments that advanced the next fiscal year's revenue to compensate for a lack of revenue in the relevant year either (i) deferred the payment of debts to the next fiscal year, or (ii) carried forward the projects to be executed in the relevant fiscal year to the next due to a lack of revenue in the relevant year. If this took place whilst the intention was to rebuild public finances, the Commissioner of the Bureau of Home Affairs had to be notified (and after 1960, the Minister of Home Affairs) by a date specified by cabinet order after the resolution of the assembly of a distressed entity, and a financial reconstruction plan as specified by the Commissioner of the Bureau of Home Affairs had to be established.<sup>46</sup> Upon the approval of a financial reconstruction plan by the Commissioner of the Bureau of Home Affairs, financial reconstruction bodies were enabled to issue financial reconstruction bonds with permission of the Commissioner of the Bureau of Home Affairs to cover the lack of revenue in the relevant fiscal year, and to allocate the financial resources of retirement allowances to employees who had left the body from the day when the plan was approved, to the day when the plan would have finished by virtue of the revision or abolition of the employment system or a decrease in budget.<sup>47</sup> Financial reconstruction bonds for the former purpose had to be repaid within approximately seven years from the following fiscal year, and those for the latter purpose had to be repaid within three years from the following fiscal year.<sup>48</sup> Subject to the annual budget, the state could replenish the amount equivalent to the interest payment for the financial reconstruction bond in excess of that paid at a fixed rate of interest of 3.5% per annum, but not exceeding the amount paid at above a fixed rate of 5% per annum.<sup>49</sup> If the Commissioner of the Bureau of Home Affairs found that the management of the financial reconstruction body did not conform to the financial reconstruction plan, the Commissioner could request that the execution of parts of the budget deemed not to conform to the financial reconstruction plan be suspended and other necessary measures be taken in the management of the financial administration of the financial reconstruction body.<sup>50</sup>

### **3.2 Problems with the former Local Financial Reconstruction Act, and the direction of reform**

From 1999 to 2019 decentralisation reform was underway in Japan, and the necessity of the full liberalisation of municipal bonds and developing rehabilitation-type bankruptcy legislation were examined.<sup>51</sup> In particular, under the former Local Fiscal Reconstruction

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<sup>46</sup> Former Local Finance Reconstruction Act, art 2.

<sup>47</sup> *Idem*, art 12, para 1 and art 14.

<sup>48</sup> *Idem*, art 13.

<sup>49</sup> *Idem*, art 15.

<sup>50</sup> *Idem*, art 21.

<sup>51</sup> Decentralization 21st Century Vision Advisory Panel, *Decentralization 21st Century Vision Advisory Panel Report* (2010) at 5-6, available [here](#).

Act the permission from the former Minister of Home Affairs (now the Minister of Internal Affairs and Communications) was required for the issuance of municipal bonds to achieve financial soundness of local governments and give credibility to the municipal bonds. However, following the decentralisation reforms in 1999, in principle, municipal bonds can be issued in consultation with the Minister of Internal Affairs and Communications.<sup>52</sup> Therefore, as for the issuance of municipal bonds, it was deemed urgent to ensure that the issuance of municipal bonds is left to the autonomy of local governments and that municipal bonds are rated in the capital market according to the creditworthiness of each local government. As for the need to develop a rehabilitation type of bankruptcy legislation, it was suggested that early corrective measures based on transparent rules be taken; otherwise, rehabilitative measures will be taken as the second step.<sup>53</sup>

It was also pointed out that the quasi-reconstruction of the former Local Financial Reconstruction Act had the following problems:<sup>54</sup>

- each body did not disclose easy-to-understand financial information on a daily basis in order to enable early correction and rehabilitation when needed. There were insufficient means to ensure the objectivity and accuracy of financial indicators and their basis of calculation;
- there were only standards for the entity to be financially reconstructed, and there was no function to encourage correction at an early stage. Hence, what should be addressed by working on fiscal soundness at an early stage could lead to a serious situation and, consequently, long-term reconstruction. This ultimately imposed an excessive burden on residents;
- as only a substantial balance ratio (flow index) was used as a basis for reconstruction bodies, bodies whose other indicators (such as real debt-service ratio) deteriorated or that had issues with stock-based fiscal conditions, for example, were not eligible. In addition, the former Local Financial Reconstruction Act mainly intended for ordinary accounting, so relationships with public enterprises and local public corporations were not considered; and
- mechanisms to promote reconstruction were limited.

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<sup>52</sup> For instance, as discussed below, when local governments that have prepared the financial rehabilitation plan issue municipal bonds, the permission of the Minister of Internal Affairs and Communications is still needed.

<sup>53</sup> Since the 2012 fiscal year, local governments that meet certain fiscal condition standards can, in principle, eliminate the need for consultation on the issuance of private and other funds procured in the financial markets. Since the 2016 fiscal year, consultations on some issuances of public-funded bonds have been unnecessary, and a pre-notification system has been introduced.

<sup>54</sup> New Local Financial Rehabilitation System Study Group, *New Local Financial Revitalization System Study Group Report* (2006) at 2, available [here](#).

It was also pointed out that, as for the reconstruction system (including quasi-reconstruction) in public enterprises, (i) there was a separate system completely independent of the reconstruction system centred on ordinary accounting, (ii) disclosure of financial information was insufficient, (iii) the management situation of the business was often directly linked to the burden on residents, and (iv) there was no function for early correction.<sup>55</sup> It was suggested that, in addition to overcoming the above issues, it was necessary to establish an early correction scheme based on transparent rules, considering that it is important to continue to provide basic administrative services to residents in the operation of local public bodies and to establish a new two-step procedure in which the rehabilitation scheme is applied if the financial position does not improve.<sup>56</sup>

It was also suggested that the reform should be examined separately in the event where (i) rehabilitation is carried out under the basic framework of the current local administrative and financial system and (ii) the fundamental reform of the local administrative and fiscal system (abolition of administrative duties by the government, enhancement of local taxes, drastic reform of financial resources measures for investment projects, liberalisation of local bonds, reform of government subsidy, and allocation tax) were undertaken during the progress of the restoration and it was considered with a view to transition from (i) to (ii) by the movement of decentralisation.<sup>57</sup> Regarding debt adjustment, it was ensured that there would be an examination of (i) whether it was necessary to have a mechanism to motivate creditors to respond to debt adjustments, (ii) how rational standards should be set for debt adjustment, (iii) how to consider the head's management responsibilities, (iv) what matters should involve courts, (v) the opinions about the responsibilities and burdens of states with large amounts of receivables compared with private creditors, (vi) how to raise funds for local governments with weak fiscal strengths, and (vii) how to introduce collateral settings for private financial institutions for debts by local governments.<sup>58</sup>

### 3.3 Outline of the Act on Assurance of Sound Financial Status of Local Governments

Based on the results of the study discussed above, the Local Financial Soundness Act was enacted in 2007.<sup>59</sup> Pre-enactment discussions were considered as directing the so-called rehabilitation type of legislation to introduce the liberalisation of municipal bonds and debt adjustments in a similar manner to Chapter 9 of the Federal Bankruptcy Code of the United States.<sup>60</sup> However, because of the technical difficulties of making debt adjustments immediately,<sup>61</sup> institutionalising debt adjustments was postponed and, in the end, the new act only realised "the two-step procedures in which early corrective measures based on

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<sup>55</sup> *Ibid.*

<sup>56</sup> *Ibid.*

<sup>57</sup> *Idem*, at 4.

<sup>58</sup> *Idem*, at 14.

<sup>59</sup> Act No 94 of 2007.

<sup>60</sup> Decentralization 21<sup>st</sup> Century Vision Advisory Panel, *Decentralization 21<sup>st</sup> Century Vision Advisory Panel Report* (2010) at 5-6, available [here](#).

<sup>61</sup> S Konishi, *Act on Fiscal Soundness of Local Governments and The Ratio of Soundness: Points for System and Financial Reconstruction* (Gakuyo Shobo, Tokyo, 2008) at 149.

transparent rules shall be taken, otherwise rehabilitative measures shall be taken as the second step",<sup>62</sup> or the introduction of an early corrective scheme and rehabilitation scheme.<sup>63</sup>

### 3.3.1 Purpose of the Local Financial Soundness Act and the ratio of the soundness judgment

The Local Financial Soundness Act aims to promote the soundness of the public finances of local governments by establishing a system for (i) announcing the ratio for determining the soundness of local governments, and (ii) local governments to formulate a plan for achieving early soundness or rehabilitation of public finances and the soundness of public enterprises according to this ratio. It provides for the system of promoting the early soundness of public finances by establishing the standards for early soundness as a preliminary stage of the financial rehabilitation procedure.<sup>64</sup> The heads of local governments are required to report and disclose on an annual basis the ratio for determining soundness after receiving the relevant financial results from the previous year.<sup>65</sup> Prefectural governors and the heads of ordinance-designated cities must report the published standards for financial soundness to the Minister of Internal Affairs and Communications and to the heads of municipalities and special wards, excluding those of ordinance-designated cities who must report them to the prefectural governors of each area.<sup>66</sup>

The ratio for determining soundness involves the ratios of real deficits (that is, the ratio of real deficits of local governments to the amount of standard fiscal scale in the general accounts),<sup>67</sup> consolidated real deficits (that is, the ratio of the standard fiscal scale of the real deficit to the amount of the standard fiscal scale of the real deficit for all the local government's accounts, including the special accounts of public enterprises in addition to the general account of the local governments alone),<sup>68</sup> real local bond expenses (that is, the ratio of principal and principal redemptions and quasi-principal and quasi-interest redemptions, including public enterprises and unions, to the standard fiscal scale of the amount of in the general accounts of local governments),<sup>69</sup> and future burdens (that is, the ratio of the standard fiscal scale of the amount in the general accounts of local governments to the substantial liabilities that the general account of local governments shall bear in the future for all public enterprises, unions, and semi-public joint companies).<sup>70</sup> In particular, the ratio of consolidated real deficits, real local bond expenses and future burdens differ from the system of the former Local Financial Reconstruction Act,

<sup>62</sup> Decentralization 21<sup>st</sup> Century Vision Advisory Panel, *Decentralization 21<sup>st</sup> Century Vision Advisory Panel Report* (2010) at 7, available [here](#).

<sup>63</sup> New Local Financial Rehabilitation System Study Group, *New Local Financial Revitalization System Study Group Report* (2006) at 12, available [here](#).

<sup>64</sup> Local Financial Soundness Act, art 1.

<sup>65</sup> *Idem*, art 3, para 1.

<sup>66</sup> *Idem*, art 3, para 3.

<sup>67</sup> *Idem*, art 2, no 1.

<sup>68</sup> *Idem*, art 2, no 2.

<sup>69</sup> *Idem*, art 2, no 3.

<sup>70</sup> *Idem*, art 2, no 4.



in that they cover not only the general accounts of local governments but also accounts for public enterprises, unions, and semi-public joint companies.

### 3.3.2 *Early correcting scheme*

If any of the soundness judgment ratios are greater than or equal to the criteria for early soundness (unless they are deemed to be higher than the financial rehabilitation standard), a yellow card will be issued to the respective local government, and early measures to uphold the soundness of public finances will be implemented. Specifically, the heads of local governments assigned a yellow card (financial soundness bodies) shall establish a financial soundness plan, starting from the year that it will announce the ratio of the soundness decision by the end of the fiscal year, including that year.<sup>71</sup> A financial soundness plan will consider the factors that caused an entity's financial decline. Additionally, it will aim to restore the balance between revenue and expenditure in the general account and in others where there is a real deficit. Furthermore, if any of the ratios of consolidated real deficits, real bond expenses or future burden is more than the corresponding criterion for early soundness, this ratio shall be reduced to less than the criterion for early soundness. Moreover, the heads of local governments shall prepare a financial soundness plan that includes (i) an analysis of the factors causing the soundness judgment ratio to exceed the criterion for early soundness, (ii) the planning period, (iii) the basic policy for financial soundness, (iv) measures to substantially restore the balance between revenue and expenditure in the general account and in others where a real deficit exists, (v) measures to reduce any excessive ratio to the required ratio for early soundness, (vi) plans for revenue and expenditure for each fiscal year within the planning period, (vii) the prospect for the ratio of the soundness judgment for each fiscal year within the planning period, and (viii) matters necessary relevant to achieving the early soundness of public finances in addition to the above.<sup>72</sup>

The financial soundness plan shall be prepared by the heads of local governments and established through the assembly's resolution.<sup>73</sup> When local governments have established a financial soundness plan, they must promptly announce it. Prefectures and ordinance-designated cities (municipalities and special wards) must report any plans to the Minister of Internal Affairs and Communications (prefectural governors). The prefectural governors who receive the reports from municipalities and special wards shall

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<sup>71</sup> *Idem*, art 4, para 1. The ratio of real deficit for the criteria for early soundness is 11.25-15% (in the case of municipalities, depending on the financial scale) or 3.75% (in the case of prefectures, excluding Tokyo). The ratio of consolidated real deficits for the criteria for early soundness is 16.25-20% (in the case of municipalities, depending on the financial scale) or 8.75% (in the case of prefectures, excluding Tokyo). The ratio of real bond expenses for the criteria for early soundness is 25%. The future burden ratio for the criteria for early soundness is 350% (in the case of the municipalities, excluding ordinance-designated cities) or 400% (in the case of prefectures and ordinance-designated cities). Also see Order for Enforcement of the Local Financial Soundness Act, s 7 and <https://www.soumu.go.jp/iken/zaisei/kenzenka/index3.html>.

<sup>72</sup> Local Financial Soundness Act, art 4, para 2.

<sup>73</sup> *Idem*, art 5, para 1.

promptly provide a summary of the financial soundness plan to the Minister of Internal Affairs and Communications.<sup>74</sup>

By 30 September of each year, the head of a financial soundness body that established a financial soundness plan shall submit to the assembly a report on the implementation status of the financial soundness plan that clarifies progress from the prior year's financial results, and make it public. In the case of prefectures and the ordinance-designated cities, the prefectural governors and the heads of the ordinance-designated cities must also report on the implementation status of the financial soundness plan to the Minister of Internal Affairs and Communications, and in the case of municipalities (excluding the ordinance-designated cities and special wards), the head of the municipality must report to the prefectural governor. Moreover, the prefectural governor who receives the report from the municipality and the special ward must provide a summary of the financial soundness plan to the Minister of Internal Affairs and Communications.<sup>75</sup> Prefectural governors shall compile reports on the implementation status of the financial soundness plan annually and make outlines of plan public,<sup>76</sup> whilst the Minister of Internal Affairs and Communications shall compile and makes public the summary of the financial soundness plan every year.<sup>77</sup>

Under an early corrective scheme, the involvement of the national government and prefectures is limited, as these schemes aim to regain early financial soundness by encouraging local governments to make voluntary improvement efforts. That is, if the Minister of Internal Affairs and Communications or a prefectural governor finds it extremely difficult to recover the financial soundness of a financial soundness body in view of the implementation status of its financial soundness plan, he may make necessary recommendations to the head of the financial soundness body, and these recommendations should be made public.<sup>78</sup> When the head of a financial soundness body receives a recommendation, such head must promptly report the contents of the recommendation to the assembly of the financial soundness body and notify its audit committee members.<sup>79</sup>

### 3.3.3 *Financial rehabilitation schemes*

For local governments whose real deficit, consolidated real deficit or real bond expense ratios (these three ratios are referred to as the ratio for determining rehabilitation) is higher than or equal to the financial rehabilitation standard, a red card will be issued and the national government will be strongly involved. The future burden ratio is not included in the ratio for determining rehabilitation because this indicates the possibility of deterioration of future cash flow but does not immediately indicate the urgency of fiscal

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<sup>74</sup> *Idem*, art 5, para 2.

<sup>75</sup> *Idem*, art 6, para 1.

<sup>76</sup> *Idem*, art 6, para 2.

<sup>77</sup> *Idem*, art 6, para 3.

<sup>78</sup> *Idem*, art 7, paras 1-3.

<sup>79</sup> *Idem*, art 7, para 4.

deterioration.<sup>80</sup> Specifically, local governments assigned a red card (financial rehabilitation bodies) shall establish a financial rehabilitation plan, starting from the year that it will announce the ratio of the soundness decision by the end of the fiscal year, including that year.<sup>81</sup> When a financial soundness body has established a financial rehabilitation plan, the originally established financial soundness plan will no longer be effective.<sup>82</sup>

Based on the results of the analysis of the factors that caused a local government's financial situation to significantly deteriorate, the goal is to substantially restore the balance between revenue and expenditure in general accounts and to reduce the ratio of real public debt expenses or future burden to meet the criteria for early soundness within the minimum period. The financial rehabilitation plan should include (i) an analysis of factors that caused the rehabilitation judgment ratio to exceed the fiscal rehabilitation standard, (ii) the planning period, (iii) the basic policy for financial rehabilitation, (iv) plans for re-examining affairs and enterprises, organisational rationalisation, and other measures to reduce expenditures, (v) plans for increasing the amount of income generated from local taxes and other income generated for the fiscal year after the relevant fiscal year so that it is higher than before, (vi) plans to collect local taxes unpaid in the previous fiscal year, (vii) plans for changing the amount of royalties and fees, disposing of properties and other measures to increase revenue, (viii) plans for increasing local taxes by imposing local tax at a rate exceeding the standard tax rate provided in the Local Tax Act<sup>83</sup> or non-statutory ordinary taxes, (ix) plans for revenue and expenditure for each fiscal year within the planning period, (x) the redemption amount of the rehabilitation special bond for each fiscal year within the planning period when issuing it, (xi) the prospect for the ratio for determining soundness for each fiscal year within the planning period, and (xii) other matters necessary for financial rehabilitation.<sup>84</sup>

A financial rehabilitation plan must be prepared by the heads of local governments and established through a resolution passed by the relevant assembly.<sup>85</sup> When a local government of a prefecture has established a financial rehabilitation plan, it must promptly make it public and report it to the Minister of Internal Affairs and Communications, and when a municipality or a special ward has established a financial rehabilitation plan, it must

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<sup>80</sup> K Uga, *Summary of the Local Autonomy Law* (9<sup>th</sup> ed, Yuhikaku, Tokyo, 2021) at 222.

<sup>81</sup> Local Financial Soundness Act, art 8, para 1. The ratio of real deficits for financial rehabilitation criteria is 5% in the case of prefectures, and 20% in the case of municipalities and special wards. The ratio of consolidated real deficits is 15% in the case of prefectures, and 30% in the case of municipalities and special wards, and the ratio of real bond expenses is 35%. Order for Enforcement of the Local Financial Soundness Act, art 8. See also New Local Financial Rehabilitation System Study Group, *New Local Financial Revitalization System Study Group Report* (2006) at 2, available [here](#).

<sup>82</sup> Local Financial Soundness Act, art 8, para 2.

<sup>83</sup> Act No 226 of 1950, art 3, para 1. The Local Tax Act is a national law which is regarded as a frame law, and local taxes for local governments are provided for in the regulations of each local government. See also M Usui, *Summary of Mechanism and Law of Local Tax* (Gakuyo Shobo, Tokyo, 2001) at 8.

<sup>84</sup> Local Financial Soundness Act, art 8, para 3.

<sup>85</sup> *Idem*, art 9, para 1.

promptly make it public and report it to the Minister of Internal Affairs and Communications via prefectural governors.<sup>86</sup>

After the assembly's resolution, a local government of a prefecture may consult with the Minister of Internal Affairs and Communications directly, and that of a municipality or a special ward may consult with the Minister of Internal Affairs and Communications through a prefectural governor and it may request the Minister's consent to a financial rehabilitation plan.<sup>87</sup> Although the Minister's consent is not obligatory, a local government may not use local bonds as a source of revenue for expenditure if it has not obtained the Minister's consent, except in cases where they are used as a source of revenue for disaster recovery projects.<sup>88</sup> Upon gaining the Minister's consent, a local government may issue municipal bonds, called rehabilitation special bonds, to systematically resolve the shortfall in revenue and expenditure within the planned period of the financial rehabilitation plan, by transferring the shortfall to municipal bonds and redeeming them within the planned period.<sup>89</sup> Moreover, local governments that have established a financial rehabilitation plan, including those that have done so with a ratio for determining rehabilitation exceeding the criteria for financial rehabilitation, cannot issue municipal bonds unless they obtain permission from the Minister of Internal Affairs and Communications.<sup>90</sup>

In formulating a financial rehabilitation plan, national construction projects with costs that are to be shared by both the national and local governments must be considered. Upon receipt of a financial rehabilitation plan from a local government, the Minister of Internal Affairs and Communications must promptly notify the heads of each ministry about this matter who, in turn, must inform the Minister about such construction projects.<sup>91</sup> They must convey the total amount of expenses related to the project and the amount of the burden assigned to the financial rehabilitation body before commencing its implementation.<sup>92</sup>

The Minister of Internal Affairs and Communications must make public the contents of any financial rehabilitation plans reported by local governments every fiscal year.<sup>93</sup> The head of a financial rehabilitation body must produce a report for the assembly detailing the status of their plan's implementation in view of the financial results of the previous fiscal year, make the report public, and submit it to the Minister of Internal Affairs and Communications by 30 September of each year.<sup>94</sup> If necessary, the Minister of Internal Affairs and Communications may investigate the implementation status of a plan or request that a report be submitted to a financial rehabilitation body.<sup>95</sup>

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<sup>86</sup> *Idem*, art 9, para 2.

<sup>87</sup> *Idem*, art 10, para 1.

<sup>88</sup> *Idem*, art 11.

<sup>89</sup> *Idem*, art 12, paras 1 and 2.

<sup>90</sup> *Idem*, art 13, para 1.

<sup>91</sup> *Idem*, art 14, para 1.

<sup>92</sup> *Idem*, art 14, para 2.

<sup>93</sup> *Idem*, art 15.

<sup>94</sup> *Idem*, art 18, para 1.

<sup>95</sup> *Idem*, art 19.

In the case of financial soundness bodies, the involvement of national government and prefectures are limited as the aim is to realise the early soundness of public finances by encouraging improvement efforts. Meanwhile, in the case of financial rehabilitation bodies, if it is recognised that the management of their fiscal system does not conform to their financial rehabilitation plan or that it is difficult to rehabilitate their finances, the Minister of Internal Affairs and Communications may recommend that the head of the financial rehabilitation body change the budget and its financial rehabilitation plan and take other necessary measures.<sup>96</sup> When the head of a financial rehabilitation body receives a recommendation, he must promptly report the contents of the recommendation to the assembly of the financial rehabilitation body, notify the audit committee members,<sup>97</sup> and submit a report to the Minister of Internal Affairs and Communications on the measures taken based on the recommendation.<sup>98</sup>

### 3.3.4 *Sound management of public enterprises*

Upon receipt of the prior year's financial results of a public enterprise, the head of the local public entity that manages that public enterprise must promptly report the ratio of financial shortfall (that is, financial shortfall ratio for the previous fiscal year to the scale of the previous year's business) to the assembly and make it public.<sup>99</sup> If the financial shortfall ratio does not meet the criteria for soundness of public enterprise management, a local government must establish a management soundness plan for the public enterprise (soundness management enterprise) within the first fiscal year after the fiscal year in which the financial shortfall ratio is publicised.<sup>100</sup> The matters to be included in the management soundness plan are (i) an analysis of factors that caused the financial shortfall ratio to exceed the management soundness standard, (ii) the planning period, (iii) the basic policy for soundness management, (iv) measures to reduce the financial shortfall ratio to less than the criteria for deciding the soundness of management, (v) plans for revenue and expenditure for each fiscal year, (vi) prospects for the financial shortfall ratio for each fiscal year, and (vii) matters necessary for the soundness of management.<sup>101</sup> The provisions of financial soundness bodies apply *mutatis mutandis* to the formulation of management soundness plans, reports on the implementation status of management soundness plans, and recommendations from the national government.<sup>102</sup>

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<sup>96</sup> *Idem*, art 20, para 1.

<sup>97</sup> *Idem*, art 20, para 2.

<sup>98</sup> *Idem*, art 20, para 3.

<sup>99</sup> *Idem*, art 22, paras 1 and 2.

<sup>100</sup> *Idem*, art 23, para 1. The ratio for deciding the soundness of management is 20%. Also see the Order for Enforcement of the Local Financial Soundness Act, s 19.

<sup>101</sup> Local Financial Soundness Act, art 23, para 2.

<sup>102</sup> *Idem*, art 24.

## 4. Status and specific examples after the enactment of the Local Financial Soundness Act

### 4.1 Status after enactment of the Local Financial Soundness Act

Since the enactment of the Local Financial Soundness Act in 2007, the total number of prefectures, municipalities, and special wards designated as financial soundness bodies was 40, and the number of financial rehabilitation bodies was 43. However, there has been only one financial rehabilitation body (which was a fiscal reconstruction body under former legislation) that was designated as a financial rehabilitation body since 2007, and no financial soundness bodies since 2013. These developments suggest that the purpose of the Local Financial Soundness Act of voluntarily restoring public finances at an earlier stage has nearly been realised. As there have been no new early soundness or financial rehabilitation bodies since 2008, the Local Financial Soundness Act now functions as a fiscal discipline mechanism for local governments. Although some public-accounting enterprises have become soundness management enterprises, they are becoming soundness management enterprises less frequently, which suggests that the Local Financial Soundness Act is fulfilling its purpose (see Table 1 below).

### 4.2 The law in practice

Yubari City in Hokkaido Prefecture became a financial reconstruction body under the former Local Fiscal Reconstruction Act, and it remains a financial rehabilitation body. Yubari City prospered as a coal mining town and boasted a population of more than 100,000 people at its peak, but the coal industry declined due to different energy conversion gaining prominence. The 24 coal mines that it operated at its peak closed one after another after 1965, and all of its coal mines were closed by 1990. Instead of coal mines, Yubari City took the initiative to develop ski and other resorts, but after an economic decline in 1990 its financial situation deteriorated. In 2006, Yubari City became a financial reconstruction body under the former Local Fiscal Reconstruction Act. After the former legislation was abolished, Yubari City became a financial rehabilitation body under the Local Financial Soundness Act.

Yubari City's ratio for determining rehabilitation failed to meet the corresponding criteria in 2006, and it formulated a financial rehabilitation plan to fully repay a 32.2 billion Yen deficit.<sup>103</sup> This plan dictates that the financial rehabilitation period is from 2009 to 2029 and deficits will be eliminated by 2026. As a guiding principle, the development of effective policies with limited financial resources for the maintenance of regional vitality and future urban development is suggested. In particular, the measures considered are raising citizen and property taxes as well as other fees (for example, garbage disposal fees) to secure revenue, facilitate staff reduction, minimise staff labour costs, conduct a fundamental review of the clerical work to reduce expenditure, and plan for a compact town. Furthermore, the national government is expected to secure the total amount of local allocation tax and to bear a partial burden of interest on special rehabilitation bonds

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<sup>103</sup> In respect of the financial rehabilitation plan formulated by Yubari City, see [here](#).

(and the Hokkaido Prefecture is expected to bear a partial burden of interest on special rehabilitation bonds), and dismiss a portion of its staff.

Although the elimination of Yubari City's deficit currently seems to be on track, the population decline is greater than expected. Yubari City's population was 12,828 as at December 2006, whilst as at March 2022 it was 6,959.<sup>104</sup> Moreover, the percentage of the population aged 65 has risen from 41.70% as at April 2007 to 53.43% as at March 2022, which means that the population is rapidly ageing.<sup>105</sup> Except for the rate of the individual inhabitant tax returning to the standard tax rate under the Local Tax Act since the 2017 fiscal year, there is currently no change in Yubari City's situation. Many burdens remain, and service levels are low.

## 5. Conclusion

The discussion above outlines the legislation for dealing with financially distressed local governments in Japan. The provisions contained in the Local Financial Soundness Act seem to be functioning, and only Yubari City - a financial rehabilitation body - is currently undergoing financial rehabilitation through a financial rehabilitation scheme under the Local Financial Soundness Act. Fiscal rigidity in most municipalities is progressing because of the fiscal discipline under the Local Financial Soundness Act. However, as revenues decrease and expenditures increase because of the Covid-19 pandemic and ageing populations, reform of local government bankruptcy legislation, including debt adjustment, will become inevitable in the not-too-distant future.<sup>106</sup>

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<sup>104</sup> Yubari, "Population Transition (Basic Resident Register Base)" available [here](#).

<sup>105</sup> Yubari, "Aging Population and Aging Rate (2021)" available [here](#). The ageing rate of Japan as a whole was 20.1% as at September 2005 and was 29.1% as at September 2021. Statistics Bureau, Ministry of Internal Affairs and Communications, "The Elderly in Japan from the Viewpoint of Statistics - After Respect for the Aged Day - Elderly population (2021)" available [here](#).

<sup>106</sup> Famously, Kyoto City, which is a tourist city, is expected to possibly become a financial rehabilitation body in 2028 because there are many temples and shrines where properties, etcetera, are tax-exempt. In this regard, see The Yomiuri Shimbun, "Kyoto The Crisis of Fiscal Collapse, Becoming a Financial Rehabilitation Body, Plan to Improve the balance by 160 billion yen" (26 May 2021), available [here](#).

**Table 1**

Year	Early Soundness Body		Financial Rehabilitation Body		Number of Cities	Management Soundness Enterprises	Number of Public-accounting Enterprises
	Prefecture	City	Prefecture	City			
2007	0	40	0	3	1810	151	7441
2008	0	21(0)	0	1(0)	1798	61 (4)	7345
2009	0	13(0)	0	1(0)	1750	49 (5)	7146
2010	0	4(0)	0	1(0)	1746	38 (2)	7077
2011	0	1(0)	0	1(0)	1742	36 (5)	6956
2012	0	1(0)	0	1(0)	1742	20 (1)	6806
2013	0	0	0	1(0)	1741	18 (5)	6872
2014	0	0	0	1(0)	1741	11 (2)	6823
2015	0	0	0	1(0)	1741	10 (2)	6785
2016	0	0	0	1(0)	1741	9 (1)	6688
2017	0	0	0	1(0)	1741	11 (4)	6525
2018	0	0	0	1(0)	1741	7 (3)	6426
2019	0	0	0	1(0)	1741	5 (3)	6285

Changes in the Number of Early Soundness Bodies, Fiscal Rehabilitation Bodies and Management Soundness Enterprises

(Source: the Ministry of Internal Affairs and Communications' website news materials, edited version)

# The numbers in parenthesis denote the number of new entities.



# Local public entities in distress - a critical analysis of the Dutch approach

By Gert-Jan Boon\* and Jelle Nijland\*\*

## 1. Introduction

Public interests add complexity to the “regular” corporate restructuring and insolvency law framework. These frameworks are geared towards maximising the value of a distressed debtor’s assets for the benefit of its general body of creditors, but this objective may be impeded when public interests are involved. Notably, issues will appear where a financially distressed debtor is a public entity that performs public law functions or exercises public authority at a national, regional, or local level. In handling the restructuring or insolvency of such a debtor, there is an intricate interplay between the economic as well as public dimensions of a public entity experiencing financial distress.

This chapter examines the challenges of Dutch local public entities in financial distress. In particular, it is an inquiry into the extent to which the Dutch legislator has provided for approaches tailored to this type of debtor. This chapter will not only analyse municipalities – it also analyses other entities that are otherwise closely intertwined with municipalities, or have been designated with the pursuance of specific public duties.

In this chapter, the structure of the Dutch corporate restructuring and insolvency regime will be outlined, which will provide an overview of the main tools that are available – also for local public entities – for dealing with financial distress (paragraph 2). Next, there will be an elaboration on what local public entities entail under Dutch law, and in particular, the categories of basic<sup>1</sup> and hybrid<sup>2</sup> local public entities (paragraph 3). There will be a review as to what extent the corporate restructuring and insolvency law framework is applicable to local public entities that experience financial distress and / or have become insolvent. This will also include a discussion of the tools available to specific local public entities to resolve their financial distress (paragraph 4). This chapter will contain a discussion on some practical cases (paragraph 5), followed by a conclusion (paragraph 6).

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<sup>1</sup> In this chapter, basic local public entities are defined by the authors as “any public authority or entity which is partially or totally funded by tax levies, which provides essential services (eg transport, education, care and utilities), but not necessarily or not always at market price and does so for a local community”.

<sup>2</sup> In this chapter, hybrid local public entities are defined by the authors as “any entity (including corporations) which is publicly or privately owned, which carries out fundamental services or which is responsible for the production or distribution of essential goods and operates at a local (territorial or regional) level”.

## 2. The Dutch corporate restructuring and insolvency framework

### 2.1 Introduction

In the Netherlands, restructuring and insolvency matters are primarily, but not exclusively, dealt with by the *Faillissementswet* (Dutch Bankruptcy Act (DBA)).<sup>3</sup> The DBA provides for four main insolvency proceedings: (i) *faillissement* (bankruptcy),<sup>4</sup> (ii) *surseance van betaling* (suspension of payments),<sup>5</sup> (iii) *homologatie onderhands akkoord* (confirmation of a private restructuring plan),<sup>6</sup> and (iv) *schuldsanering natuurlijke personen* (debt restructuring for natural persons).<sup>7</sup> Of these four proceedings, the former three are available to corporate debtors.

Under Dutch restructuring and insolvency law, creditors traditionally maintain a strong position. Secured creditors hold a particularly strong position since they are not prevented from exercising their pre-petition rights and powers in the suspension of payments and bankruptcy proceeding.<sup>8</sup> This notion has shifted to some extent due to the passing of the *Wet homologatie onderhands akkoord* (Act on the Confirmation of a Private Restructuring Plan (WHOA)). The WHOA provides more room for debtors than in bankruptcy and in suspension of payments, since the WHOA enables the debtor to continue fully in possession of its activity and property.<sup>9</sup>

### 2.2 Bankruptcy

A bankruptcy proceeding is primarily directed at the (piecemeal) liquidation of a debtor. Upon a request from either a debtor or its creditors, the court may commence a bankruptcy proceeding. Upon declaring a debtor bankrupt,<sup>10</sup> the court will appoint one or more *curatoren* (insolvency practitioners) and *rechters-commissarissen* (supervisory judges).<sup>11</sup> As a direct consequence of the commencement of a bankruptcy proceeding, a

<sup>3</sup> The DBA was adopted in 1893, and has been in force since 1 September 1896. Subsequently, various amendments have been included in the DBA. In this regard, see B Wessels, *Insolventierecht, Faillietverklaring (Deel I)* (5<sup>th</sup> ed, Deventer, Kluwer, 2018) at paras 1051-1053c. The DBA can be accessed [here](#).

<sup>4</sup> DBA, arts 1 *et seq.*

<sup>5</sup> *Idem*, arts 214 *et seq.*

<sup>6</sup> *Idem*, arts 369 *et seq.*

<sup>7</sup> *Idem*, arts 284 *et seq.* The debt restructuring (for natural persons) is a liquidation-oriented proceeding. Usually, *bona fide* insolvent natural persons will receive a discharge three years after the commencement of this proceeding.

<sup>8</sup> *Idem*, art 57. This may be different only in case of an *afkoelingsperiode* (stay) (DBA, art 63a).

<sup>9</sup> *Kamerstukken II 2018/19*, 25 249, no 3, at 24 (Explanatory Memorandum).

<sup>10</sup> DBA, arts 1(1) and 6(3) contains the conditions for a bankruptcy declaration. Article 6(3) states that: “[t]he bankruptcy order shall be issued if facts or circumstances have been summarily proved which show that the debtor is in a situation where he has ceased to pay his debts as and when they fall due and, where the petition is made by a creditor, the latter’s right to claim”.

<sup>11</sup> DBA, art 14. The DBA does not define who can be appointed as insolvency practitioner. However, the courts have developed procedural rules that are applicable to the suspension of payments and bankruptcy proceedings. Furthermore, the body of the Dutch supervisory judges in matters of insolvency (Recofa) has

debtor is divested of its powers to dispose of, and administer, its assets. Instead, an insolvency practitioner will possess these powers.<sup>12</sup>

Insolvency practitioners, tasked with the administration and liquidation of a debtor's estate,<sup>13</sup> will aim to maximise the value of a debtor's estate for its creditors collectively.<sup>14</sup> A piecemeal liquidation may be utilised to maximise the value of an estate. However, in practice, an insolvency practitioner will often pursue a restructuring of the business of the debtor that they are appointed to. This can take different forms. For instance, an insolvency practitioner can negotiate a (partial) going-concern sale when such a sale would be in the best interest of a debtor's creditors. Alternatively, a debtor can propose to its creditors a restructuring plan in bankruptcy.<sup>15</sup> When the proposed plan is supported by the required majority<sup>16</sup> and subsequently confirmed by a court,<sup>17</sup> it becomes binding on all ordinary unsecured creditors, including dissenting ones.<sup>18</sup> Consequently, such a plan is referred to as a compulsory restructuring plan (*dwangakkoord*).

Unlike in the suspension of payments, the supervisory judge plays an active role in bankruptcy proceedings. This role involves supervision of an insolvency practitioner's administration and liquidation of an insolvent estate.<sup>19</sup> For various legal acts, an insolvency practitioner will also require a supervisory judge's approval. Furthermore, during a bankruptcy proceeding, any of a debtor's creditors, its creditors' committee (if appointed),<sup>20</sup> or the debtor itself can raise objections against the conduct of an insolvency practitioner with the supervisory judge.<sup>21</sup>

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developed further guidelines for bankruptcy and suspension of payments and principles for the appointment of liquidators and joint administrators in bankruptcies and suspension of payments. See *Procesreglement verzoekschriftprocedures insolventiezaken rechtbanken* (2021) available [here](#); *Recofa richtlijnen voor faillissementen en surseances* (2019) available [here](#); and *Recofa-uitgangspunten bij de benoeming van curatoren en bewindvoerders in faillissementen en surseances van betaling* (2013) available [here](#).

<sup>12</sup> DBA, arts 23 and 68(1).

<sup>13</sup> *Idem*, art 68(1).

<sup>14</sup> *Ibid*.

<sup>15</sup> *Idem*, art 138.

<sup>16</sup> *Idem*, art 143.

<sup>17</sup> *Idem*, art 153.

<sup>18</sup> *Idem*, art 157. With secured or preferential creditors, a consensual agreement may be pursued. Upon confirmation of a restructuring plan, the (corporate) debtor will not be dissolved (DBA, art 19(1)(c)), and the creditors will not regain their rights of foreclosure (DBA, art 195 is not applicable in case of a restructuring plan).

<sup>19</sup> *Idem*, art 64.

<sup>20</sup> *Idem*, arts 74 *et seq*.

<sup>21</sup> *Idem*, art 69.

## 2.3 Suspension of payments

Suspension of payments is only available to debtors exercising a business or profession,<sup>22</sup> and aims to facilitate the continuation of imminently insolvent but viable companies. A suspension of payments is, unlike bankruptcy, available at the debtor's request only.<sup>23</sup> It provides an automatic stay of enforcement actions by unsecured ordinary creditors against a debtor. This stay provides a debtor with time to propose a restructuring plan and reorganise its business in order to regain viability. Suspension of payments can be requested when a debtor foresees that it will be unable to continue paying its debts as they fall due.<sup>24</sup> Upon submitting a request, the suspension of payments will be granted automatically on a provisional basis, provided that certain formal requirements are met.<sup>25</sup> Following this provisional period, a court will decide whether to grant a petitioning debtor a final suspension of payments for up to 18 months.<sup>26</sup>

Whilst excused from making payments during the suspension of payments, a debtor will prepare and propose a restructuring plan (also referred to as a composition) to its unsecured creditors. This restructuring plan must be adopted by these creditors and confirmed by a court. A court sanction will make the plan binding on any dissenting unsecured creditors.<sup>27</sup> In practice, this proceeding is generally considered to precede a request for the opening of bankruptcy proceedings and is not the road to achieve a restructuring.<sup>28</sup>

When a (provisional) suspension of payments is granted, a court will appoint one or more *bewindvoerders* (joint administrators) and typically one or more supervisory judges for the duration of the proceeding.<sup>29</sup> Whilst utilising a suspension of payments, a debtor is only partially divested of its powers, since a debtor and an appointed administrator or administrators are bound to jointly administer the estate.<sup>30</sup>

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<sup>22</sup> *Idem*, art 214(4) provides that natural persons not exercising a business or profession cannot be granted a suspension of payments.

<sup>23</sup> *Idem*, art 214(1).

<sup>24</sup> *Ibid.*

<sup>25</sup> The DBA provides no specified time for this provisional suspension of payments. Court procedural rules state that within two to four months after granting the provisional suspension of payments, a hearing will be held regarding granting the final suspension of payments. See DBA, arts 215(2) and 2.3.1. Also see *Procesreglement verzoekschriftprocedures insolventiezaken rechtbanken* (2020) available [here](#).

<sup>26</sup> DBA, art 223(1) provides that the court may decide to provide a further extension, if required.

<sup>27</sup> *Idem*, arts 252 *et seq.*

<sup>28</sup> See for instance *Kamerstukken II 2001/02, 24 036, no 238, at 1.*

<sup>29</sup> DBA, arts 215(2) and 216.

<sup>30</sup> *Idem*, art 228 requires co-operation, authorisation, or assistance from the joint administrator in any act of the debtor administering the debtor's estate or disposing of assets.

## 2.4 *Wet homologatie onderhands akkoord*

In 2021, the WHOA entered into force as a new part of the DBA, partially implementing the EU Directive on Preventive Restructuring (PRD 2019).<sup>31</sup> The WHOA is a framework designed to facilitate the adoption of a plan, involving a debtor and (part of) its creditors and shareholders, that aims to spare the relevant debtor from entering into bankruptcy.<sup>32</sup> A plan in terms of the WHOA may result in a restructuring or – if doing so would also bring a better result for the affected parties compared to a bankruptcy proceeding – a simplified liquidation of a debtor.<sup>33</sup>

A WHOA is available to all debtors engaged in business activities, regardless of their corporate form. Debtors may utilise this framework when they find themselves in a situation where it can “reasonably be envisaged” that they will become unable to continue paying their debts as they fall due.<sup>34</sup> In addition, individual creditors, shareholders, the *ondernemingsraad* (works council), and *personeelsvertegenwoordiging* (employee representative body) may submit a request to a court to appoint a *herstructureringsdeskundige* (restructuring expert),<sup>35</sup> and an involuntary WHOA process would be commenced following such an appointment. If appointed, a restructuring expert is tasked with preparing a WHOA plan for (some of) the creditors and / or shareholders.<sup>36</sup> Simultaneously, a debtor subject to an involuntary WHOA case may continue to prepare a WHOA plan.<sup>37</sup> Additionally, a request to appoint a restructuring expert may be made by a debtor at any time in a voluntary WHOA case.<sup>38</sup>

In contrast to a bankruptcy proceeding, a debtor is fully in possession of its estate and its activities, even if a restructuring expert is appointed.<sup>39</sup> Courts have a limited role – notably, the role of courts can be limited to only hearing a request for confirmation of a WHOA plan.<sup>40</sup> If no restructuring expert has been appointed, a court may *ex officio* or, on request,

<sup>31</sup> Explanatory Memorandum to the *Voorontwerp implementatiewet richtlijn herstructurering en insolventie* (Draft bill Implementing Act EU Preventive Restructuring Directive) (2021) available [here](#).

<sup>32</sup> *Kamerstukken II 2018/19, 25 249, no 3, at 1-2* (Explanatory Memorandum). Although sometimes referred to as a “WHOA proceeding”, the WHOA is, in fact, a framework. It is built as a modular tool, with a range of options enabling the involved parties to shape the process.

<sup>33</sup> A WHOA is available as a dual-track, meaning it can be either a public or a non-public process. The non-public (or private) WHOA framework does not involve public notification that the debtor intends to offer a restructuring plan in the public insolvency register and Official Gazette. In addition, all requests are heard in chambers in a closed hearing.

<sup>34</sup> DBA, arts 370(1) and (3).

<sup>35</sup> *Landelijk procesreglement WHOA zaken rechtbanken* (2021), art 3 contains further procedural rules for the appointment of a restructuring expert. Available [here](#).

<sup>36</sup> DBA, art 371(1).

<sup>37</sup> *Ibid.* For a debtor to submit a plan to the affected creditors and shareholders, it will have to have this approved by the appointed restructuring expert.

<sup>38</sup> *Kamerstukken II 2018/19, 25 249, no 3, at 41* (Explanatory Memorandum).

<sup>39</sup> See R van Sigtenhorst, “Commentary to DBA, Article 371” in J L M Groenewegen and F M J Verstijlen (eds), *Tekst en Commentaar Insolventierecht* (Wolters Kluwer, Deventer, 2021).

<sup>40</sup> DBA, arts 383 and 384 contain the refusal grounds to reject confirmation.

appoint an *observator* (observer). The observer has a supervisory role and the duty to monitor the process and the interests of creditors.<sup>41</sup>

Under certain conditions, the WHOA provides for a cross-class cram-down, enabling courts to confirm a WHOA plan (also binding dissenting classes) when, in principle, at least one in-the-money class of creditors has adopted the WHOA plan. Furthermore, for a court to confirm a WHOA plan, there must be an absence of any grounds for refusal, such as (unjustified) violation of the best-interest-test or the relaxed absolute priority rule.<sup>42</sup> A confirmation makes the plan binding on all affected creditors and shareholders.

## 2.5 Out-of-court compositions

In addition to the aforementioned restructuring and insolvency proceedings, a debtor may pursue a *buitengerechtigd akkoord* (out-of-of court composition) to achieve a restructuring. A debtor may propose a composition to (a part of) its creditors. In practice, the adoption of a composition requires the full support of the affected creditors. Often, compositions are prevented from being passed due to strategic hold-out positions of creditors.

In certain limited cases, it is possible to bind a dissenting creditor in an out-of-court composition. In case law, limited exceptions to the consensual nature of an out-of-court composition have been accepted when the rejection constitutes abuse of power.<sup>43</sup>

## 2.6 Pending legislative reforms

Currently, several reforms are pending to amend the Dutch restructuring and insolvency regime. Firstly, the bill for the *Wet continuïteit ondernemingen I* (Business Continuation Act I (WCO I)) is pending at the Dutch Senate. Its passing would introduce a statutory basis for pre-packaged bankruptcy.<sup>44</sup> WCO I provides a framework that determines the criteria for the appointment of a preliminary supervisory judge and a *beoogd curator* (preliminary liquidator).<sup>45</sup> The bill sets out the role and (limited) powers that these actors have,<sup>46</sup> as well

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<sup>41</sup> *Idem*, art 380(1).

<sup>42</sup> *Idem*, arts 384(3) and (4)(b).

<sup>43</sup> Supreme Court 12 August 2005, ECLI:NL:HR:2005:AT7799 (*Payroll*), at 3.5.2 and 3.5.3. The abuse of power exception is available under exceptional circumstances only. A situation in which a creditor is aware of the pressing financial situation of a debtor or an imminent bankruptcy will, in general, not justify this exception. An exception is also not justified when a majority of creditors that are willing to accept the out-of-court composition characterise the rejection of another creditor as an abuse of power. Furthermore, the Supreme Court has ruled that the abuse of power standard also applies when a creditor (whilst rejecting the composition) seeks to obtain payment of a larger part of his claim from the debtor than what other creditors obtained under the out-of-court composition (Supreme Court 24 March 2017, ECLI:NL:HR:2017:485 (*Mondia / V&D*) at 3.4.3 and 3.4.4).

<sup>44</sup> See the legislative proposal for the WCO I, available [here](#).

<sup>45</sup> WCO I, art 363.

<sup>46</sup> *Idem*, arts 364-366.

as the effects of their appointment.<sup>47</sup> However, uncertainty has emerged regarding the protection of employees in a transfer of an undertaking effected by a pre-packaged bankruptcy. Preliminary questions that were asked to the Court of Justice of the European Union (CJEU) in the case of *Smallsteps* did not resolve this uncertainty.<sup>48</sup> In fact, this slowed down the legislative process of the WCO I, and the use of pre-packs has also dwindled in recent years.<sup>49</sup> A recent decision of the CJEU on similar preliminary questions on the position of employees in pre-packaged bankruptcy in the case of *Heiploeg* has, however, given more clarity and may revive the legislative process.<sup>50</sup>

The remainder of this chapter focuses on the restructuring and insolvency regime as it currently exists and that is available to local public entities.

### 3. Defining and describing Dutch local public entities

#### 3.1 Introduction

Under Dutch law, no uniform and / or single definition exists to define public and / or local entities. The position and variety of entities and bodies with a public nature are treated in terms of different laws. Therefore, in this part an autonomous Dutch interpretation will be developed of what local public entities are by reviewing the definitions in different sources of Dutch public law.<sup>51</sup> It is important to note that, in recent decades, public interests and public functions have been attended to in increasingly diverse ways. They are not solely and directly under the control of formal governmental bodies, such as the State, provinces, and municipalities, but have, in some instances, been delegated to private parties or

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<sup>47</sup> *Idem*, art 368.

<sup>48</sup> CJEU 22 June 2017, ECLI:EU:C:2017:489 (*FNV cs / Smallsteps*), from which it followed, in short, that a pre-packaged bankruptcy did not fall within the so-called “bankruptcy exception” in terms of EU Directive 2001/23/EC on Transfer of Undertakings, art 5(1). Consider in this regard also CJEU 16 May 2019, ECLI:EU:C:2019:424 (*Plessers / PREFACO and Belgium*), which confirmed the *Smallsteps* decision.

<sup>49</sup> *Kamerstukken II* 2018/19, 33 695, no 18, at 2-3. In response to the decisions of the CJEU, the Minister for Legal Protection has prepared a separate legislative proposal dealing with the position of employees. This is contained in the *Voorontwerp Wet overgang van onderneming in faillissement* (Draft Act on the Transfer of Undertaking in Bankruptcy), which was submitted for public consultation in 2019 receiving mixed responses. The draft bill is available [here](#). To proceed with the bill WCO I whilst the preliminary questions on *Heiploeg* are pending, the Minister for Legal Protection has prepared a new legislative proposal - the WCO I Amending Act (or Nouvelle WCO I) in 2021. This draft WCO I Amending Act aims to temporarily restrict the scope of the WCO I until there is certainty on the position of employees. Under the WCO I Amending Act, the Minister proposes to make the WCO I available only to debtors with activities serving societal interests (such as schools and hospitals) and who are seeking to utilise the provisions of the WCO I for the purpose of simplified liquidation. In addition, the liquidator’s (or preliminary liquidator’s) task is amended to give (in these cases only) priority to societal interests above the creditors’ interests collectively. In this regard, see Nouvelle WCO I, at 1-2 (art II, part II, sub B), available [here](#); and Explanatory Memorandum to the Nouvelle WCO I, at 8-9.

<sup>50</sup> CJEU 28 April 2022, ECLI:EU:C:2022:321 (*FNV / Heiploeg*).

<sup>51</sup> Compare also J A F Peters and R D Vriesendorp, “Insolvency of Public Entities other than the State under Dutch Law”, in E Hondius (ed), *Netherlands Reports to the Sixteenth International Congress of Comparative Law: Brisbane 2002* (Intersentia, Antwerp, 2002) at 408-11 and 418-419, also providing various examples of the different types of local public entities distinguished in this chapter.

privatised. This creates a diversified spectrum of what entities may qualify as a local public entity.

In this section, we will distinguish between four main groups of local public entities: (i) *openbare lichamen* (public bodies) recognised under the Dutch Constitution (paragraph 3.2), (ii) public law legal persons (paragraph 3.3), (iii) entities with “a-organs” and “b-organs”, including legal entities instituted by public law (they have so-called a-organs) and bodies invested with public authority (they have so-called b-organs) under public law (paragraph 3.4), and (iv) *verbonden partijen* (related parties) of municipalities (paragraph 3.5). The following sets out a general overview of the nature of these local public entities from the perspectives of constitutional law, private law, public law and administrative law. Whereas entities may qualify as one of the aforementioned four categories, it does not rule out that, besides a public function, they also perform (regular) commercial activities. Consequently, hybrid forms of entities engaging to some extent both in commercial and public activities exist.

### 3.2 Local public entities under the Constitution

Although the Dutch Constitution does not refer to “public entities”, it does refer to public bodies. Public bodies are administrative divisions within the Dutch state. Article 123 of the Constitution regulates the most important public bodies: the State (central government), provinces (regional government), municipalities (local government), and *waterschappen* (water authorities).<sup>52</sup> A municipality – which is regulated in the Constitution and in the *Gemeentewet* (Municipalities Act) – is the only public body that qualifies as a local public entity, since the others operate regionally.

Furthermore, article 134(1) of the Constitution provides the basis for establishing other public bodies, stating that: “[p]ublic bodies for the professions and trades and other public bodies may be established and dissolved by or pursuant to an act of Parliament”. Furthermore, their duties, organisation, composition, and powers (including legislative powers) will also be regulated by an act of Parliament.<sup>53</sup>

These public bodies typically operate nationally or regionally.<sup>54</sup> However, there are some examples of public bodies that operate more locally, such as *Eurode* (a public body established for the purpose of co-operation between two municipalities on the Dutch and German border) and the *Gezamenlijke Brandweer* (Joint Fire Brigade, a fire brigade which provides firefighting services for an area in the Rotterdam region with a large petrochemical and refining industry).

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<sup>52</sup> The 21 water authorities are administrative bodies tasked with managing water barriers, regional water management, and the treatment of wastewater.

<sup>53</sup> Dutch Constitution, art 134(2).

<sup>54</sup> For instance, the *Nederlandse Orde van Advocaten* (Netherlands Bar), *Veiligheidsregio's* (Safety Regions), and the *Koninklijke Nederlandse Beroepsorganisatie van Accountants* (Royal Netherlands Institute of Chartered Accountants).



### 3.3 Local public entities under private law

Book 2 of the *Burgerlijk Wetboek* (Dutch Civil Code, (DCC)) does not provide a definition of local public entities but introduces the concept of *publiekrechtelijke rechtspersonen* (public law legal persons). The DCC determines which bodies and entities qualify as public law legal persons and, therefore, possess legal personality.<sup>55</sup> This includes the aforementioned public bodies that are regulated by the Constitution (paragraph 3.2).<sup>56</sup> In addition, this includes the “additional public bodies” that fall within the scope of article 134 of the Constitution; however, this is subject to them having a regulatory competence.<sup>57</sup> This competence encompasses the power to introduce regulatory measures, which is not automatically the case with additional public bodies.<sup>58</sup> Finally, other bodies which perform a governmental task also possess legal personality, but only to the extent that this is provided under or pursuant to the law.<sup>59</sup> At a local level, this includes municipalities and, for instance, public notaries and bailiffs as far as their public duties are concerned.<sup>60</sup>

For matters of property law, public law legal persons are considered equal to natural persons and consequently may, from a civil law perspective, act as the bearer of civil law rights and obligations.<sup>61</sup> This is relevant for accessing the Dutch insolvency regime, as will be elaborated below.

### 3.4 Local public entities under administrative law

From an administrative law perspective,<sup>62</sup> institutions that may qualify as public (local) entities are referred to as *bestuursorganen* (administrative bodies) in the *Algemene wet bestuursrecht* (Dutch General Administrative Law Act, (DGALA)).<sup>63</sup> This act defines which bodies have administrative (or legislative) powers (and associated obligations). In defining

<sup>55</sup> DCC, art 2:1. See also R D Vriesendorp and J A F Peters, “Insolventie van overheden”, *Tvl* (2002) 188 at para 2(a).

<sup>56</sup> DCC, art 2:1(1), and also see para 3.2.

<sup>57</sup> *Ibid.* For several general examples, see R D Vriesendorp and J A F Peters, “Insolventie van overheden”, *Tvl* (2002) 188 at para 2(a).

<sup>58</sup> Dutch Constitution, art 134(2).

<sup>59</sup> DCC, art 2:1(2). For several general examples, see R D Vriesendorp and J A F Peters, “Insolventie van overheden”, *Tvl* (2002) 188 at para 2(a).

<sup>60</sup> The civil law notary qualifies both as a public office and a company. Moreover, the funds received for its public duty are separated from its private funds by means of a trust account (*rekening derdengelden*) (in terms of *Wet op het notarisambt* (Act on the Notarial Profession), art 25). A similar principle applies to bailiffs (in terms of *Gerechtsdeurwaarderswet* (Bailiffs Act), art 19).

<sup>61</sup> DCC, arts 1:1(3) and 2:5.

<sup>62</sup> Dutch administrative law also recognises the *zelfstandig bestuursorgaan* (independent administrative body, (ZBO)) as regulated by the *Kaderwet zelfstandige bestuursorganen* (Framework Act Independent Administrative Bodies), available [here](#). These bodies perform certain administrative tasks and / or have certain administrative powers that are performed hierarchically and separately from other administrative bodies. However, a Minister is responsible for the ZBO’s policy and will supervise its activities. ZBOs are typically active either nationally or regionally, but not locally. The organs of these bodies may be an a- or b-organ, if a ZBO meets the requirements. An overview of ZBOs is available [here](#).

<sup>63</sup> The DGALA is available [here](#). An unofficial translation has been provided by the *Autoriteit Consument en Markt* (Dutch Authority Consumers and Markets) and is available [here](#).

administrative bodies, DGALA distinguishes between two distinct types of administrative bodies as follows:

“Administrative body means:

- (a) an organ of a legal entity that has been established under public law, or
- (b) another person or body which is invested with any public authority.”<sup>64</sup>

In reference to this provision, administrative bodies are referred to as either an “a-organ” or a “b-organ.”

### 3.4.1 A-organ

A-organs are the organs of legal entities instituted by public law. Firstly, it refers to bodies that have administrative power and qualify as an aforementioned public law legal person.<sup>65</sup> Their organs can qualify as an administrative body. For municipalities, a-organs are, for instance, the *burgemeester* (Major), the *gemeenteraad* (Municipal Council), and the *college van burgemeester en wethouders* (Municipal Executive).<sup>66</sup> Furthermore, there may also be a-organs of other public legal entities, as this also includes those entities that have otherwise obtained legislative powers under the Constitution. At a local level, this includes, for instance, public notaries and bailiffs.<sup>67</sup> Overall, the entities to which the a-organs belong will qualify as local public entities.

### 3.4.2 B-organ

B-organs are part of other administrative bodies that are granted public authority.<sup>68</sup> In particular, they concern private legal persons, but only to the extent that they are afforded certain public authority. However, b-organs typically include entities that provide or exercise public functions at a regional or national level.<sup>69</sup>

In case law, several extra-legal b-organs have been recognised. These b-organs have not formally been granted public authority but *de facto* meet the requirements to qualify as b-organs. In the case of *Stichting bevordering leefkwaliteit Schiphol*, the court dictated that there are two requirements that must be satisfied for a private legal person to qualify as a

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<sup>64</sup> DGALA, art 1:1(1).

<sup>65</sup> See the discussion in para 3.3.

<sup>66</sup> Municipalities Act, art 6.

<sup>67</sup> J C A de Poorter, “Commentary to Awb, Article 1:1”, in TC Borman *et al* (eds), *Tekst en Commentaar Algemene wet bestuursrecht* (Wolters Kluwer, Deventer, 2021) at 2.

<sup>68</sup> DGALA, art 1:1(1)(b).

<sup>69</sup> See, for example, the *Koninklijke Nederlandse Akademie van Wetenschappen* (Royal Netherlands Academy of Arts and Sciences), the *Sociale Verzekeringsbank* (Social Insurance Bank), the *Nederlandsche Bank* (Dutch Central Bank), and the *Luchthaven Schiphol* (Amsterdam Airport Schiphol), which provide regional or national activities. For more examples, see R D Vriesendorp and J A F Peters, “Insolventie van overheden”, *Tvl* (2002) 188 at para 2(a).

b-organ. Firstly, the power to execute public authority by making cash payments or providing other provisions must, to a greater extent, be determined by an a-organ. Secondly, in making cash payments or providing other provisions, the private legal person must be funded by the a-organ (for at least two-thirds of its funding).<sup>70</sup> This is a limited exception, applying only to several specific, local public entities.<sup>71</sup>

For both a- and b-organs, property law-related legal acts taken by them are attributed to the legal person to which they belong.<sup>72</sup> Therefore, these legal persons can qualify as local public entities.

### 3.5 Related parties as local public entities

The last category of public entities is related parties. This is a specific form of co-operation between a private law party and a municipality. This form of co-operation is seen as requiring more commitment than, for example, a collaboration with a municipality based on purchasing agreements. Agreeing to co-operate with a related party increases the responsibility of the municipality as it entails a financial risk for the municipality, and this necessitates certain oversight from the municipality over the related party.

According to the *Besluit begroting en verantwoording provincies en gemeenten* (Resolution on Budget and Accountability Municipalities and Provinces (BBV)),<sup>73</sup> a related party is defined as a private law or a public law organisation in which the municipality has both an administrative and a financial interest.<sup>74</sup> An administrative interest is present when the municipality can exert control over the entity through its representation on the board or by having voting rights.<sup>75</sup> A financial interest includes the budgetary means provided by the municipality to the related party that cannot be recovered if the related party goes bankrupt, or the amount for which the municipality bears liability in case the related party fails to meet its obligations.<sup>76</sup> Examples, although differing amongst municipalities, may include water companies, electricity companies and waste collection companies, and also cultural or educational institutions.

Furthermore, it may be the case that municipalities, provinces and water authorities collaborate in a public law entity, and such collaboration will usually qualify the entity as a

<sup>70</sup> ABRvS 17 September 2014, ECLI:NL:RVS:2014:3379 (*Stichting bevordering kwaliteit leefomgeving Schiphol*), at 5.1 and 5.2.

<sup>71</sup> See also ABRvS 30 November 1995, ECLI:NL:RVS:1995:ZF1850 (*Stichting Silicose Oud-Mijnwerkers*).

<sup>72</sup> DGALA, art 1:1(4).

<sup>73</sup> The text of the BBV is available [here](#). For prior versions and the resolution for the water authorities, see [here](#).

<sup>74</sup> BBV, art 1(1)(b). It also comprises European Groupings of Territorial Cooperation (as regulated in Regulation (EC) No 1082/2006 of the European Parliament and of the Council of 5 July 2006 on a European grouping of territorial co-operation (EGTC)) in which a municipality has an administrative and financial stake (BBV, art 1(2)).

<sup>75</sup> *Idem*, art 1(1)(d).

<sup>76</sup> *Idem*, art 1(1)(c). Due to this financial interest, a municipality is required to disclose related parties in its financial statements (*Idem*, arts 5, 8(3)(b), 9(f) and 15).

related party. Such collaborations are further regulated in the *Wet gemeenschappelijke regelingen* (Common Regulations Act).<sup>77</sup> It provides for five forms of collaboration, and two of these forms result in a separate body possessing legal personality, namely the *bedrijfsvoeringsorganisatie* (management organisation) and the *openbaar lichaam* (public body).<sup>78</sup> Furthermore, municipalities may also establish private law legal persons, such as limited liability companies, foundations and associations. This involvement may qualify the legal person as a related party. Such forms of co-operation have been instituted in part by privatising and liberalising markets.<sup>79</sup> Examples include the *Gemeentelijke Gezondheidsdienst* (Municipal Health Office) and the *Veiligheidsregio's* (Safety Regions).<sup>80</sup>

### 3.6 Dutch local public entities

In summary, there are various statutory grounds to distinguish local public entities under Dutch law. Based on public and private law, local public entities include, in particular, public bodies such as municipalities. They qualify as a so-called basic local public entity as defined in this project.

Furthermore, there are several forms of so-called hybrid local public entities, which are not mutually exclusive and are based on different laws. As previously discussed, there are a few specific and rather local public bodies qualifying as hybrid local public entities, and these include Eurode and the Joint Fire Brigade. Furthermore, hybrid local public entities also include entities that qualify as public law legal persons (as recognised under private law) and administrative bodies (as recognised under administrative law). Although there is an overlap with public bodies as to which entities qualify as a hybrid local public entity, there are some specific examples of hybrid local public entities. For instance, this is the case with public notaries and bailiffs that the authors have qualified as hybrid local public entities under administrative law. To the extent that they perform public duties, Dutch law provides a tailor-made framework to deal with their financial distress. This is also the case with the bodies of extra-legal b-organs. These bodies are not formally granted any public authority, and it is difficult to assess their existence. However, as with the *Stichting bevordering leefkwaliteit Schiphol* discussed above, their activities may be more local.

The last group of hybrid local public entities is formed by parties related to municipalities (related parties). It is left to municipalities to decide which entities are their related parties. For instance, municipal health offices, waste disposal companies and energy companies may constitute related parties. Overall, a notable feature of hybrid local public entities is that they may combine both private and public activities, although the extent of each may differ per entity.

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<sup>77</sup> The act is available [here](#).

<sup>78</sup> Common Regulations Act, arts 8(1) and (2). See also [www.rijksoverheid.nl/onderwerpen/gemeenten/intergemeentelijke-samenwerking](http://www.rijksoverheid.nl/onderwerpen/gemeenten/intergemeentelijke-samenwerking). A register of all collaborations is available [here](#).

<sup>79</sup> R D Vriesendorp and J A F Peters, "Insolventie van overheden", *Tvl* (2002) 188 at para 2(c).

<sup>80</sup> *Wet publieke gezondheid* (Public Health Act), art 14 and *Wet veiligheidsregio's* (Safety Regions Act), art 9.

## 4. The legal framework for dealing with local public entities in distress

### 4.1 Introduction

After the discussion on what local public entities are, this part discusses the legal framework that deals with local public entities in financial distress. Here, a distinction must be made between municipalities on the one hand, and hybrid local public entities on the other. In respect of municipalities, Dutch law provides for several layers of oversight and resolution to prevent or deal with financial distress. These include, in principle, (i) provincial oversight, (ii) article 12-status, and (iii) bankruptcy. For hybrid local public entities, in principle, the general corporate law restructuring and insolvency regime is available. In addition, for related parties, supervision by the municipality will be ongoing. The local audit offices of municipalities (*gemeentelijke of decentrale rekenkamer*) will conduct this supervision.<sup>81</sup> However, a higher body – such as a municipality – may prevent the hybrid local public entity from using a corporate insolvency regime and instead provide additional funds to resolve the financial distress. A higher body is particularly likely to make this intervention when important public functions are at stake.

The following sections will deal with the general public law and corporate insolvency law frameworks and their availability to municipalities and hybrid local public entities (paragraphs 4.2-4.6); the specific provisions that apply to municipalities in financial distress (paragraph 4.7); and how these frameworks deal with specific issues, including conducting a cause analysis of the financial distress, directors' liability, the position of creditors, and obtaining new and interim finance (paragraph 4.8).

### 4.2 Provincial oversight over municipalities

The financial well-being of municipalities is subject to ongoing monitoring from the provinces.<sup>82</sup> The aim of provincial oversight is to ensure that municipalities have a structural and real budget.<sup>83</sup> To this end, the municipalities have a duty to provide structural information to the province.<sup>84</sup>

The Municipalities Act requires the Municipal Executive to provide the *Gedeputeerde Staten* (Provincial Executive) with information regarding the budget and the annual accounts each year. At the same time, the Municipalities Act provides the Provincial Executive with the ability to supervise, investigate and amend municipal budgets.<sup>85</sup> In principle, a Provincial Executive conducts *repressief toezicht* (retrospective oversight).

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<sup>81</sup> A bill is pending to ensure that each municipality is obliged to establish an independent (or joint) audit office. The bill also extends the investigative powers of audit offices (*Wetsvoorstel versterking decentrale rekenkamer*) and is available [here](#).

<sup>82</sup> Municipalities Act, art 124b.

<sup>83</sup> *Idem*, art 203.

<sup>84</sup> *Idem*, arts 120 and 124h and Provinces Act, art 78.

<sup>85</sup> These duties and powers on the budget and annual accounts of a municipality are elaborated in the subordinate act – the BBV.

Consequently, there is generally a lot of room for a municipality to set its own financial policies. However, this shifts to *preventief toezicht* (preventive oversight) if a Provincial Executive observes incongruity with statutory obligations, thus triggering an active monitoring role.<sup>86</sup>

#### 4.2.1 *Financial investigation by the Provincial Executive*

Municipal Councils set the parameters for the financial policy of municipalities.<sup>87</sup> A Provincial Executive has the power to initiate, at any time, a financial investigation into this financial policy. An investigation may scrutinise the administration and the structure of the financial organisation.<sup>88</sup> Provincial Executives should have grounds to initiate such an investigation.<sup>89</sup> Notably, a financial investigation itself does not replace the ordinary review of a financial organisation by an accountant.

#### 4.2.2 *Provincial Executives and municipal budgeting*

##### 4.2.2.1 *Requirements of the municipal budget*

Municipalities obtain their funds from several sources. They do so by (i) levying taxes and raising income from (semi-) commercial activities, (ii) obtaining funds from the State's *Gemeentefonds* (Municipalities Fund), and (iii) raising additional funds through special (State) payments for implementing specific policies.<sup>90</sup> Municipal Councils are obliged to decide on a budget annually.<sup>91</sup> Should a municipality face financial distress, such municipality is required to firstly improve its income and reduce its expenses.

A Municipal Executive prepares a proposal for a budget.<sup>92</sup> The proposed budget must comprise of an overview of the financial means necessary to fulfil all duties that a municipality is charged with, and also all municipal activities. Additionally, a Municipal Council must state which financial means it expects to allocate for each activity.<sup>93</sup> It is the specific duty of Municipal Councils to ensure that the budget provides a structural and real balance or, if this requirement is not met, assert that it expects to be able to achieve this in

<sup>86</sup> Compare Dutch Constitution, art 132(3) and *Kamerstukken II 1985/86*, 19 403, no 3, at 62-63 (Explanatory Memorandum). Before the current Municipalities Act came into force, the previous Municipalities Act (1851) allowed for stronger preventive supervision of the financial situation of a municipality. It was required for each annual budget and each amendment to the budget to be provided to a Provincial Executive and to obtain its approval.

<sup>87</sup> Municipalities Act, art 212(1).

<sup>88</sup> *Idem*, art 215.

<sup>89</sup> The legislator has not detailed what grounds will suffice. For further detail, see *Kamerstukken II 1985/86*, 19 403, no 3, at 173 (Explanatory Memorandum).

<sup>90</sup> Further see [www.rijksoverheid.nl/onderwerpen/financien-gemeenten-en-provincies/belastinginkomsten-en-specifieke-uitkeringen-gemeenten-en-provincies/specifieke-uitkeringen-sisa-gemeenten-en-provincies](http://www.rijksoverheid.nl/onderwerpen/financien-gemeenten-en-provincies/belastinginkomsten-en-specifieke-uitkeringen-gemeenten-en-provincies/specifieke-uitkeringen-sisa-gemeenten-en-provincies).

<sup>91</sup> Municipalities Act, art 189(1). The Municipal Council will also in a regulation lay down rules for monitoring the financial administration and set up of the financial organisation (Municipalities Act, art 213(1)).

<sup>92</sup> *Idem*, art 190.

<sup>93</sup> *Ibid*.

upcoming years.<sup>94</sup> The requirement of a structural balance obliges the municipality to ensure that structural expenses are met by structural income.<sup>95</sup>

The Municipal Executive is permitted to make expenses up to the amounts indicated in the budget.<sup>96</sup> Amendments to the budget can be made only up to the end of the fiscal year to which it applies.<sup>97</sup>

#### 4.2.2.2 *Amendment and approval of the budget by the Provincial Executive*

A Municipal Executive will send a budget that is approved by a Municipal Council to a Provincial Executive.<sup>98</sup> A Provincial Executive has the power to amend the budget if certain mandatory expenses are not fully included.<sup>99</sup> Furthermore, a Provincial Executive may, if need be, order the respective municipal officer (a civil servant) to make mandatory expense payments as included in the budget.<sup>100</sup>

If a municipal budget does not provide a structural and real balance, and it is not expected that this will be the case in the coming years, a budget will *de jure* require the approval of a Provincial Executive (preventive supervision).<sup>101</sup> When the budget or annual accounts are not provided in a timely manner to a Provincial Executive, it may decide that the subsequent budget and any amendments to it require its approval.<sup>102</sup> Approval of a municipal budget may only be refused by a Provincial Executive on the basis of contravention with the law or for reasons of general financial interests.<sup>103</sup>

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<sup>94</sup> *Idem*, art 189(2).

<sup>95</sup> *Kamerstukken II 2011/12*, 33 302, no 3, at 2 (Explanatory Memorandum). In practice, it particularly requires that the budget shows no deficit, or when that is not the case, that the multi-annual budget estimate shows no deficit (*Kamerstukken II 2012/13*, 33 302, no 6, at 2-3). The budgetary standards are further elaborated in the BBV and in the *Gemeenschappelijk financieel toezichtkader* (Common financial supervisory framework (GTK)). The BBV sets a national standard for structuring budgets (and annual accounts) and gives further guidance regarding what a structured and balanced budget is (BBV, arts 2 *et seq*). In addition, the BBV also sets accountability requirements, which relate to the information that must be submitted to the general public and to the provinces (see BBV, art 71). The terminology of the BBV differs from that of the Municipalities Act. Only the budget, as referred to in the BBV, art 7(3)(a), should be considered as the budget referred to in the Municipalities Act, art 190. Furthermore, the GTK framework is jointly prepared by the provinces to perform their financial supervisory role. The most recent GTK in 2020, for instance, as adopted by the province of Zeeland, can be found [here](#).

<sup>96</sup> Municipalities Act, art 189(3).

<sup>97</sup> *Idem*, art 192.

<sup>98</sup> *Idem*, art 191(2).

<sup>99</sup> *Idem*, art 193. Mandatory expenses include (i) the interest and repayments of loans of the municipality and other immediately payable debts, (ii) expenses that under or pursuant to the law must be made by the municipality, and (iii) expenses related to the mandatory co-operation by the municipal authority for executing laws and subordinate laws.

<sup>100</sup> *Idem*, art 195.

<sup>101</sup> *Idem*, art 203(1). However, the Provincial Executive is required to notify the municipal authority hereof before the start of the budget year.

<sup>102</sup> *Idem*, art 203(2).

<sup>103</sup> *Idem*, art 206.

Even when the proposed amendments to a budget are not yet approved by the Provincial Executive, a municipal authority may still be required to enter into obligations. However, the municipal authority must obtain prior approval from the Provincial Executive before assuming any obligations.<sup>104</sup> This does not prevent Municipal Councils from deciding to enter into obligations in urgent situations.<sup>105</sup> However, if the Provincial Executive does not approve of the decision to enter into any obligations under these circumstances, a Provincial Executive may hold each councillor that voted in favour of the decision personally liable for an equal part of the obligation.<sup>106</sup>

#### 4.2.3 *Submission of annual accounts to Provincial Executive*

In addition to the budget, the Municipal Executive will provide the Provincial Executive with approved annual accounts and an annual report each annum.<sup>107</sup> This is accompanied by reports from the Municipal Executive regarding the effectiveness and efficiency of the municipalities' policy and conduct over the previous year.<sup>108</sup> If applicable, such report will also include the Municipal Council's decisions on the proposal for an indemnity decision.<sup>109</sup>

#### 4.3 **Article 12-status: additional allowance for distressed municipalities**

Financing of municipalities is partly provided by the State's Municipalities Fund, which is regulated by the *Financiële-verhoudingswet* (Financial Relations Act (Fvw)). This fund is jointly managed by the Minister of Interior and Kingdom Relations and the Minister of Finance. Annually, a municipality has the right to receive a general allowance from the Municipalities Fund.<sup>110</sup> The Municipalities Fund is designed in such a way that the distribution of the allowances amongst the municipalities are adjusted annually for differences regarding the ability of individual municipalities to raise income themselves and for their necessary expenses.<sup>111</sup>

The allocation of an allowance may not suffice in specific cases, and therefore article 12 of the Fvw provides for a hardship clause. It allows the Municipal Council to request the Minister of Interior and Kingdom Relations and the Minister of Finance to pay the municipality an additional allowance. The additional allowance is deducted from the overall amount available for the general allowance to all municipalities.<sup>112</sup>

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<sup>104</sup> *Idem*, art 208(1).

<sup>105</sup> *Idem*, art 209(1).

<sup>106</sup> *Idem*, art 210(1).

<sup>107</sup> *Idem*, art 200.

<sup>108</sup> *Idem*, arts 179(2) and 213a(2).

<sup>109</sup> *Idem*, art 200.

<sup>110</sup> Fvw, art 6(1).

<sup>111</sup> *Ibid.*

<sup>112</sup> *Idem*, art 6(4).



The additional allowance will only be paid if the general financial means of a municipality lack both substantially and structurally.<sup>113</sup> The additional allowance aims to assist municipalities to return to solvency and regain financial stability. A prerequisite is that the municipality's independent income is of a sufficient level.<sup>114</sup> Every municipality that obtains an additional allowance is obliged to take measures to improve its financial situation.<sup>115</sup>

#### 4.4 Bankruptcy and local public entities

In contrast to the case for hybrid local public entities, there are no prior cases of a municipality being declared bankrupt under the DBA.<sup>116</sup> As a result, it remains debated whether municipalities can qualify as debtors for this proceeding. Some authors argue that the law allows for municipalities to be declared bankrupt,<sup>117</sup> whereas others argue that it

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<sup>113</sup> The procedures and policy regarding providing an additional allowance have been expanded with the *Besluit financiële verhouding 2001* (Resolution on Financial Relations 2001),<sup>113</sup> the *Regeling aanvullende uitkering gemeentefonds* (Regulation on Additional Allowance from the Municipalities Fund),<sup>113</sup> and the *Handleiding artikel 12 Financiële-verhoudingswet 2017* (Guidance Article 12 Financial Relations Act 2017).<sup>113</sup> Notably, these provide further guidance on what qualifies as a substantial and structural deficit and what is a reasonable level of income.

<sup>114</sup> Fww, art 12(2). Parliamentary history dictates that an applying municipality must show, for the year for which the additional allowance is requested, as well as for the next three years, that the budget shows a deficit. Also, the applying municipality must have sought to raise its income to a reasonable level (*Kamerstukken II 1995/96*, 24 552, no 3, at 65 (Explanatory Memorandum). Between 2017 and 2020, two municipalities have received an additional allowance. In this regard, see [here](#)).

<sup>115</sup> Fww, art 12(5).

<sup>116</sup> Dutch Supreme Court 23 June 1922, W 10933, NJ 1922, at 1030. Although the case considered the bankruptcy of the municipality of Wormerveer, the Supreme Court ultimately did not express whether or not it was possible for a municipality to be declared bankrupt. For further reading, see District Court Utrecht 23 September 1892 and 19 November 1892, W 6273 regarding the water authority Groot-Mijdrecht, which was initially declared bankrupt, but, following creditor objections, was later declared as not bankrupt. See also B Wessels, *Insolventierecht, Faillietverklaring (Deel I)* (5<sup>th</sup> ed, Kluwer, Deventer, 2018) at para 1135 and J A F Peters and R D Vriesendorp, "Insolvency of Public Entities other than the State under Dutch Law", in E Hondius (ed), *Netherlands Reports to the Sixteenth International Congress of Comparative Law: Brisbane 2002* (Intersentia, Antwerp, 2002) at 407.

<sup>117</sup> B Wessels, *Insolventierecht, Faillietverklaring (Deel I)* (5<sup>th</sup> ed, Kluwer, Deventer, 2018) at para 1135.

is unclear,<sup>118</sup> undesirable,<sup>119</sup> or not available to municipalities because the proceeding conflicts with public law and public interest.<sup>120</sup>

All legal persons (including public law legal persons)<sup>121</sup> are equal to natural persons with respect to matters of property law unless the law states otherwise.<sup>122</sup> This includes municipalities, which qualify as public law legal persons. Therefore, municipalities could, in matters related to property law, be treated equally to other legal persons and should therefore be able to enter bankruptcy proceedings.<sup>123</sup>

The legislator has also considered bankruptcy as a proceeding open to all debtors, including a municipality. Parliamentary history dictates that: *“eene burgerlijke gemeente kan ook failliet verklaard worden”* (a municipality can also be declared bankrupt).<sup>124</sup> It has also been stated in parliamentary discussion that if a water authority went bankrupt, its assets would be liquidated by an insolvency practitioner, and the board of the water authority would resume its powers post-liquidation. The water board will not cease to exist since it is a public body that can only be dissolved by public law rules and cannot be dissolved by private law provisions. Similarly, a municipality will not cease to exist since its existence is not dependent on its private assets.<sup>125</sup> In a municipal bankruptcy, the

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<sup>118</sup> R P Cleveringa, *“Maatregelen ter voorkoming van faillissement en surséance van betaling”* in *Vereniging voor de vergelijkende studie van het recht van België en Nederland, Jaarboek VI - 1055-1956* (W E J Tjeenk Willink & Antwerp, De Sikkel, Zwolle, 1955) at 103-104; and N J Polak, *Insolventierecht, bewerkt door Mr. M. Pannevis* (14<sup>th</sup> ed, Wolters Kluwer, Deventer, 2017) at para 3.9.4.

<sup>119</sup> Peters and Vriesendorp recognise that the DBA does not provide deviating rules for public bodies such as municipalities, but argue that public bodies should not be able to be declared bankrupt. Considering their role as building blocks in the Dutch state structure, a bankruptcy would create insurmountable problems should they no longer be able to conduct their public administration. The bankruptcy of an entity tasked with matters of public order, safety, and healthcare would be particularly problematic. Furthermore, the role of insolvency practitioners would conflict with the framework for setting and supervising the budget of a Municipal Executive (see the discussion in para 4.2.2). See J A F Peters and R D Vriesendorp, *“Insolvency of Public Entities other than the State under Dutch Law”*, in E Hondius (ed), *Netherlands Reports to the Sixteenth International Congress of Comparative Law: Brisbane 2002* (Intersentia, Antwerp, 2002) at 416.

<sup>120</sup> See M Scheltema and M W Scheltema, *Gemeenschappelijk recht. Wisselwerking tussen publiek- en privaatrecht (Handboeken staats- en bestuursrecht)* (Kluwer, Deventer, 2013) at para 3.2.8.

<sup>121</sup> See the discussion in para 3.3.

<sup>122</sup> DCC, art 2:5.

<sup>123</sup> B Wessels, *“Kan een provincie failliet gaan?”*, *NTBR* (1999) 289 at 290; and B Wessels, *Insolventierecht, Faillietverklaring (Deel I)* (5<sup>th</sup> ed, Kluwer, Deventer, 2018) at para 1135. On similar grounds Van Kooten argues that a church, with legal personality not based on DCC, art 2:1 but based on DCC, art 2:2(2), would also fall within the scope of DCC, art 2:5 and can be subject to bankruptcy proceedings. In this regard, see T van Kooten, *Het kerkgenootschap in de neutrale staat. Een verkenning en analyse van de positie van het kerkgenootschap binnen de Nederlandse rechtsorde*, (Boom Juridische Uitgevers, Den Haag, 2017) at 268 and 272 available [here](#).

<sup>124</sup> G W van der Feltz, *Geschiedenis van de Wet op het faillissement en de surséance van betaling: volledige verzameling van regeeringsontwerpen, gewisselde stukken, gevoerde beraadslagingen enz, deel I* (Erven F Bohn, Haarlem, 1896) at 308.

<sup>125</sup> *Idem*, at 307 and 308.

insolvency practitioner may obtain the power to liquidate the assets but not the power to assume the municipality's public law powers.<sup>126</sup>

In principle, the scope of a bankruptcy proceeding would include all of the assets of a municipality or hybrid local public entity. Certain assets that are excluded from the bankruptcy attachment are listed in article 21 of the DBA. Whilst an attachment cannot comprise assets intended for *openbare dienst* (public service) outside of bankruptcy,<sup>127</sup> this exception is not included in article 21 of the DBA and is, therefore, not applicable in bankruptcy. This is also reflected, in general, in the DCC, which states that a creditor can make a claim against any of a debtor's assets.<sup>128</sup>

Whilst bankrupt, a debtor is divested of its ability to dispose of and administer its estate. Nevertheless, an appointed insolvency practitioner does not assume all of a debtor's powers. In a recent case, the Dutch Supreme Court reiterated that a bankruptcy proceeding only affects the assets of an insolvent debtor, and not the insolvent debtor itself. It was reiterated that a debtor is not divested of other (civil law) powers.<sup>129</sup> Bankruptcy proceedings only affect certain private law powers of debtors that constitute public law legal persons, but not their public law powers.<sup>130</sup> However, since a debtor will have no possession of its assets, this will typically prevent it from exercising its remaining civil and public law powers.

#### 4.5 Suspension of payments and local public entities

It is not fully clear how accessible the suspension of payments and the WHOA are to local public entities.<sup>131</sup> The suspension of payments (that was originally part of the Code of Commerce) allows a debtor to deal with temporary liquidity issues to regain solvency. Its aim may also serve the needs of local public entities in financial distress.<sup>132</sup> The legislator has introduced the suspension of payments provisions in the DBA so that it is a proceeding

<sup>126</sup> *Idem*, at 307-314.

<sup>127</sup> *Wetboek van Rechtsvordering* (Dutch Code of Civil Procedure (DCCP)), art 703.

<sup>128</sup> DCC, art 3:276. See also R D Vriesendorp and J A F Peters, "Insolventie van overheden", *Tvl* (2002) 188 at para 3. However, others have argued that DCCP, arts 437, 479 and 703 prevent attachment of assets that are used for performing public law powers. In this regard, see M Scheltema and M W Scheltema, *Gemeenschappelijk recht Wisselwerking tussen publiek- en privaatrecht (Handboeken staats- en bestuursrecht)* (Kluwer, Deventer, 2013) at para 3.2.8.

<sup>129</sup> The Supreme Court also decided that the debtor and its directors would keep their (other) civil rights and powers, including the right of a bankrupt debtor to sue and appear in court. See Dutch Supreme Court 24 April 2020, ECLI:NL:HR:2020:801, at 4.1.2. Compare also A G Valk, 20 December 2020, ECLI:NL:PHR:2019:1373 at 4.3.

<sup>130</sup> On the complexities in regard, see R D Vriesendorp and J A F Peters, "Insolventie van overheden", *Tvl* (2002) 188; and G W van der Feltz, *Geschiedenis van de Wet op het faillissement en de surséance van betaling: volledige verzameling van regeeringsontwerpen, gewisselde stukken, gevoerde beraadslagingen enz*, deel II, (Erven F Bohn, Haarlem, 1896) at 308.

<sup>131</sup> For the WHOA, see the discussion in para 4.6.

<sup>132</sup> B Wessels, *Insolventierecht, Surseance van betaling (Part VIII)* (5<sup>th</sup> ed, Kluwer, Deventer, 2021) at para 8005.

that is available to all debtors (whereas this was previously limited to merchants only).<sup>133</sup> According to the DBA, the suspension of payments includes all legal persons within its scope with only a few exceptions.<sup>134</sup> Notably, business activities are not required since foundations and associations may also use a suspension of payments procedure.<sup>135</sup> Similar to bankruptcy, there is uncertainty as to the extent that the proceeding is open to municipalities and other public law legal persons.

In addition to the prior discussion on bankruptcy,<sup>136</sup> the suspension of payments serves as a procedure that deals with imminent insolvency and prevents bankruptcy. For municipalities, there are also alternative frameworks with similar objectives, such as provincial oversight and article 12-status. This may make a suspension of payments superfluous for municipal debtors.<sup>137</sup> Also, in contrast to the bankruptcy procedure, it originally emerged as a tool specifically for commerce. Previous parliamentary discussion does not elaborate on its applicability to public law legal persons. However, given the limited statutory exclusions to the scope of the suspension of payments, the authors argue that this does not generally rule out the possibility that local public entities can file for this procedure. In particular for hybrid local public entities, which are not subject to provincial oversight, suspension of payments can still have practical relevance.<sup>138</sup>

#### 4.6 *Wet homologatie onderhands akkoord* and local public entities

A WHOA<sup>139</sup> is available to debtors that conduct a business,<sup>140</sup> and this limits the extent to which local public entities can make use of this framework. Courts have elaborated on the relevant factors to consider when determining whether a debtor's activities qualify as business activities for the purpose of determining whether the WHOA may be utilised.<sup>141</sup>

<sup>133</sup> See G W van der Feltz, *Geschiedenis van de Wet op het faillissement en de surséance van betaling: volledige verzameling van regeeringsontwerpen, gewisselde stukken, gevoerde beraadslagingen enz*, deel II, (Erven F Bohn, Haarlem, 1896) at 337.

<sup>134</sup> M P van Eeden-van Harskamp, "Commentary to Article 214 DBA", in J L M Groenewegen and F M J Verstijlen (eds), *Tekst en Commentaar Insolventierecht* (Wolters Kluwer, Deventer, 2021). Article 214(4) of the DBA only limits the scope of the suspension of payments, and does not exclude local public entities.

<sup>135</sup> B Wessels, *Insolventierecht, Surseance van betaling (Part VIII)* (5<sup>th</sup> ed, Kluwer, Deventer, 2021) at para 8019. He also states that suspension of payments is available only to civil law legal persons, although this is not substantiated.

<sup>136</sup> See the discussion in para 4.4.

<sup>137</sup> R P Cleveringa, "Maatregelen ter voorkoming van faillissement en surséance van betaling", in *Vereniging voor de vergelijkende studie van het recht van België en Nederland, Jaarboek VI - 1055-1956* (W E J Tjeenk Willink & Antwerp, De Sikkell, Zwolle, 1955) at 103-104. Compare also Dutch Supreme Court 26 January 1990, ECLI:NL:HR:1990:AC0965 (*Staat / Windmill*), at 3.2.

<sup>138</sup> See for instance public notaries, for which the Act on the Notarial Profession, art 26(d) confirms that, despite qualifying as a public law legal person, a public notary can petition to utilise suspension of payments.

<sup>139</sup> Recital 20 PRD 2019 recommends that EU Member States limit preventive restructuring frameworks to exclude public bodies from its scope. However, the Dutch legislator has not explicitly so provided for the WHOA.

<sup>140</sup> See *Kamerstukken II 2018/19*, 35 249, no 3, at 1, 2, 4 and 29 (Explanatory Memorandum).

<sup>141</sup> District Court Midden-Nederland 26 March 2021, ECLI:NL:RBMNE:2021:1255, at 3.6, drawing on DCC, art 3:15i; and *Algemene wet inzake rijksbelastingen* (State Taxes Act), art 52(1) that considers factors such as duration and scope of the debtor's activities, the available time for such activities, as well as the envisaged

Overall, municipalities do not aim to make a profit, are not known for their commercial activities, and typically will not engage in high-risk entrepreneurial activities. Still, municipalities may perform some activities that qualify as business activities, which, in certain cases, may have a significant impact on their budget. However, they do so as public law legal persons, and they are generally not conducting a business. Therefore, the authors consider that municipalities cannot utilise a WHOA. The position pertaining to hybrid local public entities is less clear. Whether they may utilise a WHOA depends on the nature of their public activities and / or whether they also qualify as public law legal persons. A hybrid local public entity's activities could conceivably qualify as overall business activities.

#### 4.7 Miscellaneous provisions applicable to local public entities

In addition to the abovementioned generic procedures and frameworks available to local public entities, there are several special provisions with limited scope. The first is the right of a municipality to reclaim school grounds and buildings that it has made significant investments for construction, or renovation, in. This right may be invoked when the activities of a primary or secondary school are discontinued, such as following the bankruptcy of an entity operating a school. The grounds and buildings that were used for education will be transferred in ownership from the school to the municipality.<sup>142</sup>

Secondly, a municipality has specific reporting duties for its related parties, which involves reporting on their programme plan, annual budget and balance sheet.<sup>143</sup> These reporting duties should also enable the bodies of the municipality to respond to the financial distress of these related parties.

Thirdly, another way to address municipalities in financial distress can be to redevise them. According to the Constitution, municipalities are established and dissolved by law, which also regulates the change of municipal borders.<sup>144</sup> In principle, the initiative for a municipal redivision lies with the municipality itself. However, in case of evident governance issues that a municipality cannot address itself, a Provincial Executive may submit a proposal for a redivision of the municipality to the Minister of Interior and Kingdom Affairs. This may be the case when the municipality faces serious financial problems.<sup>145</sup> If the proposal is

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profit, entrepreneurial risk, the revenue, size of the investments made, the number of customers and the public familiarity of the business (activities).

<sup>142</sup> *Wet op het primair onderwijs* (Primary Education Act), art 110(4); *Wet op het voortgezet onderwijs* (Secondary Education Act), art 76u(4); and DCC, art 3:80(3). To this end, a similar provision for certain educational buildings of expertise centres is provided in *Wet op de Expertisecentra* (Expertise Centre Act), art 108(4).

<sup>143</sup> BBV, arts 5, 8(3)(b), 9(2)(f) and 36.

<sup>144</sup> Dutch Constitution, art 123. This has been elaborated in the *Wet algemene regels herindeling* (Act on General Rules for Redivision) and the *Beleidskader gemeentelijke herindeling* (Municipal Redivision Policy Framework), which state how proposals for municipal redivisions are assessed and reviewed by the Minister of the Interior and Kingdom Relations.

<sup>145</sup> Municipal Redivision Policy Framework, p 2; and Act on General Rules for Redivision, art 8.

supported by the Minister of Interior and Kingdom Affairs, a bill to this end will be submitted to Parliament.

Furthermore, various laws that provide or delegate specific public law powers to hybrid local public entities may be withdrawn following the commencement of a bankruptcy procedure or suspension of payments. Additionally, those laws may contain provisions that offer specific tools for dealing with financial distress. Both types of provisions exist in relation to, for instance, notaries and bailiffs.<sup>146</sup>

## 4.8 Selected technical and procedure rules

At the end of paragraph 4, the authors provide an overview of selected technical and procedural themes relevant to local public entities that are subject to any of the aforementioned procedures or frameworks.

### 4.8.1 Cause investigation into the financial distress of local public entities

For bankruptcy proceedings, there is an explicit statutory ground requiring insolvency practitioners to conduct investigations to determine the causes of the bankruptcy, and this also applies when the debtor is a local public entity.<sup>147</sup> No similar duty arises in a suspension of payments or in a WHOA. However, a restructuring expert or observer, if appointed, will have access to all records and all other relevant information of a debtor in order to perform a review.<sup>148</sup> Furthermore, the law requires that a WHOA plan provides details on the nature, extent, and causes of a debtor's financial difficulties.<sup>149</sup>

In cases of provincial oversight, a Provincial Executive may at any time commence a financial investigation into the causes of the financial distress.<sup>150</sup> Furthermore, when applying for article 12-status, a municipality must indicate the grounds on which the application is based. This includes, amongst other things, an explanation of the causes that justify an additional allowance from the Municipalities Fund.<sup>151</sup> In addition, a cause analysis of the financial distress is carried out by the State's article 12-inspector.<sup>152</sup>

<sup>146</sup> See Act on the Notarial Profession, art 26(1)(d), which provides for a suspension of the notary, for instance, when he has been declared bankrupt. Bailiffs Act, art 51(b) provides a similar provision for bailiffs. See R D Vriesendorp and J A F Peters, "Insolventie van overheden", *Tvl* (2002) 188 at para 4(a). Furthermore, Act on the Notarial Profession, art 25b opens up the possibility to appoint a silent administrator (for up to one year) when the continuation of a notary's office has become uncertain. A similar provision is provided for bailiffs (Bailiffs Act, art 33a).

<sup>147</sup> DBA, art 68; and *Kamerstukken II* 2014/15, 34 253, no 3, at 13 (Explanatory Memorandum).

<sup>148</sup> DBA, arts 371(8) and (9). In addition, the debtor – as well as his employees, supervisory directors, and shareholders – are obliged to co-operate with and provide the restructuring expert with all relevant information. Failure to co-operate may result in directors being found liable (*Kamerstukken II* 2018/19, 35 249, no 3, at 42 (Explanatory Memorandum)).

<sup>149</sup> DBA, art 375(2)(c)(3).

<sup>150</sup> Municipalities Act, art 215.

<sup>151</sup> *Handleiding Artikel 12 Financiële-verhoudingswet 2017*, at 9.

<sup>152</sup> *Idem*, at 6.

#### 4.8.2 *Directors' liability for the mismanagement of local public entities*

There are several grounds for civil liability of directors who caused financial distress or acted in a manner detrimental to the general body of creditors. However, different rules apply to public and civil law legal persons. In short, directors of civil law legal persons may be held liable by companies themselves in cases of mismanagement.<sup>153</sup> In cases of bankruptcy, there is an additional statutory ground for insolvency practitioners to hold directors of civil law legal persons liable for mismanagement.<sup>154</sup> Furthermore, if a director's conduct related to the financial distress qualifies as a tort, an affected third party may hold a director or a civil servant of both a public or civil law legal person personally liable.<sup>155</sup>

Liability may also become an issue for Municipal Councils. When a municipality is subject to preventive oversight, it requires the approval of a Provincial Executive to enter into legal obligations. If a municipality enters into obligations without prior or later approval from a Provincial Executive, each Municipal Council member who voted in favour is personally liable for an equal share of the value of the obligations assumed.<sup>156</sup>

#### 4.8.3 *Creditors of local public entities*

This discussion will focus on the extent to which creditors' (voting) rights can be impaired or excluded and whether they can be subjected to intra-class and cross-class cram-downs when a (restructuring) plan is proposed in a bankruptcy proceeding, a suspension of payments, or a WHOA. In this regard, no special rules apply to creditors of local public entities in distress. Furthermore, their rights are, in principle, not directly affected when a local public entity is subject to provincial oversight or has obtained article 12-status.

##### 4.8.3.1 *Bankruptcy and suspension of payments plan*

In both bankruptcy and suspension of payments, local public entity debtors may propose a plan to their creditors. In principle, a plan is limited to all unsecured creditors.<sup>157</sup> Secured and preferential creditors are not subject to a plan, unless they make themselves voluntarily subject to the restructuring plan and renounce their preference.<sup>158</sup> Unsecured creditors are not put into different classes for the purpose of voting on a plan. Consequently, there is no cross-class cram-down mechanism but rather an intra-class cram-down.<sup>159</sup>

<sup>153</sup> DCC, art 2:9. It does not apply to directors of public law legal persons, subject to DCC, art 2:1(3).

<sup>154</sup> *Idem*, arts 2:138 and 2:148. It does not apply to directors of public law legal persons, subject to DCC, art 2:1(3).

<sup>155</sup> *Idem*, art 6:162. See also C H Sieburgh, *Mr. C. Assers Handleiding tot de beoefening van het Nederlands Burgerlijk Recht. 6. Verbintenissenrecht. Deel IV. De verbintenis uit de wet* (Wolters Kluwer, Deventer, 2019) at 338.

<sup>156</sup> See the discussion in para 4.2.2.

<sup>157</sup> DBA, arts 138, 143, 157, 252 and 232.

<sup>158</sup> *Idem*, arts 143 and 257(2).

<sup>159</sup> *Idem*, arts 145 and 268.

In bankruptcy, affected creditors will have voting rights subject to verification of their claim after submitting such claim with the insolvency practitioner.<sup>160</sup> In a suspension of payments, no formal verification process takes place. However, claims must be submitted with a joint administrator, who will assess the claims.<sup>161</sup>

During a meeting of the creditors, which is presided over by a supervisory judge, a debtor can discuss the plan with its creditors. If necessary, a debtor can still amend the plan to ensure that there will be sufficient creditors that will vote in favour of the plan.<sup>162</sup> A cram-down is available when at least a simple majority of the recognised and admitted creditors, representing not less than half of the recognised and provisionally admitted claims, vote in favour of the plan.<sup>163</sup> The court will confirm the plan unless certain procedural and material fairness standards are not met.<sup>164</sup> Upon court confirmation, all affected creditors, including those that dissented, are bound by the plan.<sup>165</sup>

#### 4.8.3.2 *Plan under the Wet homologatie onderhands akkoord*

In a WHOA, a debtor and / or restructuring expert will propose a plan to the debtor (if applicable), (a part of) its creditors and shareholders. The affected creditors and shareholders will be placed in separate classes if the rights they would have in liquidation or under the plan are so different that they are not in a comparable position. Regardless, at least secured and unsecured creditors will be separated.<sup>166</sup>

Affected creditors and shareholders have the right to vote on a plan. However, they may face both an intra-class cram-down and a cross-class cram-down.<sup>167</sup> A class of creditors has adopted the plan when it is adopted by creditors representing at least two-thirds of the value of the claims of creditors who cast their vote in that class.<sup>168</sup> Furthermore, the court

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<sup>160</sup> *Idem*, arts 108 *et seq.*

<sup>161</sup> *Idem*, arts 257 *et seq.*

<sup>162</sup> *Idem*, arts 139, 141, 144 and 265.

<sup>163</sup> *Idem*, arts 145 and 268. Furthermore, if this is not met, the plan can still be confirmed where (i) at least three-fourths of the creditors voted in favour of the plan, (ii) the dissenting creditors are not worse off in liquidation, and (iii) they have no other good reason to reject the plan (DBA, arts 146 and 268a).

<sup>164</sup> *Idem*, arts 153(2) and (3), and 272(2) and (3). These grounds include, in particular, when the assets of the estate significantly exceed the value distributed under the plan, when the performance of the plan is not sufficiently guaranteed, or if the plan was realised by fraud, undue preference of one or more creditors, or otherwise unfair means. Furthermore, a plan that does not secure repayment of state aid will not be confirmed (DBA, art 362(3)).

<sup>165</sup> *Idem*, arts 157 and 273.

<sup>166</sup> *Idem*, art 374(1).

<sup>167</sup> *Idem*, art 381(3).

<sup>168</sup> *Idem*, art 381(7). A similar standard applies to each class of shareholders. They have adopted the plan when it has been adopted by shareholders representing at least two-thirds of the total amount of issued capital belonging to shareholders that are part of that class, and who cast their vote in that class (DBA, art 381(8)).



may confirm the plan when at least one “in-the-money”<sup>169</sup> class of creditors has approved the plan.<sup>170</sup>

A court will not confirm a plan in cases where there are general or special grounds for rejection. Courts will assess *ex officio* and, at the request of an affected creditor or shareholder, whether certain procedural fairness standards are met (the general grounds for refusing confirmation).<sup>171</sup> Furthermore, an affected creditor or shareholder – who has voted against the plan – can oppose confirmation if he would be worse off under the plan than in a bankruptcy proceeding (best-interest-test).<sup>172</sup> In addition, dissenting creditors or shareholders in a dissenting class can oppose confirmation when certain standards for a fair allocation of value under the plan are not met.<sup>173</sup>

#### 4.8.4 *New and interim financing*

In pursuing a successful restructuring of a debtor or its business, new and interim financing is often important. In the course of bankruptcy, a suspension of payments or a WHOA, new or interim financing may be acquired. However, where such funding is acquired in the course of a suspension of payments or a WHOA, there may be liability risks involved when the new or interim finance is held to be detrimental to the general body of creditors in the event of a subsequent bankruptcy. Also, there is a risk that such transactions may be avoided by an insolvency practitioner in a subsequent bankruptcy proceeding.<sup>174</sup> To prevent avoidance actions in a WHOA, a debtor may request a court, under certain circumstances, to pre-approve a debtor entering into such a transaction.<sup>175</sup>

### 5. Local public entities in distress in Dutch practice

As discussed above, there are a variety of tools available to deal with local public entities in distress. For basic local public entities (municipalities), there have been no reported instances in which a bankruptcy or suspensions of payments procedure has been used. Case law in this regard is limited. In 1892, a court declared that a water authority (a public body) was in a “state of financial incapacity”. However, a creditor successfully opposed this

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<sup>169</sup> A class of creditors is considered “in the money” if these creditors would be (partially) satisfied in their claims in a bankruptcy proceeding.

<sup>170</sup> DBA, art 383(1).

<sup>171</sup> *Idem*, art 384(2).

<sup>172</sup> *Idem*, art 384(3).

<sup>173</sup> *Idem*, art 384(4). This can be the case when: (i) traders in small and medium enterprises or tort creditors receive less than 20% of the value of their claims, (ii) there is no reasonable ground for the derogation from the absolute priority rule, or if this would be to the detriment of the objecting creditor or shareholder, (iii) creditors, except those that fall under (iv), cannot opt for a cash pay-out under the plan, and (iv) secured creditor extending credit on a commercial basis are offered shares or certificates and do not have the right to opt for distribution in another form. Furthermore, a plan that does not secure repayment of state aid will not be confirmed (DBA, art 362(3)).

<sup>174</sup> DBA, arts 42 *et seq* lists the requirements that this is subject to.

<sup>175</sup> *Idem*, art 42a.

declaration, and the court's decision was set aside.<sup>176</sup> There has also been one case where a bankruptcy request was filed for a municipality. However, the court decided that the municipality did not meet the requirements for bankruptcy.<sup>177</sup>

Instead of entering bankruptcy proceedings, several municipalities have become subject to retrospective supervision by their province, while some have also obtained article 12-status. Currently, out of the 352 municipalities in the Netherlands, 13 municipalities are subject to preventive supervision, with one municipality holding article 12-status.<sup>178</sup>

For hybrid local public entities in distress, there are no statistics on the extent to which higher bodies extend additional funding, nor on their use of the Dutch restructuring or insolvency regime. However, there have been various cases reported in recent years where a hybrid local public entity has been, for instance, subject to a bankruptcy proceeding.<sup>179</sup> In practice, financial distress does not always result in a local public entity becoming subject to a bankruptcy proceeding. For instance, an involved municipality can provide additional funding or decide to sell its shares to a new investor.<sup>180</sup>

## 6. Conclusion

The Dutch legislator seems to have taken a straightforward approach by adopting a default rule that local public entities in distress – both public law and civil law legal persons – may become subject to bankruptcy proceedings as an *ultimum remedium* so that they can deal with their financial distress. However, this does not imply that the regime for dealing with local public entities in financial distress is that clear. On the one hand there are alternative routes to address financial distress of local public entities (and prevent bankruptcy). On the other hand, questions relating to the concurrence of civil and public law (in particular regarding how to deal with public interests and who will perform public law functions or exercise public law authority when dealing with financial distress) are often left unaddressed by the legislator. What results is a regulatory corporate restructuring and insolvency framework that offers solutions tailored to address matters of property law and sometimes of the law of obligations, but with limited consideration for public law implications.

To date, there have been no cases where a basic local public entity – a municipality – has been declared bankrupt. The consequences and complications of a bankruptcy

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<sup>176</sup> District Court Utrecht 23 September 1892 and 19 November 1892, W 6273. See also B Wessels, *Insolventierecht, Faillietverklaring (Deel I)* (5<sup>th</sup> ed, Kluwer, Deventer, 2018) at para 1135.

<sup>177</sup> Dutch Supreme Court 23 June 1922, W 10933, NJ 1922, at 1030 (*Wormerveer*).

<sup>178</sup> *Financieel toezichtsverslag 2021, verslag over het provinciaal financieel toezicht op gemeenten en gemeenschappelijke regelingen*, 31 March 2021 at 5, available [here](#).

<sup>179</sup> Examples include the International Horticultural Expo Floriade (see [here](#)) and the sheltered employment company Caparis (see [here](#)).

<sup>180</sup> In respect of a waste plant company in Amsterdam, the municipality decided to sell the shares that it held (see [here](#)). Also see the case of *Licom*, a company that provides sheltered employment. After it entered bankruptcy proceedings, both the Municipal Executive and Provincial Executive provided the company with additional funds to continue its operations (see [here](#)).

proceeding for the public function of a municipality make bankruptcy undesirable. Instead, ongoing provincial oversight (retrospective by default and preventive for cause) should safeguard a financially sound budget. Should oversight fail to remedy a local public entity's financial distress, an article 12-status can be afforded and additional financial support granted. Given the limited number of municipalities that are subject to preventive provincial oversight or have been granted article 12-status, this mechanism seems effective in preventing and addressing financial distress. However, the system is based on solidarity amongst municipalities. Municipalities are expected to maximise their efforts for a balanced budget, but when they fail to do so, the additional allowance they are granted by virtue of their article 12-status is deducted from the overall annual amount available for municipalities from the Municipalities Fund. Whereas the framework for municipalities in financial distress works well in general, it will not provide a solid solution to address structural underfinancing of municipalities or more *ad hoc* budgetary disruptions – such as with the Covid-19 pandemic – impacting a large part of the municipalities.

Hybrid local public entities are a broad and diverse group of entities with a local public authority or a local public function. In many cases, they will be subject to some supervision of a municipality or other public body from whom they also receive their financing, or part thereof. When a hybrid local public entity faces financial distress, and there is no further (municipal) financing available, it will have to make use of the general corporate restructuring and insolvency regime. However, the applicability of this regime depends largely on the scope and type of public law powers and / or public law functions exercised by a debtor. This is an area that will likely receive more attention in the future, not least because of the impact of the Covid-19 pandemic and an impending economic recession on local public entities.

## Local public entities in distress - a critical analysis of the Nigerian approach

By Iyare Otabor-Olubor\* and Anthony Idigbe\*\*

### 1. General context of local public entities and insolvency law in Nigeria

Local public entities (local governments) in Nigeria serve as the agents for the federal government and as arms for implementing the federal government's ideals, initiatives, and objectives.<sup>1</sup> A local public entity is a government tool used to manage and deliver government services and amenities more efficiently and effectively,<sup>2</sup> and is seen as capable of assessing the needs of local communities and is therefore viewed as a competent unit of government. This can be seen from the 1976 Local Government Reform which states that local public entities in Nigeria are a tier of the federal government and, therefore, they are expected to exercise governmental powers at a local level.<sup>3</sup> Currently, there are 774 local public entities spread across the 36 states in Nigeria.

The high level of debt of local public entities can sometimes put their functioning at risk whilst attempting to fulfil their mandate of providing essential public services to their respective communities. Consequently, local governments might not be able to deal with crises such as the Covid-19 pandemic since they lack the necessary emergency funds. Additionally, excessive debt may discourage public investment and infrastructure financing, which could limit sustainable development.<sup>4</sup>

The more a local public entity borrows from the market, the less creditworthy it becomes, thus resulting in increased costs of borrowing for both the local public entity and the national government or other authorities guaranteeing its debt.<sup>5</sup> When the revenues from its sources and inter-governmental transfers are insufficient to meet spending obligations,

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<sup>1</sup> I Okechukwu, N Ndidi and M Njideka, "Intergovernmental Fiscal Relations and Local Government Performance in Nigeria", *International Journal of Recent Research in Commerce Economics and Management* (2019) 6 (2) 258 at 261.

<sup>2</sup> *Ibid.*

<sup>3</sup> D Olowu, "Governance and Policy Relevance of the Nigerian 40-year Grassroots Revolution: 1976-2016", *International Review of Administrative Science* (2019) 85(4) at 726; and D Olowu, "A Decade of Local Government Reform in Nigeria: 1976-1986", *International Review of Administrative Science* (1986) 52(3) at 287.

<sup>4</sup> The African Charter on the Values and Principles of Decentralisation, Local Governance and Local Development 2014 (African Local Governance Charter), art 7. The African Local Governance Charter serves as a framework on which the African Union encourages African countries to adopt a sustainable resource management system for their respective local governments. Nigeria is not yet a signatory to this Charter. Also see H Blöchliger and J Kim, *Fiscal Federalism - Making Decentralisation Work* (OECD, Paris, 2016) at 107.

<sup>5</sup> K Herold *et al*, "Insolvency Frameworks for State and Local Governments", *OECD Journal on Budgeting* (2020) 20 at 97.

a financially constrained local public entity will run out of viable options in the absence of an efficient insolvency framework capable of deleveraging the entity and restoring its viability. Additionally, it is arguably possible that a soft budget constraint is at play where the increased cost of borrowing, and the local public entity's inability to pay the debt, are persistently covered by fiscal aid granted by the state to support the local public entity in distress.<sup>6</sup> This can lead to an institutional moral hazard when local public entities are rescued by their state, which may influence their decisions away from national efforts in improving efficiency, thus increasing the potential risk of economic failure.<sup>7</sup>

Insolvency regulations covering sub-national insolvencies are rare in Africa. Nigeria has not formulated any defined set of rules addressing corporate insolvency in cases of financial crises.

The Companies and Allied Matters Act 2020 currently regulates the activities of companies in Nigeria. Although passed by the Senate on 10 March 2020 as the Companies and Allied Matters (Repeal and Re-enactment) Act, it was only assented into law by the Nigerian President on 7 August 2020. However, the new law still does not address any form of sovereign or sub-sovereign debt or municipal insolvency.

Before the Companies and Allied Matters Act 2020, the Companies and Allied Matters Act 1990 regulated corporate insolvency in Nigeria. Until it was repealed, there had not been any significant amendments to the Companies and Allied Matters Act 1990 since its enactment over thirty years ago.<sup>8</sup> The insolvency regime of 1990 focused on the interests of creditors. Its primary objective was to facilitate the planning of ways to maximise the amount received following the realisation of a debtor's assets and, subsequently, the benefit of a company's creditors. There were no set provisions to facilitate corporate rescue, particularly for other stakeholders such as debtors, competing claimants and public entities. The Companies and Allied Matters Act 1990 predominantly provided solutions to creditors in the enforcement of debt collections.<sup>9</sup> These mechanisms were receivership, winding-up, arrangement, and compromise.<sup>10</sup>

A reason for the winding-up of a company in Nigeria is its failure to pay its debts. In *Afrotech Technical Services v MIA & Sons Ltd and Anor*,<sup>11</sup> the Nigerian Supreme Court laid down processes for the winding-up of a company. The court defined an insolvent entity as a person that has either ceased to pay his debts in the ordinary course of business or

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<sup>6</sup> S Park, "Understanding Public Sector Debt: Financial Vicious Circle under the Soft Budget Constraint", *Public Organization Review* (2018) 18 at 71.

<sup>7</sup> M Vahabi, "The Soft Budget Constraint: A Theoretical Clarification", *Louvain Economic Review* (2001) 67 at 157. The soft budget constraints "alludes to a situation in which a state-owned enterprise may survive even in case of persistent losses thanks to the financial aid of a paternalistic state".

<sup>8</sup> Corporate insolvency was also partly regulated by the Companies Winding Up Rules.

<sup>9</sup> E Nwauche, "The Duties of a Receiver/Manager in Nigeria and Ghana", *International Insolvency Review* (2005) 14 at 71.

<sup>10</sup> Companies and Allied Matters Act 1990, Parts XIV and XVI. Also see B Adebola, "Common Law, Judicial Precedents and the Nigerian Receivership Procedure", *Journal of African Law* (2014) 58 at 129.

<sup>11</sup> (2000) 15 NWLR (Pt 692) 730 SC.

cannot pay his debts as they fall due. The Companies and Allied Matters Act 2020 have explained and grouped an entity's inability to pay debts into three categories:<sup>12</sup>

- (a) a creditor owed an amount by a company exceeding N 200,000 (USD 500), has served on the company at its registered office or head office, a claim requiring the company to pay the debt, and the company has for three weeks defaulted or has not satisfied the creditor up to a reasonable sum;
- (b) execution or other process issued on a judgment, act or order of any court as an obligation in favour of a creditor against the company has not been fulfilled either in whole or in part; or
- (c) if the court is satisfied that the company is unable to pay its debts upon considering existing liabilities of the company.

The Companies and Allied Matters Act 2020 brought business-friendly changes to Nigeria. Notably, this legislation introduced rescue mechanisms for insolvent companies. These rescue mechanisms are company administration and company voluntary arrangement. These procedures and receivership will be analysed in this chapter. Companies utilising either company voluntary arrangements or company administrations continue to operate as going concerns.

A company voluntary arrangement can be explained as an agreement between an insolvent company and its creditors that allows that company to structure repayment plans to satisfy its debts.<sup>13</sup> The Companies and Allied Matters Act 2020 does not define the company voluntary arrangement mechanism. However, a company voluntary arrangement is defined as a mechanism that allows companies to be rescued through an agreement with their creditors, and these agreements typically involve creditors accepting less or none of the money that a debtor owes them.<sup>14</sup> A debtor may propose a repayment plan to its creditors that allows any due repayments to be spread over an agreed period of time. By allowing a company to remain under the control of its present management whilst being supervised by a qualified insolvency practitioner, the company voluntary arrangement procedure offers a relatively low-cost and straightforward way to restructure a company's affairs.

The company administration restructuring procedure in Nigeria involves an administrator managing the assets of an insolvent company with the intention of rescuing all or part of its business and preserving its value as a going concern.<sup>15</sup> This task also involves achieving a better outcome for the company's creditors, for example by ensuring that their security

<sup>12</sup> Companies and Allied Matters Act 2020 (CAMA 2020), ss 570(a)-(c).

<sup>13</sup> M Parkinson, *Corporate Governance in Transition: Dealing with Financial Distress and Insolvency in UK Companies* (Palgrave Macmillan, London, 2018) at 43.

<sup>14</sup> S Frisby, "Insolvency Law and Insolvency Practice: Principles and Pragmatism Diverge?", *Current Legal Problems* (2011) 64 at 349.

<sup>15</sup> CAMA 2020, s 444.

interests in a company's assets are preserved. However, a company administration can be used to return a company to solvency instead of winding-up the company or putting it in receivership. Despite the primary objective of the Companies and Allied Matters Act 2020 of corporate rescue, an administrator may choose a different course if it is determined that it would not be possible to rescue the company to which they are appointed, or it has no reasonable prospect of success.<sup>16</sup>

Another option that may be initiated by the court or a competing claimant is receivership (that is, the appointment of a receiver or manager) under the Companies and Allied Matters Act 2020, which requires a receiver or manager to manage the affairs of a company.<sup>17</sup> A court may appoint a receiver or manager over the property or undertaking of a company, and the activities of the appointee will be directed by a court on behalf of the company to which they are appointed.<sup>18</sup> Similarly, where an appointee is appointed out of court under a power contained in an instrument such as a debenture, such appointee will be deemed to be a fiduciary agent of the person on whose behalf the appointment was made, and must observe good faith in the course of business.<sup>19</sup> Whilst doing so, a receiver or manager is expected to act in the best interests of the company to which they are appointed as a whole. This involves preserving a company's assets, continuing its business, and promoting the purposes for which the company was created in a diligent and sensible manner.<sup>20</sup>

## 2. Local public entities in distress in Nigeria

The existence of local public entities, also known as local governments, and a local government system, stems from the 1999 Constitution of the Federal Republic of Nigeria (the Constitution or CFRN 1999). The Constitution allows state governments to articulate provisions concerning the establishment, structure, composition, finance, and functions of local public entities through local government councils.<sup>21</sup> Local public entities are, therefore, a creation of the Constitution<sup>22</sup> and statutes, even though the statutorily created local public entities are arguably for national administrative convenience to satisfy the requirement of local governance at the grassroots level.<sup>23</sup> In theory, local public entities are administratively set up to accommodate the interests of multicultural minorities, and, as a result, such interests can be integrated into the national development agenda of the country.<sup>24</sup> Local public entities are regulated by means of state legislation.

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<sup>16</sup> *Idem*, ss 445 and 502.

<sup>17</sup> *Idem*, Ch 19.

<sup>18</sup> *Idem*, s 552.

<sup>19</sup> *Idem*, s 553(1).

<sup>20</sup> *Idem*, s 553(2).

<sup>21</sup> CFRN 1999, ss 7(1) and 8(3). Also see Local Government (Administration) Law, s 4 (as amended), Cap L89 LLS 2015.

<sup>22</sup> CFRN 1999, Sch 1, Part 1. Also see CFRN 1999, s 3(2), which establishes the local government council as the organ that exercises the juristic powers of local public entities.

<sup>23</sup> A Tobi and G Oikhala, "Local Government Reforms and Grassroots Development in Nigeria", *Journal of Administrative Science* (2021) 18 113 at 118.

<sup>24</sup> *Idem*, at 114.

There continues to be an ongoing constitutional dispute about the legal status of local public entities created by states outside of the 774 local public entities listed in the Constitution.<sup>25</sup> In the statutes of some federal states, such as those in Lagos State, there has been an attempt to expand the legal capacity and personality of local public entities by means of local council development areas (additionally created by Lagos State). Local council development areas act like many companies – they can enter into transactions and conclude all other acts associated with having a corporate personality, such as suing or being sued and owning property and assets through their governing organ (a local government council).

There also seems to be no barrier regarding the right of local public entities to set up special purpose vehicle companies in accordance with the Companies and Allied Matters Act 2020 to hold assets. This conclusion does not emerge clearly from the Companies and Allied Matters Act 2020. Whilst it can be directly inferred from the law, to date there have been no apparent examples of special purpose vehicles being subject to the provisions of the Companies and Allied Matters Act 2020.<sup>26</sup> Furthermore, the relevance of setting up a special purpose vehicle is doubtful due to the restrictive control exacted over local public entities by their respective state governments.

Both the Constitution<sup>27</sup> and the local statutes<sup>28</sup> ascribe several functions to local public entities, which have further expanded their powers over the years.<sup>29</sup> The execution of the constitutional and statutory functions requires funding. However, by their very creation, local public entities do not enjoy financial autonomy as they are dependent on allocations from the federal and state governments for funding. Another source of financing is taxation. Local public entities are empowered by the Constitution to collect taxes and rates as directed by the State House of Assembly.<sup>30</sup> Despite the number of taxes and levies

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<sup>25</sup> See, for instance, the Local Government (Administration) Law of Lagos State as amended. This law further created additional local council development areas in addition to the local public entities originally created for Lagos State. There remains an ongoing constitutional dispute as to the legal status of any local public entity created by states outside of the 774 local public entities listed under the CFRN 1999. Revenue allocation has been based on those listed in the CFRN 1999. Lagos has complained that its number of local public entities is inadequate compared to the population. Even with the creation of 54 local public entities by Lagos, its federal allocation did not increase.

<sup>26</sup> Investment and Securities Act (ISA) 2007, s 2A (ii), (iii), (ix) and (x); and ss 171(b) and 171(d).

<sup>27</sup> CFRN 1999, Sch IV provides for the functions of local public entities. These functions include making recommendations to the states' commission on economic planning, collection of rates, registration of births, construction and maintenance of public facilities as prescribed by the House of Assembly, participation with state governments' councils with respect to the development of agriculture, maintenance of health services, adult and vocational education, as well as other functions.

<sup>28</sup> Cross-River State Local Government Law, s 34(e), for instance, provides that a local public entity shall charge such rates and taxes as may be approved by the Cross-River State House of Assembly.

<sup>29</sup> *Ibid.*

<sup>30</sup> For instance, local public entities in Lagos State are empowered to collect the following taxes and rates: shop and kiosk rates; tenement rates; on-and-off liquor license fees; slaughter slab fees; marriage, birth and death registration fees; naming of street registration fees, excluding any street in the state capital; right of occupancy fees on lands in the suburban areas, excluding those collectable by the federal and state governments; markets taxes and levies, excluding any market where state finance is involved; motor park levies; domestic animal license fees; bicycle and road closure fees; radio and television license fees



collected by local public entities (and in an attempt to increase the internally generated revenue of the various local public entities), there is often a persisting problem of double taxation. This problem occurs when the same taxes are imposed and collected under a different guise. In some cases, taxes or levies that are not provided by law are collected by the same local public entities, thereby resembling a problem of illegal taxation.

Local public entities also resort to borrowing to meet their financial obligations. This form of funding has been preferred over direct allocations and taxes in recent times. This financing structure is often sourced through the issuance of irrevocable standing payment orders or sinking funds against their internal growth rate (IGR) or even a project finance model where a finance provider controls receivables from a funded project.

Many local public entities and state governments have become so leveraged that they receive zero allocation from the government and federal and state authorities due to their ongoing borrowing obligations. Creditors are negatively affected by the uncertainty surrounding central allocations to local public entities, as well as default fluctuations on tax revenues, as these changes may make payment for their services more challenging, particularly in a legal framework characterised by the absence of provisions applicable to local public entities.<sup>31</sup>

Nonetheless, creditors have the right to sue local public entities in civil courts should they fail to comply with their obligations. In the past, some creditors have commenced proceedings against local public entities.<sup>32</sup> Since the major creditors of local public entities are banks and other financial institutions regulated by the Central Bank of Nigeria, and bearing in mind the contagion effect of local government insolvency issues, the federal government is always forced to intervene through the regulator (the Central Bank of Nigeria). They jointly and informally resolve insolvency issues faced by local public entities to avoid embarrassment.

Whilst insolvencies of natural persons are mostly regulated by the Bankruptcy Act 2004 in Nigeria, corporate insolvencies are generally catered for under the Companies and Allied Matters Act 2020. Unlike what happens in the United States (US),<sup>33</sup> the Companies and Allied Matters Act 2020 and other Nigerian laws are silent on local sub-sovereign or municipal insolvency. An issue also exists regarding whether local public entities, as sub-sovereigns created by the Constitution or statute, can be subjected to insolvency

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(although this does not apply to radio and television transmitters); vehicle radio license fees; wrong parking charges; public convenience, sewage and refuse disposal fees; religious places establishment permit fees; signboard and advertisement permit fees; and wharf landing charges, where applicable. In this regard, see [here](#).

<sup>31</sup> M Ani and F Olarewaju, "Osun Flirts with Insolvency, Spends 91% of FAAC Servicing Debt in Q1" (Business Day, 11 August 2020), available [here](#).

<sup>32</sup> *Idanre Local Government v Government of Ondo State* (2010) 14 NWLR (pt. 1214) 509; and O Abifarin, J Babalola, J Olatoke and E Adesina, "A Comparative Analysis of Financial Assistance to States by the Central Government in Nigeria and America", *University of The Gambia Law Review* (2018) 1 at 141.

<sup>33</sup> US Bankruptcy Code on Municipal Debts Adjustments, Ch 9.

proceedings, particularly winding-up, within the confines of the Companies and Allied Matters Act 2020. Nothing in the current law suggests that insolvency proceedings can be commenced by or taken out against local governments.

Some cases of litigation are highly relevant to the above considerations and challenges, including when state government bodies may use corporate investment vehicles to do business. Therefore, this chapter will build on these few cases to discuss the framework applicable to local public entities (mainly special purpose vehicles) in distress.

## 2.1 Access to finance for local public entities

Local public entities in Nigeria are both constitutionally and statutorily created and thus cannot ordinarily be owned by a higher public, federal or corporate body, even if they exist in the jurisdiction of the local public entity. State governments exercise a considerable amount of control over local public entities, which have often found themselves engulfed in a persistent struggle for both political and financial independence from states. However, there is a collection of local public entities known as the Association of Local Governments of Nigeria, which is an umbrella membership body for local public entities in Nigeria with no constitutional basis. The Association of Local Governments of Nigeria has however been incurring debts on behalf of all the local public entities and has frequently accessed the local public entities' funds in the Consolidated Revenue Fund or Excess Crude Fund.<sup>34</sup>

As already noted, local public entities in Nigeria are a creation of the Constitution<sup>35</sup> and statute. Sections 1 and 2 of the Local Government (Administration) Law of Lagos State, as amended by Law Number 3 of 2006, reiterates this. It also dictates that, unlike for companies, the individuals at the helm of these bodies are elected officials, not (debt or equity) capital providers or investors nominees and / or appointees.<sup>36</sup> Section 2A, which deals with the legal status and functions of local public entities, also acknowledges that they can (i) own and / or dispose of properties, (ii) sue and be sued, and (iii) assume all the rights and duties of a legal entity and be bound by contracts.<sup>37</sup> To this end, local public entities are conceptually capable of owning shares (technically intangible personal property in a legal sense). However, it must be pointed out that the legislation and the provisions that have been cited for Lagos State are still shrouded in complexity. It may be the case that, since local public entities are subject to the control of the higher body of the state, they cannot own shares by themselves or at least for themselves.

It is to be noted that the employees of these entities are usually civil servants of the state and benefit from their salary claims being granted a preferential ranking in distribution. Such claims constitute a first charge on amounts received by the state government from the

<sup>34</sup> *Riok Nigeria Ltd and 3 Ors v Incorporated Trustees of Association of Local Government of Nigeria (ALGON)* Suit No: FCT/HC/CV/2129/2014.

<sup>35</sup> CFRN 1999, s 7(1) and Sch IV provides for the functions of local public entities.

<sup>36</sup> Investment and Securities Act (ISA) 2007, ss 2A (ii), (iii), (ix) and (x); and ss 171(b) and 171(d).

<sup>37</sup> Local Government (Administration) Law of Lagos State, ss 2A (ii), (iii), (ix) and (x).

Federation Accounts for the benefits of the local public entities.<sup>38</sup> It should also be noted that because of their statutory creation, mode of funding, and subordination to the state, local public entities are ultimately controlled by the state. They do not enjoy financial autonomy as the Constitution makes local government councils dependent on state governments for their allocation of funding. The Constitution states that the amount standing to the credit of local government councils in the Federation Account should also be allocated to the states for the benefit of the local government councils on such terms and in such manner as may be provided by the National Assembly.<sup>39</sup>

The Constitution further states that each state shall maintain a special account to be called the State Joint Local Government Account.<sup>40</sup> This account will receive all allocations from the local government councils of the state from the Federation Account and from the government of the state, which allocation shall be subject to section 162(7) of the Constitution.<sup>41</sup> Disbursements will be payable to local government councils in their area of jurisdiction, and any disbursements will be proportional to the local government's total revenue on such terms and in such manner as may be prescribed by the National Assembly. State governments have been able to divert part of the funds allocated to local governments by abusing these provisions.<sup>42</sup> Local government councils have been debilitated by this, making it challenging for them to discharge their responsibilities. In addition, each local government council is rarely compensated for its statutory revenue allocation from the state budget.<sup>43</sup> Section 4 of the Allocation of Revenue (Federation Account) Act 1981 states, in addition to the allocation made from the Federation Account to local public entity councils, that each state in Nigeria should remit to the State Joint Local Government Account during each quarter of the financial year a sum representing 10% of a state's internally generated revenue. Accordingly, 10% of a state's revenues must be assigned to each local government in that state, as directed by a State House of Assembly.<sup>44</sup>

In principle, local public entities as being mainly a creation of the Constitution, can themselves conceptually hold properties, enter into contracts, and create or have an interest in other companies. Local public entities can also conceptually own shares either wholly or partly in other entities, as well as raise capital (issue loan stock, bonds or other debt instruments) in the capital market.<sup>45</sup> However, they are still controlled by their respective state governments.

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<sup>38</sup> Allocation of Revenue (Federation Account) Act 1981, s 3.

<sup>39</sup> CFRN 1999, s 162(5).

<sup>40</sup> *Idem*, s 162(6).

<sup>41</sup> *Idem*, s 162(7) states that each state shall pay to the local government councils in its area of jurisdiction such proportion of its total revenue on such terms and in such manner as may be prescribed by the National Assembly.

<sup>42</sup> O Abosede, "Legal Intervention for the Autonomy of Local Government Councils in Nigeria", *European Journal of Law and Political Science* (2021) 2 3 at 6.

<sup>43</sup> *Ibid*.

<sup>44</sup> Allocation of Revenue (Federation Account) Act 1981, s 4(2).

<sup>45</sup> Investment and Securities Act (ISA) 2007, ss 171(b) and (d); and Pt 1(3).

There is nothing in the Constitution and statutes referred to that precludes local public entities from forming or joining associations or groups to raise finance or protect their financial and contractual interest because they are legislative creations and imbued with a substantial level of juristic personality as a sub-sovereign entity. However, one of the only instances of participation or joinder in an association seems to have been a disaster. This issue was highlighted in the litigation surrounding the Association of Local Governments of Nigeria. Upon gaining membership to this association, local public entities faced indebtedness and litigation rather than an improved administration.<sup>46</sup>

## 2.2 Insolvency reforms for local public entities

There are, to the best of the authors' knowledge, no reforms to the general insolvency regime in Nigeria that have been introduced that are likely to have a substantial impact on local public entities, despite the increasing risk of business failures due to the Covid-19 pandemic.<sup>47</sup> Nonetheless, the House of Representatives passed the Emergency Economic Stimulus Bill 2020 (the Bill) on 24 March 2020 to provide a broader framework for managing Covid-19-induced financial distress, which, upon passage by the Senate, may infinitesimally impact on local public entities one way or the other. As previously discussed, a new corporate insolvency framework under the Companies and Allied Matters Act 2020 was passed by the President on 7 August 2020 and is now in force.

There have been increased efforts in recent times to make local public entities both politically and financially independent of states through advocacy for direct allocation and the removal of the power of the state governors to dissolve local government councils and appoint a caretaker committee to administer the affairs of local public entities. This trend has become very popular amongst many state governors.

However, the Supreme Court of Nigeria, in a very recent unanimous decision, held that henceforth "the Act giving legislative powers to state House of Assembly members to undertake the process of sacking elected local government chairmen is null and void".<sup>48</sup> The panel of justices unanimously declared that only the legislative arm of a local government council is empowered with the residual constitutional backing allowing them to dismiss council chairpersons that may be found blameworthy of any gross misconduct or violations of rules in guiding public servants.<sup>49</sup>

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<sup>46</sup> *Incorporated Trustees of Association of Local Government of Nigeria (ALGON) v Riok Nigeria Limited and Ors* (2018) LPELR-45289 (CA) Suit No: FCT/HC/CV/2129/2014.

<sup>47</sup> Including the recent ascent into law of the new CAMA 2020.

<sup>48</sup> Appeal No: SC/120/2013 - the sequel to an appeal filed by 16 Ekiti state local government chairpersons who were elected during Ayodele Fayose's tenure as Ekiti State Governor and were dismissed by the incumbent Governor Kayode Fayemi of Ekiti state.

<sup>49</sup> The Supreme Court further directed that a copy of the judgment should be served to all 36 State Houses of Assembly and the Minister of Federal Capital Territory on or before 30 December 2019. There are claims by the Office of the Attorney General of the Federation that it has since directed all state governments to comply with the Supreme Court's judgment, although most of the defaulting states have denied receiving any letter on the subject matter of local government administration from the Office of the Attorney General of the Federation. Please see [here](#).

### 3. Dealing with local public entities in distress

#### 3.1 Principles and framework

Unlike the US Bankruptcy Code which offers protection to insolvent municipalities under Chapter 9, there is no specific legislation dealing with government insolvency in Nigeria. Thus, there is no legislation specifically applicable to local public entities in distress.

The Companies and Allied Matters Act 2020, as amended, provides the framework for corporate insolvency. This regime only applies to local public entities that hold assets and do business through special purpose vehicles subject to section 21 of the Companies and Allied Matters Act 2020 that identifies the classification of corporate bodies in Nigeria. If this is so, these corporate bodies may become subject to various insolvency procedures such as receivership by a lender, schemes of arrangements and compromise, company voluntary arrangement, creditor voluntary liquidation, administration, winding-up by the court, or dissolution if registered as an association or incorporated trustees. Otherwise, general insolvency law would only tangentially apply to affect the interest of local public entities only in the context of investments or interests in other entities, in which case the local public entity owning the other entity or entities would be ranked at the bottom of the priority pyramid in distribution and categorised as shareholders without any preferential treatment.

Therefore, the challenge stems from the lack of any formal means of legislative insolvency or restructuring resolution framework for local public entities. Data released as far back as 2018 revealed that 17 states in Nigeria (representing almost half of the states) were insolvent as their internally generated revenues in 2017 were far below 10% of their receipts from the Federation Account allocation in the same year.<sup>50</sup> This goes to show that many of the states and, by extension, their local public entities were heavily insolvent. In the absence of insolvency legislation dealing specifically with government insolvency, many states and indeed local public entities have devised survival strategies. Some local public entities have found it convenient to issue irrevocable standing payment orders to creditors, and these can be used to repay loans from intervention funds and securities issued in the domestic capital market.<sup>51</sup> Once an irrevocable standing payment order is established, a transaction takes place automatically without any intervention from a local public entity. Loans granted by commercial banks may also be serviced through irrevocable standing payment orders. In Nigeria, debt may be deducted by the Federal Ministry of Finance from the Federal Allocation Amount Committee allocations to the local public entities and credited to the lenders' bank accounts.<sup>52</sup> Irrevocable standing payment order funds can also be generated on local public entities' taxation accounts with municipal financial institutions or allocations from the federal government, but many local

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<sup>50</sup> Agency Report, "Half of Nigeria's 36 states insolvent - Report" (*Premium Times*, 29 April 2018), available [here](#).

<sup>51</sup> L Razlog *et al*, "State Debt Management in Nigeria: Challenges and Lessons Learned", *Discussion Paper MTI Global Practice* (April 2020) No 19 at 21.

<sup>52</sup> *Idem*, at 13.

public entities are now tending towards zero allocation where the debt surpasses the liquidity of the local public entity.<sup>53</sup> This allocation can be attributed to the issuance of multiple standing orders for payment to creditors, thereby making it difficult to pay the salaries of civil servants.<sup>54</sup> It is also not uncommon to find the federal government having to intervene by issuing bailout funds to states and local public entities by extension.<sup>55</sup>

Nevertheless, local public entities may still be subjected to debt recovery through enforcement actions levied on their assets. In the absence of a sub-sovereign insolvency framework and informal intervention by the state or a federal government, there could be competing claims by creditors. Where execution is levied on core assets of local public entities, their ability to remain viable and operate as a going concern is significantly limited.

Although local public entities are constitutionally subjected to states in terms of fiscal allocation, they are not precluded from debt resolution or assistance, even though there is no specific debt resolution mechanism applicable only to them. As noted above, the informal process involving intervention by state and federal governments – often through the Central Bank of Nigeria – has proved successful over time. Nevertheless, the absence of fiscal autonomy remains a major drawback to the effectiveness of local public entities in Nigeria.

There have been insinuations that some State Joint Local Government Accounts are operated in a manner that often prevents local public entities from receiving the expected allocation whilst others hardly ever make their contributions as stipulated by section 162(7) of the Constitution, which states that each state shall pay to the local government councils in its area of jurisdiction such proportion of its total revenue on such terms and in such manner as may be prescribed by the National Assembly. Nonetheless, apart from the internally generated revenues of local public entities, financial assistance from state governments remains a substantial source of funding.

Aside from benefiting from the support of state governments, local public entities or their partly- or wholly-owned entities may also take advantage of the capital market to raise funds to complement their revenue. Despite being able to access loans from the public for developmental purposes, the problems of corruption and lack of accountability remain evident. Often, the loans advanced are not utilised for their specified purposes and consequently, there has been a myriad of litigations during state and local public entity insolvency processes. The drawback is that creditors will be constrained to the usual debt recovery processes and may thus find it very difficult to recover the loans that they have made in the absence of specialised insolvency laws applicable to these entities.

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<sup>53</sup> Some of these standing orders are subject to litigation that the authors have been involved in. See, for example, *Ecobank Nig Ltd v Ekiti State Government and 4 Ors* (Suit No: FHC/ABJ/CS/465/2015).

<sup>54</sup> The same position also applies to state governments.

<sup>55</sup> "Ebonyi, Ekiti, Imo, Ogun, Oyo get FG's bail-out funds" (*Ebonyi State News*, 15 September 2015), available [here](#).

### 3.2 Parties

Although there is no specific legislation dealing with the insolvency of local public entities, both state and federal governments have informally provided the needed rescue with little or no involvement from local public entities in the negotiation process with creditors, which is typically led by the federal and relevant state governments. As previously discussed, certain local public entities had set up the Association of Local Governments of Nigeria as an umbrella body to play a lead role in piloting the affairs and pursuing the interest of local public entities; however, this association has largely been ineffective, as the local public entities party to it do not seem to be directly in control thereof.

However, when a local public entity is operating via an investment or special purpose vehicle that holds certain assets, it may be able to use a rescue plan or negotiation for rescue and / or restructuring for procedures such as company voluntary arrangements. Moratoriums are not available, and secured creditors are unable to seize corporate control where a company voluntary arrangement, a scheme of arrangement, or a compromise is utilised. Thus, a local public entity, through its special purpose vehicle, can essentially pass a business rescue scheme sanctioned by a court and backed by a qualified majority of its (secured) creditors and members.

Creditors enjoy normal contractual rights. They can also have secured rights through irrevocable standing payment orders, IGR sinking funds, asset securitisation, etcetera, and these rights are protected in insolvency. Requests for the issuance of an irrevocable standing payment order are usually directed to the Ministry of Finance and confirmed by a Federal Accountant-General.<sup>56</sup> This request is carried out before approval is procured. It is through irrevocable standing payment orders that both state governments and the federal government are involved in the rescue affairs of local public entities, as they must pay on the irrevocable standing payment orders, which is usually confirmed by the Federal Accountant-General. A breach of an irrevocable standing payment order transforms into a sovereign breach.<sup>57</sup> Unsecured creditors may typically utilise a contractual remedy following a breach. As there is no local public entity insolvency framework, each creditor is left to its fate.

### 3.3 Technical rules / procedures

Where a local public entity is operating through an investment vehicle or special purpose vehicle, the priority rules applicable to the different categories of creditors under the

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<sup>56</sup> "Debt Management Office Revised External and Domestic Borrowing Guidelines for the Federal Government, State Governments, FCT, and their Agencies 2020", available [here](#).

<sup>57</sup> See, for example, guidelines for borrowing released by the Debt Management Office. The federal government will, however, have recourse to either a separate irrevocable standing payment order issued to the Office of the Accountant-General of the Federation as a prerequisite for approval of borrowing, monthly deductions from the Statutory Allocation of the State, or the bank(s) collecting the Internally Generated Revenue of the State for deductions from the State's Internally Generated Revenue, as a first-line charge payment for servicing of the state's obligations on the borrowing.

Companies and Allied Matters Act 2020 apply. In terms of general priority, the Companies and Allied Matters Act 2020 recognises secured claims,<sup>58</sup> administrative expenses,<sup>59</sup> priority expenses,<sup>60</sup> preferential claims,<sup>61</sup> general unsecured claims and equity holders.<sup>62</sup> There is no special insolvency procedure for municipalities akin to the procedures that may be utilised by municipalities in other jurisdictions. Consequently, there is no authority specifically assigned the responsibility of overseeing insolvency procedures of local public entities in Nigeria. The statutorily recognised authority over a local public entity as a sub-sovereign remains with the state in which that local public entity is located, and, in most cases, it is the governor charged with intervening when an entity is in financial distress. Under general law, the Corporate Affairs Commission is the body statutorily empowered under the Companies and Allied Matters Act 2020 to administer this act and insolvency of companies for non-curial procedures. An insolvency practitioner, subject to the supervision of a court, oversees and conducts an insolvency procedure or restructuring of ordinary companies in terms of the various provisions mentioned above.

Local public entities are administered by elected officials and, particularly, chairpersons and councillors in their respective wards, as there is no set rules and laws on local public entity directorship in Nigeria. Replacement is tenured and suffrage-based, except for when replacement is necessitated due to, for instance, an abuse of office that triggered a political process of impeachment wherein the alleged erring chairperson or vice-chairperson is presented with a notice of a written allegation of misconduct. A response can be tendered, following which the leader of the Legislative Council shall determine whether an investigation will be necessary. Where it is deemed necessary, a panel will be set up to investigate the allegation and report the findings of the investigation to the local government council. The chairperson or vice-chairperson will only be impeached where a resolution for impeachment is supported and adopted by not less than a two-thirds majority of the local government council.<sup>63</sup> The effect of impeachment is that the offending chairperson or vice-chairperson will be removed from office and may be handed over to law enforcement agencies if the misconduct is sufficiently severe.

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<sup>58</sup> CAMA 2020, ss 232-234 provides for the powers of debenture holders to realise security; ss 556-558 deals with receivership and rights of prior encumbrances, and also provisions of company winding-up rules on rights and precedence of secured creditor's claims filed. Also see CAMA 2020, Ch 21 and s 657.

<sup>59</sup> *Idem*, ss 207 and 508 deals with preferential payments subject to payment of preferential or priority claims to the retention of such sums as are necessary for the costs and expenses of the winding-up. CAMA 2020, s 448 however, states that in a winding-up by the court, the court is empowered to order costs and expenses of winding-up in such order of priority as it deems fit. On the other hand, administrative expenses, including liquidator remuneration, are expressly and unequivocally stated as having priority over all other claims - see CAMA 2020, ss 484 and 657(4)(a).

<sup>60</sup> Companies Winding Up Rules, s 167 provides priority for payment (except as varied by the court).

<sup>61</sup> CAMA 2020, s 494 details rules of preferential payments for (i) labour claims, such as social insurance deductions claim, wages and salary, pensions, etc, (ii) accrued holiday remuneration, etc, and (iii) local tax, rates and charges. Also see CAMA 2020, s 657(1)-(3).

<sup>62</sup> *Idem*, s 657(6)b.

<sup>63</sup> See, for instance, Cross-River State Local Government Law, s 15.



The constitutional provision regarding removing local government chairpersons and vice-chairpersons has for a long time been put in abeyance by many municipalities whose governors have found it convenient to remove elected local government officers and appoint *ad hoc* caretaker committees inordinately. However, the Supreme Court has now held that only the legislative arm of a local government council is empowered under the Constitution to remove a local government chairperson that may be found blameworthy of gross misconduct or violations of rules in guiding public servants.<sup>64</sup> Concerning the general law on insolvent companies, directors' duties and liabilities when an entity enters into an insolvency procedure, the directors' powers are suspended or cease. An insolvency practitioner rather than a company's directors holds fiduciary duties towards its creditors rather than the company. Whilst a procedure is ongoing, a company's directors are expected to prepare the statement of affairs of the company and be available to account for all the transactions and /or money over which they exercised control to the appointed insolvency practitioner.

Pre-commencement or at the twilight of insolvency, directors' duties shift towards giving priority to protecting creditors' interests when a company begins to show signs of insolvency. At that point, a distressed company's directors must minimise losses and preserve assets for the benefit of the company's creditors. If they do not, they can be prosecuted and found liable for reckless and / or fraudulent trading (which is a criminal offence).

#### 4. The law in practice

In Nigeria, no local public entity has ever filed for insolvency because the Companies and Allied Matters Act 2020 does not explicitly provide for local public entity insolvency. The fourth schedule of the Constitution clearly states the functions of local public entities, which include the collection of local taxes. Local public entity funding in Nigeria continues to face challenges due to the reliance of local public entities on federal government funds and statutory allocations.<sup>65</sup> No local government in Nigeria can function effectively without receiving a monthly allocation. However, in practice, local public entities are unable to function efficiently and gain necessary funding due to inherent corrupt practices that ultimately worsen the quality of their public service.<sup>66</sup> It has been alleged that local public entities are prone to corrupt practices through the falsification of financial transactions, inflated contracts with false reporting, use of "ghost workers" in their local councils, and collusion with state officials that are supposed to monitor the activities of local public

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<sup>64</sup> *Governor (Ekiti State) and Ors v Olubunmo and Ors* (2016) LPELR-48040 (SC), where the Supreme Court, sitting in Abuja, decided that a state governor could not remove an elected local public entity's council members.

<sup>65</sup> U Kalu and E Agaezichi, "The Legality of Financial Bailout: The Imperative of a Legal Framework for State/Municipal Bankruptcies in Nigeria", *Nnamdi Azikiwe University Journal of International Law and Jurisprudence* (2017) 8 109 at 110.

<sup>66</sup> I Yilwa, "Challenges of Local Government Administration in Nigeria: Lessons from Comparative Analysis", *International Journal of Development and Economic Sustainability* (2015) 3 61 at 71.

entities.<sup>67</sup> Governmental institutions such as the Independent and Corrupt Practices Commission and the Economic and Financial Crimes Commission have not been successful in finding and prosecuting those guilty of corrupt practices in local public entities. Thus, corruption has continued to breed inefficiency, raise transaction costs, and is widespread amongst local public entities. The persistence of systematic corruption causes poor governance, undermines other institutions, and inhibits development. The Constitution restricts proceedings against certain public officers, such as the President and Vice President of the Federal Republic of Nigeria, as well as governors of states and their executives.<sup>68</sup> This restriction does not apply to local public entity chairmen or any of their serving public officers.<sup>69</sup>

There are no specific provisions in the Constitution regarding the dissolution of local public entities. However, certain state governments have legislated on the matter. Nevertheless, local public entities are often dissolved indiscriminately.<sup>70</sup> Oyo State, for example, provides under section 10 of the Local Government Law 2001 (as amended) that a local public entity will be dissolved after three years following the date of its first council meeting. This means that each local public entity council automatically dissolves following the expiration of the three-year term of its members, requiring new elections to be held. As opposed to holding elections at the appropriate time, state governors appoint committees under various names, such as caretaker committees, transition committees, or administrators, to run the councils. This practice of appointing committees under various names was undertaken by the governors of Taraba, Benue, Yobe, Kwara, Kogi, Bauchi, Enugu, Anambra, Imo, Ogun, Katsina, and Oyo. This practice violates section 7(1) of the Constitution, which guarantees democratically elected local public entity councils.

The Supreme Court of Nigeria affirmed this position in the case of *Governor (Ekiti State) and Ors v Olubunmo and Ors*.<sup>71</sup> In this case, it was ruled that state governors cannot dissolve local public entity councils elected by the people. The Ekiti State Governor had made a unilateral decision to dissolve an elected local public entity council in Ekiti State before the expiration of their tenure by utilising section 23(b) of the Ekiti State Local Government Administration (Amendment) Law 2001. The governor thereafter appointed caretaker committees to replace the local public entity's council members, thereby momentarily dissolving the local public entity. As a result, the Supreme Court of Nigeria invalidated the law, holding that the governor violated the Constitution by dissolving the local public entity council and replacing it with caretaker committees. The Supreme Court's decision relied on section 1(3) of the Constitution, which provides that every law is subject to the Constitution and that any law that is inconsistent with the Constitution is null

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<sup>67</sup> *Ibid.*

<sup>68</sup> CFRN 1999, s 308.

<sup>69</sup> The President and Vice President may be sued in their official capacity in civil proceedings through a different constitutional process under the CFRN 1999, s 308.

<sup>70</sup> O Abosedo, "Legal Intervention for the Autonomy of Local Government Councils in Nigeria", *European Journal of Law and Political Science* (2021) 2 3 at 8.

<sup>71</sup> (2016) LPELR-48040 (SC).

and void to the extent of its inconsistency. Consequently, any action taken under such a local government law is unconstitutional.

There is a recent decision of the Court of Appeal in the case of *Incorporated Trustees of Association of Local Government of Nigeria (ALGON) v Riok Nigeria Limited and Ors*,<sup>72</sup> emanating from a decision of the Federal Capital Territory High Court<sup>73</sup> that is of relevance. In this matter, the defendant (the Association of Local Governments of Nigeria) awarded a contract to the plaintiffs and executed a memorandum of understanding and irrevocable standing payment order in favour of each of the plaintiffs for payment of the contract sums. Judgment was awarded in the Federal High Court against the Association of Local Governments of Nigeria and on 15 December 2016, the court granted an *ex parte* request by the judgment creditor<sup>74</sup> for an order of garnishee *nisi* against the Central Bank of Nigeria. This order commanded the Central Bank of Nigeria to, amongst others, explain within 14 days why \$318,807,950.596 (the judgment sum in the said suit) should not be paid to the judgment creditor upon the execution of an earlier order absolute previously made by the Federal High Court on 3 December 2013 in an earlier case.<sup>75</sup> The claim was filed on behalf of 234 local government areas, including the Association of Local Governments of Nigeria, which was the 236<sup>th</sup> plaintiff in the case.<sup>76</sup>

The Central Bank of Nigeria, in response, filed a preliminary objection to the order *nisi* being made absolute<sup>77</sup> on the following grounds, namely that:

- the Association of Local Governments of Nigeria had no account with the Central Bank of Nigeria;
- according to section 251 of the Constitution (as amended), only the Federal High Court has exclusive jurisdiction over affairs in respect of the Central Bank of Nigeria; and
- by virtue of the Sheriffs and Civil Process Act 1945 (amended 1990), the Central Bank of Nigeria, being a public officer as a corporate public body, cannot be compelled to expend money by way of payment of judgment debt without obtaining the consent of the Office of the Attorney General of the Federation.

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<sup>72</sup> (2018) LPELR-45289 (CA).

<sup>73</sup> No FCT/HC/CV/2129/2014; *Riok Nigeria Ltd and 3 Ors v Incorporated Trustees of Association of Local Government of Nigeria (ALGON)*.

<sup>74</sup> In Suit No FCT/HC/CV/2129/2014.

<sup>75</sup> Coram, Justice Ademola in Suit No FHC/ABJ/CS/130/2013: *Lina International Ltd and Ors v FGN and 3 Ors*.

<sup>76</sup> Justice Ademola of the Federal High Court granted all the reliefs sought by the plaintiffs in the suit, including a declaration that the defendant's utilisation of monies that formed part of the Federation Account for London Club Debt Buy from 1992 until 2002, and London Club Debt Exit Payment in 2006 without the authorisation of the other tiers of government, including the local public entity councils and area councils of Nigeria was contrary to the CFRN 1999, ss 162(1), (3) and (5) and order the defendants to pay the sum claimed to the plaintiffs. See [here](#).

<sup>77</sup> In FCT/HC/CV/2129/2014.

The Federal High Court overruled the Central Bank of Nigeria's objection and made the order *nisi* absolute against the Central Bank of Nigeria.<sup>78</sup>

## 5. Conclusion

In fulfilling their objectives as agents of the federal government, local public entities implement the federal government's initiatives. Local public entities in Nigeria have the responsibility of managing and delivering the federal government services and amenities. However, access to finance and lack of a coherent insolvency framework continues to be a challenge. Insolvency or restructuring resolution frameworks for local public entities do not exist in Nigeria, so this presents a challenge when establishing creditors' rights and rights of other competing claimants against local public entities. Enacting an enabling law to cater to the financial needs of local public entities, including the administration of local public entities in distress, is necessary. Ratification of the African Local Governance Charter could be the first step in achieving this objective.<sup>79</sup>

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<sup>78</sup> *Riok Nigeria Ltd and 3 Ors v Incorporated Trustees of Association of Local Government of Nigeria (ALGON)* Suit No FCT/HC/CV/2129/2014.

<sup>79</sup> African Local Governance Charter, art 11 encourages the central government to support local public entities and to support the objectives of local public entities. Arts 12 and 14 enumerates the need for African central governments to develop transparent and inclusive policies on behalf of their local public entities while combatting all forms of corrupt practices.

## Local public entities in distress – a critical analysis of the PRC approach

By Casey Watters\*

### 1. Introduction

The Chinese economic miracle<sup>1</sup> has transformed the country at an unprecedented rate over several decades and reshaped the Chinese economy. These changes have simultaneously ushered in a range of legal reforms to address the regulatory needs of the changing economic environment, including the adoption of formal insolvency proceedings to liquidate or restructure struggling enterprises. Although the current insolvency regime is limited to business entities, China has recently adopted several reforms to its commercial laws and pilot programmes exploring personal insolvency.<sup>2</sup> Some experts anticipate that future reforms may include adoption of insolvency proceedings for local public entities or the establishment of a credit system to determine if local public entities are in a position to incur additional debt and thereby prevent overleveraging of these local entities.

The Enterprise Bankruptcy Law of the People’s Republic of China,<sup>3</sup> which came into effect in 2007, was until recently primarily unutilised. Reforms in the last several years have increased the number of cases and established a specialised judiciary to address insolvency matters. Indeed, between 2017 and 2018 the number of corporate bankruptcy procedures nearly doubled as part of an increased trend in utilising formal proceedings.

The restructuring regime is modelled on the Chapter 11 corporate bankruptcy of the United States (US) Bankruptcy Code, under which management retains control of the restructuring enterprise.<sup>4</sup> However, in practice, courts ordinarily appoint an administrator (sometimes translated as trustee) to control the debtor’s assets. This administrator may then appoint a business manager.<sup>5</sup> A moratorium also comes into effect for the duration of the reorganisation that prevents both secured and unsecured creditors from attempting to collect on their debts. However, secured creditors may petition the court for relief from the moratorium.<sup>6</sup>

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<sup>1</sup> Chinese gross domestic product (GDP) increased from USD 148 billion to USD 10.36 trillion between 1978 and 2014. See P Gunby, Y Jin, and R Reed, “Did FDI Really Cause Chinese Economic Growth? A Meta-Analysis”, *World Development* (2017) 90, at 242-255.

<sup>2</sup> D Austin and C Lin, “Personal Bankruptcy in the Middle Kingdom: China’s Local Pilot Programs and Half of a Bankruptcy System”, *American Bankruptcy Law Journal* (2021) at 81-126.

<sup>3</sup> Enterprise Bankruptcy Law of the People’s Republic of China (adopted at the 23<sup>rd</sup> Session of the Standing Committee of the 10<sup>th</sup> National People’s Congress on 27 August 2006, effective 1 June 2007) (Enterprise Bankruptcy Law 2006 or EBL (2006)).

<sup>4</sup> *Idem*, art 73.

<sup>5</sup> *Idem*, art 74.

<sup>6</sup> *Idem*, art 75.

Once the court accepts the case, the debtor has six months to submit a plan for consideration at a creditors' meeting. If the plan is accepted by a majority of creditors in each class that represents at least two-thirds of claims present, the court may sanction the scheme and it will bind all creditors. If the requisite acceptance does not occur, the court may nevertheless cram-down the plan provided that dissenting creditors receive at least their claims' liquidation value. If an administrator took control of the company, the debtor will regain control at the point of sanction. However, the administrator will ordinarily continue to supervise management's implementation of the plan and report to the court on the company's progress in implementing the plan.<sup>7</sup>

China is a large and diverse country with multiple local languages and rich cultural history. To address local variation, Chinese statutes are often brief and limited to the primary rights and obligations of companies and individuals. These laws, in turn, are subject to local interpretation and implementation. Normative documents, including guides and notices, are often issued by government organs and, while not officially law, may have legal force.<sup>8</sup> The Enterprise Bankruptcy Law 2006 of the People's Republic of China (PRC) is no different. While the general procedures and principles are the same, implementation may vary between regions, and the courts in an entity's place of incorporation have jurisdiction over the bankruptcy proceeding.<sup>9</sup>

This chapter examines the existing insolvency framework and potential reforms that would extend insolvency proceedings to local public entities. Paragraph 2 introduces the current legal framework, starting with the history of insolvency in the PRC and an overview of the three proceedings provided under the current Enterprise Bankruptcy Law 2006. Paragraph 3 addresses proposed reforms aimed at the insolvency of local public entities. The chapter then discusses the likely current treatment of contracts that are no longer necessary or with departments or entities that might cease operations due to non-insolvent restructuring of local entities in paragraph 4. Finally, paragraph 5 concludes by discussing that insolvency reforms, while likely, will probably take time and first go through local pilot programmes before national legislation is adopted.

## 2. Legal framework

### 2.1 History

The PRC abolished all law adopted prior to its establishment in 1949, including the country's bankruptcy law which was adopted in the previous decade.<sup>10</sup> At the

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<sup>7</sup> *Idem*, arts 89-90.

<sup>8</sup> E Kenneth-Southworth, C Watters and C Gu "Entrepreneurship in China: A Review of the Role of Normative Documents in China's Legal Framework for Encouraging Entrepreneurship", *Entrepreneurial Business and Economics Review* (2018) 6(4) at 71; and C Watters, X Feng and Z Tang "China Overhauls Work Permit System for Foreigners", *Industrial Law Journal* (2018) 47(2) at 263-277.

<sup>9</sup> EBL (2006), art 3.

<sup>10</sup> S Seebach, "Bankruptcy Behind the Great Wall: Should US Businesses Seeking to Invest in the Emerging Chinese Market Be Wary?", *Transnational Law Journal* (1995) 8 351 at 354.

establishment of the PRC, enterprises were almost exclusively state-owned, where the focus regarding the manufacture and distribution of products was meeting the needs of workers and citizens instead of company profits. It was not until the “reform and opening” spurred by President Deng Xiaoping that private enterprise increased, including the privatisation of state-owned enterprises, which formed the contemporary socialist market economy. These reforms established the need for an insolvency framework, with the first Enterprise Bankruptcy Law adopted in 1986 to address the insolvency of state-owned enterprises.<sup>11</sup> Although passed in 1986, the law did not come into effect until the adoption of the State-Owned Enterprise Law in 1988.

The Enterprise Bankruptcy Law 1986’s primary stated purpose was to support the “development of the planned socialist economy”, including to “strengthen the economic responsibility system”.<sup>12</sup> Implementation of the Enterprise Bankruptcy Law 1986 was initially slow with only 32 state-owned enterprises declared bankrupt by 1990.<sup>13</sup>

Under the Enterprise Bankruptcy Law 1986, the state-owned enterprise required the consent of the local government to file for bankruptcy.<sup>14</sup> The restructuring of a state-owned enterprise could be proposed by the government departments in charge of the enterprise,<sup>15</sup> and great deference was to be given to the employees’ recommendations regarding the restructuring.<sup>16</sup> Incorporating employee protections and government oversight into the restructuring process illustrates the importance of harmony and social welfare in Chinese society. This hybrid solution sought to maintain harmony while infusing market mechanisms to increase production efficiency.

The Enterprise Bankruptcy Law 2006 was adopted to expand insolvency to non-state-owned enterprises. Although the law only applies to enterprises, China is exploring the adoption of personal bankruptcy laws with pilot programmes in select jurisdictions, most notably Shenzhen.<sup>17</sup> Currently, no insolvency law extends to provincial or local government entities. The next section outlines the procedures currently available to enterprises under the Enterprise Bankruptcy Law 2006.

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<sup>11</sup> Enterprise Bankruptcy Law of the People’s Republic of China (adopted at the 18<sup>th</sup> Session of the Standing Committee of the 6<sup>th</sup> National People’s Congress on 2 December 1986 (Enterprise Bankruptcy Law 1986 or EBL (1986))).

<sup>12</sup> EBL (1986), art 1.

<sup>13</sup> N Stevens, “Confronting the Crisis of Insolvency in China’s State-Owned Enterprises: Can the Proposed Bankruptcy Law Erase the Red Ink”, *Wisconsin International Law Journal* (1997) 16 551 at 560.

<sup>14</sup> *Idem*, at 560-561.

<sup>15</sup> EBL (1986), art 17.

<sup>16</sup> *Idem*, art 20.

<sup>17</sup> D Austin and C Lin, “Personal Bankruptcy in the Middle Kingdom: China’s Local Pilot Programs and Half of a Bankruptcy System”, *American Bankruptcy Law Journal* (2021) 95 at 81; and X Zhang and F Ou, “Economic and legal necessity of personal bankruptcy legislation in China”, *International Insolvency Review* (2021) 30(2) at 289-309.

## 2.2 Insolvency procedures under the Enterprise Bankruptcy Law 2006

The Enterprise Bankruptcy Law 2006 governs three distinct procedures: a restructuring procedure structured similar to Chapter 11 of the US Bankruptcy Code, liquidation, and compromise. Compromise is modeled on the repealed Japanese composition law, but has proven unsuccessful in China with few cases utilising the option.<sup>18</sup> This part provides an overview of the three regimes under the Enterprise Bankruptcy Law 2006, providing context for the discussion on reforms and literature in the following part. Para 3 introduces the possibility of an entity's insolvency, and possible reforms. These reforms include the adoption of a credit system that would prevent an entity's insolvency by preventing entities from becoming overleveraged, and the adoption of a formal proceeding for local public entities. This chapter argues that any formal proceeding would probably share characteristics with the Enterprise Bankruptcy Law 1986, which only applied to state-owned enterprises.

### 2.2.1 Restructuring regime

The Chinese restructuring regime incorporates several tools permitting an enterprise debtor to remain in operation, thereby allowing the company to pay creditors at least what they would receive in liquidation while protecting jobs, retaining value for shareholders and, through the continued operation of the company, securing additional tax revenue. The reorganisation regime permits the court to allow management to retain control of the restructuring enterprise,<sup>19</sup> establishing a debtor-in-possession regime. However, in practice, the court ordinarily appoints an administrator (who may appoint a business manager)<sup>20</sup> to take control of the debtor and its assets. During the period of reorganisation, a stay comes into effect and applies jointly to secured and unsecured creditors while allowing secured creditors to petition the court for relief from the stay.<sup>21</sup>

The debtor or administrator (sometimes translated as trustee) must, within six months of the court accepting the case, submit a plan to the court for consideration at a creditors' meeting, which may, if accepted by over 50% of creditors in each class that represent at least two-thirds of claims of those present, be sanctioned by the court and become binding on all creditors. If the restructuring plan fails to obtain the requisite votes among certain voting classes, the court may nevertheless sanction the plan if, among other requirements, creditors receive at least the liquidation value of their claims. Once the plan is sanctioned, the debtor regains control of any assets previously managed by the administrator. However, the administrator will continue to supervise the actions of the debtor and report to the court on implementation of the plan.<sup>22</sup>

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<sup>18</sup> C Han, "The Practice of Reorganization in China", *Arizona Journal of International and Comparative Law* (2016) 33 at 275.

<sup>19</sup> EBL (2006), art 73.

<sup>20</sup> *Idem*, art 74.

<sup>21</sup> *Idem*, art 75.

<sup>22</sup> *Idem*, arts 89-90.



Although some countries are adopting similar tools into their restructuring regimes,<sup>23</sup> by passing a system with characteristics such as cross-class cram-down and a moratorium, China became the first East Asian country to adopt a US Bankruptcy Code Chapter 11-style bankruptcy system.<sup>24</sup>

### 2.2.2 Liquidation

Liquidation is a common procedure available in most jurisdictions that permits the sale of company assets and distribution of proceeds to company creditors. Chapter X of the Enterprise Bankruptcy Law 2006 governs liquidation for insolvent Chinese companies and operates in parallel to laws permitting the winding-up of solvent enterprises.<sup>25</sup> Under the procedure, an application can be made by the debtor or a creditor and, after the debtor is declared bankrupt, the debtor's assets will ordinarily be sold by the administrator at auction. After expenses, there are three levels of priority among unsecured claims, with wages, disability payments, medical subsidies and certain pensions paid first; social insurance premiums and taxes falling into the second category; and the remainder of unsecured claims paid third.<sup>26</sup> Through academic discussion and a judiciary now experienced in addressing liquidations, there is now more certainty in many complex areas, including the rights of secured creditors, preferences, the role of liquidators, and the variations on the liquidation process in the banking industry.<sup>27</sup>

### 2.2.3 Composition

Composition, also sometimes translated as settlement or compromise, is a parallel regime to restructuring that seeks expedited settlement of unsecured debts and is modeled on civil law restructuring regimes in Japan and Europe.<sup>28</sup> Under composition, the debtor proposes a settlement agreement after which the court will call a meeting of creditors. While the court is not required to investigate to ensure compliance with formalities, in practice courts ordinarily ensure that debtors are able to complete the plan before calling a meeting of creditors.<sup>29</sup> If the settlement receives the assent of over half the creditors

<sup>23</sup> C Watters, "Cross-Border Insolvency in East Asian: Collaboration and Convergence" in D Arner *et al* (eds), *Research Handbook on Asian Financial Law*, (Edward Elgar Publishing, Cheltenham, 2020); and C Watters and P Omar "Evolution of Corporate Rescue in Singapore", *Insolvency Law Journal* (2019) 17(1) at 18.

<sup>24</sup> J Rapisardi and B Zhao, "Enterprise Bankruptcy Law", *International Financial Law Review* (3 June 2010); and in South-East Asia, see C Watters, "SPVs as a Barrier to Cross-Border Insolvency Proceedings: Lessons from Indonesia", *Australian Journal of Corporate Law* (2017) 32 at 241.

<sup>25</sup> B Richards and P Ruggero, "Exiting China: Procedures to Ensure the Orderly Liquidation of a Business", *Houston Journal of International Law* (2011) 33 at 631.

<sup>26</sup> EBL (2006), art 113.

<sup>27</sup> X Kang and C Zhong, "Analysing of the Law Position of the trustee in Bankruptcy", *Law Forum* (2007) 6 at 135; and N Wang, "Research on Bankruptcy Regulations on Chinese Banks", *The Jurist* (2007) 4 at 77.

<sup>28</sup> A Godwin, "Corporate Rescue in Asia: Trends and Challenges", *Sydney Law Review* (2012) 34 at 163; and A Godwin, "A Lengthy Stay? The Impact of the PRC Enterprise Bankruptcy Law on the Rights of Secured Creditors", *UNSW Law Journal* (2007) 30 at 755.

<sup>29</sup> H Min, "Cutting-Edge Issues in Bankruptcy Trials 300" (People's Court Press, 2012); and Q Zhang, "Composition in Enterprise Bankruptcy Law of China: Crises Reflection and Reshaping", *American Bankruptcy Law Journal* (2017) 91 55 at 58.

representing at least two-thirds of the value of unsecured claims of creditors attending the meeting, the settlement can then be sanctioned by the court and becomes binding on all unsecured creditors.<sup>30</sup>

Composition has largely failed as a corporate rescue regime, accounting for less than 3% of bankruptcy cases<sup>31</sup> and leading to academics questioning the viability of the procedure.<sup>32</sup> In addition to the fact that a compromise can only bind unsecured creditors<sup>33</sup> (thereby requiring the consent of all essential secured creditors), the limited use of the compromise system stems in part from the fact that it can only be initiated by debtors. Debtors may be reluctant to apply as, if the compromise is not accepted or fails to be implemented, the court will declare the enterprise bankrupt.<sup>34</sup> However, a debtor may apply for a compromise after the court has accepted an application for bankruptcy by a creditor, but before the court declares the debtor bankrupt.<sup>35</sup> This opportunity to avoid having the company declared bankrupt may explain the continued use of the procedure in rare cases.

### 3. Local public entities and insolvency risk

While state-owned enterprises that provide public services may utilise the Enterprise Bankruptcy Law 2006 either to restructure or liquidate, there is no insolvency proceeding that pertains to government entities; thus, no cases deal with the issue of such an entity's insolvency. While governments may shift structures and priorities, leading to departments or agencies being dissolved or merged with other government bodies, it is unlikely that a local public entity would be permitted to enter the current formal insolvency framework, which is aimed at private enterprise.

The structure of governmental organisations is often complex, with "local" departments often functioning as branches of central government entities, and matters of significant importance are referred to the higher levels. This structure also makes the likelihood of a local government entity becoming insolvent substantially less likely than that of a state-owned enterprise. As such, it is important for creditors to distinguish between contracting with government entities and contracting with state-owned enterprises.

In examining the risk to contracting creditors, perhaps the best definition of "public entity" is that adopted under government procurement regulations. While there are industry specific regulations in areas such as construction, the two significant laws with respect to

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<sup>30</sup> EBL (2006), arts 97, 98 and 100.

<sup>31</sup> Q Zhang, "Composition in Enterprise Bankruptcy Law of China: Crises Reflection and Reshaping", *American Bankruptcy Law Journal* (2017) 91 55 at 56.

<sup>32</sup> *Ibid*; and S Li and Z Wang, "Empirical Analyses of the EBL: Distinctions between the Legislative Expectations and Practice", *Law Review of Corporations and Restructuring* (2011) 21.

<sup>33</sup> EBL (2006), art 100.

<sup>34</sup> *Idem*, arts 99 and 104.

<sup>35</sup> *Idem*, art 95.

procurement are the Procurement Law<sup>36</sup> and the Regulations.<sup>37</sup> This distinction is primarily important with respect to bidding rules. However, the treatment of these contracts through government restructuring or changes in policy provides insight as to how a contract may be treated should an insolvency framework applicable to local public entities be adopted in the future. Ordinarily, contracts would be assigned – an approach which aligns with the goal of the Enterprise Bankruptcy Law 2006 of “safeguarding the lawful rights and interest”<sup>38</sup> of the debtor and creditors. The Enterprise Bankruptcy Law 2006 also seeks to “maintain the order of the socialist market Contract Law economy”.<sup>39</sup> The purpose of the Contract Law of the PRC includes safeguarding the “social and economic order” and “socialist modernization”.<sup>40</sup> While the Enterprise Bankruptcy Law 2006 would not technically apply to a government entity, the social utility and stability policies underlying the Enterprise Bankruptcy Law 2006 and the Contract Law foreshadow the approach the courts or government would take should local public entities’ insolvency exist in the future.

If the restructuring of local government resulted in a contract becoming unnecessary, the contract may become invalid, as a contract is invalid if it harms the interests of the state or “harms the public interests.”<sup>41</sup> In terms of the Government Procurement Law, “[if] performance of a government procurement contract will harm the national or social interests the parties of the contract must amend or terminate the contract”.<sup>42</sup> While the party at “fault” remains liable under the law, the restructuring or removal of a government department or agency is unlikely to be considered as fault under the law, and therefore the contract will likely be terminated without continued liability for either party. This policy seems to align with the approach under the Enterprise Bankruptcy Law 2006, in that permitting the local public entity to terminate, amend, or assign the contract would be seen as in line with social interests.<sup>43</sup>

### 3.1 Future reforms: a possible new insolvency regime

Just as the Enterprise Bankruptcy Law 2006 struck a balance between free market principles and ensuring the social stability and welfare of employees, addressing any future insolvencies of local public entities will necessitate a balance of social welfare protection, including protection of employees, and ensuring accountability. A complete bailout from the central government of any insolvent local entities may create a moral hazard whereby local officials ignore debt obligations. Assistance from the central government while holding local officials accountable for economic decisions may also

<sup>36</sup> Government Procurement Law of the People’s Republic of China (Standing Committee of the National People’s Congress, 29 June 2002).

<sup>37</sup> Regulations on the Implementation of the Government Procurement Law of the People’s Republic of China.

<sup>38</sup> EBL (2006), art 1.

<sup>39</sup> *Ibid.*

<sup>40</sup> Contract Law of the People’s Republic of China (National People’s Congress, 15 March 1999), art 1.

<sup>41</sup> *Idem*, art 52.

<sup>42</sup> Government Procurement Law of the People’s Republic of China (Standing Committee of the National People’s Congress, 29 June 2002), art 50.

<sup>43</sup> The national interests could arguably apply. However, the local nature of local public entities makes the social order purpose the strongest argument under the Contract Law.

pose challenges because, as with businesses, insolvency can result from unforeseeable circumstances such as natural disasters or global economic trends. Currently, there are two solutions that have been discussed – one to prevent insolvency of local governments, and one to address insolvencies should they occur.

### 3.2 Credit system

In 2020 and 2021 many jurisdictions around the world embraced the importance of adopting pre-insolvency mechanisms that provide stability to struggling enterprises, or delay formal insolvency proceedings, thereby providing additional time for business to address solvency issues and possibly prevent formal insolvencies. Although the majority of these reforms were responses to crises where businesses that were already insolvent required an infusion of cash or increased time to meet obligations, the establishment of credit systems and stricter lending rules can also operate as a pre-insolvency system by preventing entities, including local governments, from becoming overleveraged.<sup>44</sup> As is the case in many jurisdictions globally, real estate is one of the primary sources of revenue for local governments in China. As China has experienced an astounding rate of economic development over the last several decades, local governments have become accustomed to the proceeds associated with this development. This credit system has facilitated the development of one of the most advanced systems of infrastructure. Although continued development is essential to support one of the fastest growing economies in history, an overleveraged local government may face difficulties should an unexpected economic downturn occur. One recommendation in response to increased local debt has been the establishment of a credit rating system for local entities to prevent overleveraging. Such a solution, if adopted, would likely take time as it would need to consider a plethora of factors in a nation as large and rich in diversity as China.

## 4. Local government insolvency regime

According to the director of the Credit Information System Bureau of the People’s Bank of China, research is being undertaken to expand bankruptcy systems, including permitting heavily indebted local governments to apply for bankruptcy.<sup>45</sup> If eventually adopted, the exact nature of these insolvency proceedings is still uncertain. However, the Enterprise Bankruptcy Law 1986, as it pertained exclusively to state-owned enterprises, may provide guidance on the likely approach for any future local public entities’ insolvencies. Although state-owned enterprises, as understood in many jurisdictions, may function as independent commercial entities which are owned by the government, the conceptual nature of state-owned enterprises in China makes their parallel to local public entities particularly appropriate. Apart from the Western view that each level of a government is a distinct entity and may hold shares in a state-owned enterprise, the Enterprise Bankruptcy

<sup>44</sup> W Mok, “China Must Ready Itself for Bankrupt Local Governments”, *Southern China Morning Post* (Wednesday 31 July 2013) at A11.

<sup>45</sup> X Wen, “The Central Bank Intensifies Research on Systems to Deal with Bankruptcy and Related Systems to address the Inability to Repay Debts”, *The Beijing News* (2019) available [here](#); and “Bankruptcy Mechanism on the Way” *China Daily* (19 July 2019), available [here](#).

Law 1986 defined its scope as applying to “enterprises owned by the whole people”.<sup>46</sup> The view that state-owned enterprises are owned collectively by the people underscores the need to protect the collective good and explains the role of the government and employees in the formal insolvencies proceedings under the Enterprise Bankruptcy Law 1986. As local public entities exist for the good of the people, the policies underscoring the Enterprise Bankruptcy Law 1986 were the same as those which would form any future proceeding available to local public entities. As with personal bankruptcy, pilot programmes may be used to address any local insolvencies prior to the adoption of formal legislation.

Should a local public entity become insolvent and unable to pay its debts, the insolvency could be addressed through the adoption of a formal insolvency proceeding or on a case-by-case basis examining the circumstances that led to the insolvency. It is also possible that departments at the provincial or central level would step in to ensure solvency. Any approach would need to balance two competing interests: stability and accountability.

China places great importance on the protection of employees, and would certainly seek a solution that protects employees and maintains social harmony. Incorporating accountability into a formal framework poses a greater challenge. The world is unpredictable and in spite of people's best judgment, insolvencies will sometimes occur. However, if decision-makers are reckless and their actions contribute significantly to the insolvency, they are certain to be held accountable. Due to these challenges, any insolvency regime would likely be flexible and afford significant say to employees, the rights of citizens, and other impacted parties in a manner that might mirror the Enterprise Bankruptcy Law 1986.

#### 4.1 Contracts with local public entities

The Chinese bankruptcy system does not currently extend bankruptcy protection to local governments or public entities, but instead limits protection to commercial enterprises.<sup>47</sup> However, contracts for public services with enterprises that may be viewed as local public entities in other jurisdictions are addressed by the ability to assign contracts.

The Enterprise Bankruptcy Law 2006 addresses executory contracts through article 18, which refers to under-performed contracts.<sup>48</sup> This provision addresses contracts made prior to entering the bankruptcy proceeding and which have not been completed. The

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<sup>46</sup> EBL (1986), art 2.

<sup>47</sup> L Xiaowei, *Research on the Outstanding Contract in Bankruptcy Law* (Beijing: People's Court Publishing House, 2012); and C Benhan and C Chaoran, “Research on the Limitation of the Bankruptcy Administrator’s Right to Rescind Contracts”, *Journal of Yantai University* (2018) 31(3) 30-37.

<sup>48</sup> EBL (2006), art 18 states that “[a]fter the People’s Court accepts the insolvency case, the Administrator is entitled to reject or accept the contract entered into prior to the acceptance of the case and underperformed by debtor and its counterparty. Where the Administrator fails to notify the counterparty within 2 months since the acceptance of the insolvency case or fails to respond within 30 days from the date of receiving interpellation from its counterparty, the contract shall be deemed as being rejected”.

decision whether to terminate the under-performed contract vests in the bankruptcy administrator. The administrator should however consider the social impact of their decisions and ensure they do not “unduly infringe upon the rights and interests of the other party”.<sup>49</sup> This also means that the contract should be rejected, fully accepted, or assigned and not divided into multiple obligations with the administrator selecting parts to retain and parts to reject.<sup>50</sup>

As a debtor enters the bankruptcy procedure due to insolvency, the counterparty to a contract is at risk of the debtor being unable to meet its contractual obligations. The bankruptcy procedure protects the counterparty by permitting it to require a guarantee. If the debtor is unable to demonstrate its ability to perform in terms of the contract, the administrator will be deemed to have rejected the contract.<sup>51</sup> This parallels the ability of a party to require a guarantee under the Contract Law.<sup>52</sup>

Contracts may be assigned provided that no laws exist preventing the assignment of the subject matter of the contract. Lease agreements are one form of contract that is commonly assigned during a Chinese insolvency proceeding. If the debtor seeks to assign its contractual obligations, the counterparty should be assured that the assignee is solvent and capable of performing, as once the contract is assigned, the debtor is no longer liable for non-performance of the contract should the assignee fail to perform.

If a provider of public services, which are those services ordinarily provided by semi-government entities, becomes bankrupt and is unable to continue providing the public services, then the administrator must assign the contracts to other service providers. This maximises the social protection sought through the Enterprise Bankruptcy Law 2006. Ordinarily, the municipal government at the place where the services are provided will designate another provider to accept the assignment.<sup>53</sup>

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<sup>49</sup> P Tianwen, “An Analysis of the Contract Option to Be Performed in Bankruptcy Proceedings”, *Legality Vision* (2017) 5 at 178.

<sup>50</sup> *Ibid.*

<sup>51</sup> *Ibid.*

<sup>52</sup> Contract Law, art 68, states that: “[t]he party required to perform first may suspend its performance if it has conclusive evidence establishing that the other party is in any of the following circumstances: (i) Its business has seriously deteriorated; (ii) It has engaged in transfer of assets or withdrawal of funds for the purpose of evading debts; (iii) It has lost its business creditworthiness; (iv) It is in any other circumstance which will or may cause it to lose its ability to perform. Where a party suspends performance without conclusive evidence, it shall be liable for breach of contract”. See also art 69, stating: “If a party suspends its performance in accordance with Article 68 of this law, it shall timely notify the other party. If the other party provides appropriate assurance for its performance, the party shall resume performance. After performance was suspended, if the other party fails to regain its ability to perform and fails to provide appropriate assurance within a reasonable time, the suspending party may terminate the contract”.

<sup>53</sup> C Benhan and C Chaoran, “Research on the Limitation of the Bankruptcy Administrator’s Right to Rescind Contracts”, *Journal of Yantai University* (2018) 31(3) at 30-37.

## 5. Conclusion

China has experienced an unprecedented rate of growth over the last half century which is mirrored by legal reforms, including the establishment of formal insolvency proceedings. Although the current insolvency regime does not apply to local governments or associated entities (aside from state-owned enterprises), the rights of entities contracting with these entities are governed by other laws. However, the idea of extending insolvency to local public entities has been discussed. Protections may come in the form of credit scores to prevent the overleveraging of local entities or through formal proceedings. Should formal proceedings be adopted, pilot programmes will likely first be adopted to assess the effectiveness of the proceedings prior to the adoption of a full national regime.

## Local public entities in distress - a critical analysis of the Russian approach

By Ilya Kokorin\* and Bilal Kurbanov\*\*

### 1. General context of insolvency law

The Federal Act Number 127-FZ “On Insolvency (Bankruptcy)” dated 26 October 2002 (Bankruptcy Act)<sup>1</sup> regulates the insolvency of both companies and individuals in Russia. In the past, the insolvency of credit institutions was subject to a separate law that was repealed in 2014. Insolvency law is now consolidated in a single piece of legislation, which has separate sections dealing with insolvency of special types of businesses and natural persons. The Bankruptcy Act entered into force on 2 December 2002. Since then, it has been amended more than a 100 times. For example, in 2015 a new section was added to provide for the insolvency of natural persons. Additional regulation is introduced by the acts of the Russian Government and its ministries.<sup>2</sup>

It is also worth noting that in Russia an important role is played by the acts of abstract judicial interpretation carried out by the Supreme Court and the Higher Commercial Court. The Higher Commercial Court ceased to exist in 2014 and its functions were effectively transferred to the Supreme Court. Judicial interpretation is presented in the form of the Resolutions of the Plenum of the Supreme Court, which are instructive for lower-level courts and thus have substantial influence on how law is applied in practice. There are several Resolutions of the Plenum of the Supreme Court in the area of insolvency law that should be taken into account when discussing Russian insolvency law.<sup>3</sup>

In the absence of specific and well-defined criteria, it is difficult to answer whether the current insolvency regime in Russia is creditor- or debtor-friendly. The following characteristics may however indicate the leading role of creditors in insolvency and the inclination towards a creditor-friendly model. Firstly, Russia does not have an effective and efficient reorganisation procedure, like Chapter 11 of the United States Bankruptcy Code. It is widely recognised that the existing rehabilitative procedures (financial rehabilitation, external administration and settlement agreement) have proven to be ineffective, and they are rarely used in practice. For instance, in 2019 and 2020 such procedures were applied

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<sup>1</sup> Federal Law No 127-FZ “On Insolvency (Bankruptcy)” dated 26 October 2002.

<sup>2</sup> See, eg, the Decree of the Ministry of Economic Development No 517 dated 10 December 2009 on the uniform programme of training for insolvency practitioners.

<sup>3</sup> For example, the Resolution of the Plenum of the Higher Commercial Court No 63 dated 23 December 2010 relating to transaction avoidance rules (available in Russian [here](#)). Another important resolution is Resolution of the Plenum No 35 dated 22 June 2012 that relates to procedural aspects in insolvency cases (available in Russian [here](#)).



in around 1,5% of all insolvency proceedings (and not always successfully).<sup>4</sup> Russian law does not provide for debtor-in-possession,<sup>5</sup> the division of creditors into classes, cross-class or intra-class cram down, or super priority rescue financing. Moreover, since 2017 Russian courts have started subordinating claims of insiders (such as shareholders). As a result, in many cases, loans extended by shareholders are subordinated – that is, satisfied after unsecured creditors. Secondly, at present Russian law does not have effective and efficient rules facilitating out-of-court workouts or promoting the expeditious sale of business as a going concern<sup>6</sup> and pre-packaged sales. Thirdly, creditors are granted wide-ranging powers. Unlike debtors, a creditor initiating an insolvency procedure may suggest an insolvency practitioner to be appointed by the court.<sup>7</sup> In order to file for the opening of an insolvency proceeding of a debtor company, the creditor should have a claim of at least RUB 300,000 (approximately EUR 3,600 at the December 2021 rate).<sup>8</sup> Creditors can also challenge pre-insolvency transactions (preferential, undervalued and fraudulent transactions) and bring directors’ liability claims. In practice, they actively use these powers.<sup>9</sup> Finally, creditors are the primary decision-makers when it comes to the choice of the insolvency procedure.

According to the Bankruptcy Act, the following parties partake in the insolvency process: (i) the debtor, (ii) the insolvency practitioner, (iii) creditors, (iv) competent state authorities (tax authorities), (v) federal executive bodies and executive bodies of the federal subjects and municipalities in cases provided for in the Bankruptcy Act, and (vi) security providers in the procedure of financial rehabilitation.<sup>10</sup> In addition, the following actors are granted certain (limited) rights in insolvency proceedings: representative of debtor’s employees, representative of debtor’s shareholders, representative of a creditors’ committee, etcetera.<sup>11</sup>

<sup>4</sup> EFRSB Statistical Bulletin (31 December 2019), available in Russian at [here](#). For the year 2020, see [here](#).

<sup>5</sup> Debtor’s management is automatically replaced with a court-appointed insolvency practitioner (*конкурсный управляющий*) in the procedure of insolvency winding-up (*конкурсное производство*), which is initiated in almost all insolvency cases in Russia.

<sup>6</sup> Bankruptcy Act, art 110 regulates the sale of the debtor’s enterprise. Such sale entails the transfer of different types of property intended for carrying out business activity, including land plots, buildings, equipment, inventory, claims, etc. At the same time, a debtor’s (pre-insolvency) obligations are not transferred and remain with the debtor.

<sup>7</sup> However, there are instances where courts refused to appoint an insolvency practitioner nominated by a creditor, where the insolvency practitioner was legally or *de facto* affiliated with the creditor or if there were reasonable doubts about its independence. See, eg, Decision of the Supreme Court dated 26 August 2020, No 308-ЭС-272; and Decision of the Supreme Court dated 29 May 2020, No 305-ЭС19-26656.

<sup>8</sup> Bankruptcy Act, art 6(2).

<sup>9</sup> For example, in 2019 creditors and insolvency practitioners filed 11,010 transaction avoidance claims, of which 9,489 were considered by courts. Of them 48% were successful. The number of claims for liability of directors in 2019 exceeded 6,100. Of them 28% were successful.

<sup>10</sup> Bankruptcy Act, art 34.

<sup>11</sup> *Idem*, art 35.

The leading role in insolvency proceedings is played by creditors, insolvency practitioners, debtors and courts:

- **Creditors:** Creditors are involved in all major decisions. For example, they choose (vote on) the insolvency procedure, propose an insolvency practitioner, could petition for the removal of an insolvency practitioner, challenge pre-insolvency transactions and bring claims against directors and legal and natural persons who have or had the effective control over the debtor.
- **Insolvency practitioners:** The scope of an insolvency practitioner's powers depends on the respective insolvency procedure. During the first insolvency procedure (supervision or *наблюдение*), an insolvency practitioner does not replace debtor's management and is granted limited rights.<sup>12</sup> In contrast, in insolvency winding-ups (*конкурсное производство*), an insolvency practitioner (*конкурсный управляющий*) replaces the debtor's management and is granted wide-ranging powers.<sup>13</sup>
- **Management:** The debtor's management is not replaced in a supervision procedure. Nevertheless, the law imposes a number of limitations on their powers.<sup>14</sup> These limitations relate to the need for obtaining prior approval of an insolvency practitioner for certain transactions (for example, disposition of assets with a value exceeding 5% of the value of debtor's estate, and receiving or granting loans), or to refrain from certain transactions (for example, mergers and acquisitions, creation of new legal entities, and the establishment of branches and representative offices). The supervision may last up to seven months and is typically followed by the winding-up procedure, which leads to the termination of the management's powers.
- **Courts:** Courts are also actively engaged in the direction of the insolvency process. For instance, they rule on the opening of insolvency proceedings, the appointment and removal of insolvency practitioners, acceptance of creditors' claims, and review of transaction avoidance and directors' liability claims, filed by insolvency practitioners or creditors.

In May 2021, a restructuring reform bill was introduced in the Parliament.<sup>15</sup> This bill seeks to replace the procedure of supervision and the existing (largely unworkable) rehabilitative procedures (financial rehabilitation and external administration) with the sole debt restructuring procedure. The latter would be characterised by the debtor-in-possession regime, limitations on the enforceability of *ipso facto* clauses in lease agreements, rights to terminate burdensome contracts, etcetera. The effectiveness of the new procedure in its current form may be undermined by the fact that there are no provisions mandating the division of creditors into classes or allowing for cross-class cram

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<sup>12</sup> *Idem*, art 66(1).

<sup>13</sup> *Idem*, art 129(3).

<sup>14</sup> *Idem*, art 64.

<sup>15</sup> For the bill and accompanying documents, see [here](#).

down. The bill does not include special regulation concerning local public entities (LPEs) in distress. The authors of this paper are not aware of any plans to propose or implement such regulation in the future.

## 2. Local public entities

There are three types of public-law entities in Russia: the Russian Federation, federal subjects (*субъекты федерации*) and municipalities. These entities are referred to as public-law entities in the Budget Code of the Russian Federation (Budget Code).<sup>16</sup>

Russian law does not have a generic definition of a public entity. Under the Russian Constitution, Russia is a federal state, which consists of federal subjects, namely: republics, territories, regions, cities of federal significance (Moscow and Saint Petersburg), etcetera.<sup>17</sup> A municipal entity (municipality) is addressed in law by way of a simple enumeration of different municipal entities, such as “urban or rural settlement, municipal district, municipality, city district [...]”.<sup>18</sup> These municipal entities are separately defined by law.<sup>19</sup>

Public-law entities can form legal entities (companies). There are two types of these entities, namely unitary legal entities and corporations.

Unitary legal entities are defined as legal entities whose founders do not become their members and do not acquire equity rights in them.<sup>20</sup> They include:

- state and municipal unitary enterprises (государственные и муниципальные унитарные предприятия);<sup>21</sup>
- foundations (фонды);<sup>22</sup>
- institutions (учреждения);<sup>23</sup>
- autonomous non-profit organisations (автономные некоммерческие организации);<sup>24</sup>

<sup>16</sup> Budget Code of the Russian Federation dated 31 July 1998 (No 145-FZ), art 6.

<sup>17</sup> Russian Constitution dated 12 December 1993, art 5.

<sup>18</sup> Federal Law dated 6 October 2003 No 131-FZ “On the General Principles of the Organisation of Local Self-Government in the Russian Federation”, art 2(1).

<sup>19</sup> *Ibid.*

<sup>20</sup> Russian Civil Code (Part I) dated 30 November 1994 No 51-FZ, art 65.1(1).

<sup>21</sup> See, eg, Municipal Unitary Enterprise “Sports and Concert Complex “Spektr”, city of Vologda.

<sup>22</sup> See, eg, Municipal Fund for Support of Small Businesses of the Eastern Administrative District of Moscow.

<sup>23</sup> See, eg, State Budget Institution of Healthcare of the city of Moscow named after Botkin; and Federal State Budget Institution of Culture “State Tretyakov Gallery”.

<sup>24</sup> See, eg, Autonomous non-profit organisation Analytical Center for the Government of the Russian Federation.

- state corporations (государственные корпорации);<sup>25</sup> and
- public law companies (публично-правовые компании).<sup>26</sup>

Some types of unitary legal entities do not own assets provided to them by public-law entities. Instead, they acquire special rights: (i) the right of economic management (*хозяйственное ведение* (applicable to, *inter alia*, state and municipal unitary enterprises)) or (ii) the right of operational management (*оперативное управление* (applicable to, *inter alia*, institutions)). These rights are limited compared to property rights, particularly when it comes to assets disposal. The phenomenon of legal entities with limited rights over assets extended to them by a sole founder (that is, the state, federal subject or municipality) comes from the Soviet Union past, when the state-centralised economy and state property dominated.

Concerning unitary legal entities created by the Russian Federation or a municipality, two important insolvency-related observations should be made: (i) Russian law makes some legal entities immune from insolvency,<sup>27</sup> and (ii) in a number of specific cases, Russian law also limits liability exposure of public-law entities related to the establishment and management of unitary legal entities, created by them. For example, the law provides that the asset owner in a budget institution (for example, the Russian Federation or a municipality) shall bear subsidiary liability only for personal injury caused by the budget institution.<sup>28</sup>

Corporations are defined as legal entities whose founders become their members and form their governing bodies.<sup>29</sup> They can be formed with state and municipal involvement. In this case, the Russian Federation or a municipality become shareholders in a legal entity, alone or together with private parties. Corporations created with state or municipal involvement fall under general insolvency law.

Generally, Russian law does not establish a particular mission for corporations with state or municipal ownership. Yet, some types of legal entities may be subject to specific regulation. For example, the Federal Law on Rostec provides that this state corporation has the objective of promoting the development, production and export of high-tech industrial products by Russian organisations (being developers and manufacturers of

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<sup>25</sup> See, eg, State Atomic Energy Corporation Rosatom, State Space Corporation Roscosmos, State Corporation Rostec, State Corporation Deposit Insurance Agency, and State Development Corporation VEB.RF. These entities pursue state policy on the federal (country-wide) level and therefore should not to be regarded as LPEs or hybrid LPEs.

<sup>26</sup> See, eg, Fund for the Protection of the Rights of Citizens - Participants in Shared Construction Projects, the Military Construction Company.

<sup>27</sup> For example, Federal Law dated 23 November 2007 No 270-FZ "On the State Corporation for the Promotion of the Development, Production and Export of High-Tech Industrial Products "Rostec", art 4(3) directly excludes Rostec from the scope of the Bankruptcy Act. Also see the discussion in this regard below.

<sup>28</sup> See the discussion in this regard below.

<sup>29</sup> Russian Civil Code (Part I) dated 30 November 1994 No 51-FZ, art 65.1(1).

these products).<sup>30</sup> A general mission is also set for state and municipal institutions, which can exist in the form of autonomous (*автономные*), budget (*бюджетные*) and treasury (*казенные*) institutions.<sup>31</sup> For example, a budget institution is a non-profit organisation established by the Russian Federation, its federal subject or by a municipality to carry out work and provide services in the fields of science, education, health, culture, social protection, employment, physical education and sports, as well as other areas.<sup>32</sup> Many hospitals and schools are established as either state or municipal budget institutions.<sup>33</sup> Treasury institutions are formed to provide state or municipal services, or to carry out state or municipal functions.<sup>34</sup>

The state or a municipality (an LPE in the direct sense) typically participate in the economy through legal entities, whether in the form of unitary legal entities or corporations. These legal entities, especially unitary ones, can be considered hybrid LPEs, since most of them carry out fundamental services and fulfil important public functions at local or regional level (such as education, healthcare, etcetera). These hybrid LPEs may be subject to special laws, take various corporate forms, and even fall under separate property law regimes (some inherited from the Soviet Union period). For example, a state or municipal budget institution cannot refuse to perform the assigned state or municipal task.<sup>35</sup> It may engage in activities which are not set as its main activities, but only to the extent that such engagement serves the achievement of the goals for which it has been established. Financing of this hybrid LPE is organised via subsidies from the state or municipal budget.<sup>36</sup> As pointed out above, a state or municipal budget institution holds assets on the basis of a special operational management right. This imposes limitations on transactions that such an institution may conclude. For instance, large transactions require approval from the Russian Federation or the respective municipality.<sup>37</sup>

State and municipal budget institutions and unitary enterprises are fully controlled by the state or a municipality. Yet, corporations with state or municipal participation (not to be confused with state corporations, which are unitary legal entities) may be partially owned by the state or a municipality. The exact level of such ownership is not prescribed and may change from time to time.

There are other categories of legal entities which are worth mentioning in light of the special rules for their insolvency, further discussed below. These categories are distinguished for their role in the national, regional or local economy. Among them are:

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<sup>30</sup> Federal Law dated 23 November 2007 No 270-FZ "On the State Corporation for the Promotion of the Development, Production and Export of High-Tech Industrial Products "Rostec", art 3(1).

<sup>31</sup> Russian Civil Code, art 123.22(1).

<sup>32</sup> Federal Law dated 12 January 1996 No 7-FZ "On Non-Profit Organisations", art 9.2(1).

<sup>33</sup> See, eg, Municipal Budget Educational Institution "Secondary School No 90" of Zheleznogorsk, Krasnoyarsk krai.

<sup>34</sup> Budget Code, art 6.

<sup>35</sup> Law On Non-Profit Organisations, art 9.2(3).

<sup>36</sup> *Idem*, art 9.2(6).

<sup>37</sup> *Idem*, art 9.2(13).

(i) city-forming enterprises,<sup>38</sup> (ii) strategic enterprises,<sup>39</sup> and (iii) natural monopoly entities.<sup>40</sup> The existence of city-forming enterprises is closely linked to so-called mono-cities or mono-towns. These are towns that rely heavily and are dependent on one or two legal entities. Currently there are more than 300 mono-towns in Russia. Naturally, the failure of a city-forming enterprise can have significant consequences for the population of a mono-city. Therefore, there are special provisions on their insolvency in the Bankruptcy Act. Similar public-interest driven considerations underpin regulation of insolvencies of strategic enterprises and natural monopoly entities.

### 3. Dealing with local public entities in distress - the legal framework

#### 3.1 Principles and framework

Russian law dealing with financial distress may be divided into two separate streams of regulation, namely: (i) insolvency procedures under the Bankruptcy Act (for private-law entities), and (ii) interim financial administration under the Budget Code (for public-law entities). These will be dealt with them separately.

##### 3.1.1 *Interim financial administration of public-law entities*

Russian law does not provide for the insolvency of public-law entities, such as municipalities (unlike Chapter 9, Title 11, of the United States Bankruptcy Code). Nevertheless, the Budget Code contains a special procedure entitled "Interim financial administration" (*временная финансовая администрация*), which can be applied with respect to a federal subject or a municipality with the purpose of restoring their financial stability. Russian law does not contain rules on the insolvency winding-up (liquidation) of public-law entities.

To some extent, interim financial administration may be compared to an insolvency rehabilitation procedure. However, it does not fall under the Bankruptcy Act. The interim financial administration can be introduced for a period of up to one year by court order when the past-due debt obligations of the federal subject or a municipality exceed 30% of the budget revenue of the respective federal subject, or the municipality.<sup>41</sup>

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<sup>38</sup> Bankruptcy Act, art 169. City-forming enterprises are defined as legal entities employing 25% or more of the working population of the city, or legal entities employing more than 5,000 people.

<sup>39</sup> Bankruptcy Act, art 190(1). Strategic enterprises include state-owned corporations and unitary legal entities which offer services or manufacture products of strategic importance for national defence and security, protection of public morals, and health and rights of Russian citizens. The list of all strategic enterprises is set in the Presidential Decree "On Approval of the List of Strategic Enterprises and Strategic Joint-Stock Companies" dated 4 August 2004 No 1009; and Government Directive "On Approval of the List of Strategic Enterprises and Federal Executive Authorities in Charge of Implementation of Uniform State Policy in Industries Where Such Enterprises Operate" dated 20 August 2009 No 1226-r.

<sup>40</sup> Bankruptcy Act, art 197(1). A natural monopoly entity is defined as an entity that is engaged in the production and / or sale of goods or delivery of services in the condition of natural monopoly.

<sup>41</sup> Budget Code, art 168.2(3).

The interim financial administration entails budget audits, drafting, negotiation, approval and execution of a financial rehabilitation plan, preparation of acts necessary for the implementation of the rehabilitation plan, etcetera.<sup>42</sup> The financial rehabilitation plan must be drafted by the interim financial administration within a period of up to two months from the date of entry into force of the court order,<sup>43</sup> and should include the period for the full repayment of overdue debts (up to five years), the amount of and conditions for the borrowing arrangements to refinance debt, schedule of debt repayment and measures to improve financial stability, including the list of legal acts that need to be passed in order to implement the plan.<sup>44</sup> The draft of the financial rehabilitation plan is negotiated by the parties involved in the financial rehabilitation procedure,<sup>45</sup> and must be approved by the court.<sup>46</sup>

### **3.1.2 *Insolvency of unitary legal entities and state-owned corporations***

#### **3.1.2.1. *Insolvency-immune entities***

The Russian Civil Code establishes the following general rule:<sup>47</sup>

“A legal entity, except a treasury enterprise, institution, political party and religious organization may be declared insolvent (bankrupt) by a court’s decision. A state corporation or a state company may be declared insolvent (bankrupt), where this is allowed by the federal law, which provides for the establishment of the respective entities. A foundation may not be declared insolvent (bankrupt), if this is stated in the law that provides for the establishment and operation of such a foundation. A public law company cannot be declared insolvent (bankrupt).”

The above provision introduces three categories of insolvency-immune legal entities, namely: (i) legal entities possessing absolute immunity (treasury enterprises, institutions, political parties, religious organisations and public law companies), (ii) legal entities which are presumed to be immune, unless the law applicable to their creation and operation states otherwise (such as a foundation), and (iii) legal entities which do not enjoy immunity against insolvency, unless the law creating them makes a carve out from insolvency legislation (state corporation<sup>48</sup> and state company).

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<sup>42</sup> *Idem*, art 168.3(1).

<sup>43</sup> *Idem*, art 168.4(1).

<sup>44</sup> *Idem*, art 168.4(2).

<sup>45</sup> *Idem*, art 168.4(3).

<sup>46</sup> *Idem*, art 168.5(1).

<sup>47</sup> Russian Civil Code, art 65.

<sup>48</sup> All federal laws, providing for the establishment of state corporations make a carve out from the Bankruptcy Act, making such entities immune from insolvency proceedings.

Hence, some entities which may be considered hybrid LPEs, including municipal institutions and municipal treasury enterprises (*муниципальное казенное предприятие*), cannot be declared insolvent pursuant to the Bankruptcy Act. From a practical point of view, insolvency immunity means that creditors (and debtors themselves) cannot file for insolvency in case of a payment default by the debtor. They can still bring their claims in a court. However, if the debtor's assets are insufficient, they may be deprived of an effective remedy and recourse.

### 3.1.2.2 *Non-insolvency immune entities*

Non-insolvency immune legal entities, whether organised in the form of a unitary legal entity or a state-owned corporation, fall under the Bankruptcy Act. Such entities generally have the same scope of rights and obligations in insolvency as any other legal entity. They can also be liquidated in accordance with applicable law, which varies depending on the type of a legal entity in question. For example, reorganisation and (non-insolvent) winding-up of a state and municipal unitary enterprise is addressed in the Federal Law "On State and Municipal Unitary Enterprises".<sup>49</sup> This law provides that a unitary enterprise may be liquidated by the decision of the owner of its property (such as the Russian Federation or a municipality) or by a court order on the grounds and in the manner established by the Civil Code and other federal laws.<sup>50</sup> Liquidation of non-commercial legal entities, including state and municipal institutions, is addressed in the Federal Law "On Non-Profit Organisations".<sup>51</sup>

In insolvency, shareholders of a state-owned / municipality-owned corporation or assets owners in a unitary legal entity may rescue these legal entities by performing their obligations or providing sufficient funds to allow such performance.<sup>52</sup> If all creditors' claims are satisfied, insolvency proceedings are terminated. State-owned / municipality-owned corporations and unitary legal entities may also restructure within one of the existing rehabilitative procedures (financial rehabilitation, external administration and settlement agreement).

In addition to the general insolvency rules mentioned above, the Bankruptcy Act contains a number of sub-chapters dealing with the special categories of legal entities (referred to as special entities) and introducing an extra layer of regulation. Some of these entities have been mentioned above, namely (i) city-forming enterprises, (ii) strategic enterprises, and (iii) natural monopoly entities. The need to separately regulate such entities is premised on the significance of functions performed by them and the extent of potential negative externalities caused by their failure. In other words, such entities may cause a problem of "too-big-to-fail" or "too-important-to-fail". It is clear from the Bankruptcy Act that the rules

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<sup>49</sup> Federal Law "On State and Municipal Unitary Enterprises" dated 14 November 2002 No 161-FZ, arts 29-35.

<sup>50</sup> *Idem*, art 35.

<sup>51</sup> Law On Non-Profit Organisations, arts 18-21.

<sup>52</sup> Bankruptcy Act, art 125(1).



concerning these legal entities aim to achieve policy goals, other than or in addition to asset value maximisation. The aims of the legislative framework applicable to special entities include protection of employment,<sup>53</sup> preservation of continuity of functions<sup>54</sup> and insolvency prevention.<sup>55</sup>

Insolvency of special entities is not infrequent in Russia. The overview of case law has revealed a number of disputes arising in their insolvencies which relate to the application of specific insolvency rules, such as those concerning procedures for asset sales (special requirements for buyers, non-affiliation of buyers with creditors, etcetera),<sup>56</sup> the use of additional services and attraction of additional specialists due to the case complexity,<sup>57</sup> opening of rehabilitative procedures, other procedural aspects (for example, engagement of state corporations),<sup>58</sup> refusal to perform executory contracts related to state defense orders and protection of national defense capacity.<sup>59</sup>

## 3.2 Parties

### 3.2.1 Courts

All insolvency cases in Russia fall under the jurisdiction of state commercial courts (*арбитражные суды*). In the case of a legal entity, an insolvency claim should be filed with a commercial court at the debtor's location (the debtor's registered office).<sup>60</sup> State commercial courts consider insolvency cases in relation to all legal entities and natural persons. The role of courts is not substantially changed in the proceedings concerning

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<sup>53</sup> This policy goal is evident in the provisions related to the sale of city-forming enterprises. The relevant municipality may request that the sale agreement includes an essential condition that the buyer must keep at least 50% of the employees of such an enterprise for a certain period of time (a maximum of three years). See Bankruptcy Act, art 175(1). If the buyer does not comply with this requirement, the sale agreement shall be terminated by the court upon the application of the respective municipality.

<sup>54</sup> For example, the buyer of property of a natural monopoly entity must assume the obligations of the debtor under the contracts for the supply of goods, subject of regulation of the legislation on natural monopolies. Such a buyer is also obliged to ensure the availability of manufactured and / or sold goods (works and services) for consumers. See Bankruptcy Act, art 201(2).

<sup>55</sup> The policy goal of insolvency prevention is especially evident in the provisions of the Bankruptcy Act related to strategic enterprises. The Government of the Russian Federation is tasked to take various steps and actions to prevent insolvency of strategic enterprises (corporate reorganisation, participation in the negotiations with creditors, pre-insolvency restructuring, etc). Bankruptcy Act, art 191.

<sup>56</sup> Decision of the Supreme Court dated 27 April 2020, No 306-ЭС14-7600 (2); and Decision of the Supreme Court dated 14 October 2019, No 305-ЭС19-13378 (2).

<sup>57</sup> Decision of the Commercial Court of the West Siberian District dated 16 September 2019 No Ф04-721/2012; and Decision of the Commercial Court the Far Eastern District dated 12 September 2019 No Ф03-3928/2019.

<sup>58</sup> Decision of the Commercial Court of the Volga Region dated 28 February 2019 No Ф06-42333/2018; and Decision of the Commercial Court of the North-West District dated 18 December 2019 No Ф07-15043/2019.

<sup>59</sup> Decision of the Commercial Court of the Central District dated 5 December 2017 No Ф10-4969/2017.

<sup>60</sup> Bankruptcy Act, art 33(1).

special entities. In the case of public-law entities, only the Supreme Court can open an interim financial administration with respect to a federal subject. An interim financial administration relating to a municipality can be opened by a commercial court of the federal subject, where this municipality is located. Courts authorise rehabilitation plans.<sup>61</sup>

Independence and impartiality of courts is ensured by the Commercial Procedure Code of the Russian Federation.<sup>62</sup> It is also mandated by the European Convention on Human Rights, of which Russia is a signatory.<sup>63</sup> For instance, independence and impartiality of courts are manifested in the fact that the Bankruptcy Act does not permit a court intervention in the formulation of the terms in a settlement agreement.<sup>64</sup>

### 3.2.2 *Administrative authorities*

Non-insolvency immune private-law entities fall under the scope of the Bankruptcy Act. Russia has not enacted laws dealing with insolvency of hybrid local public entities. Nevertheless, as noted above, it has introduced the rules in the Bankruptcy Act for the insolvency of special entities (for example, city-forming enterprises, strategic enterprises and natural monopoly entities), some of which may be regarded as hybrid local public entities. Separate rules also apply to credit, clearing, insurance and other financial institutions, agricultural organisations and real estate developers.<sup>65</sup> Most of these rules aim to provide more possibilities to restore financial solvency of these companies, to ensure continuity of their functions and to minimise the social and economic cost of their failure.

To promote these goals, state and municipal authorities are granted various rights. However, the authorities do not replace courts or creditors. They are involved at the stage of insolvency prevention and may provide state financial support in insolvency (for example, in the form of a state guarantee or direct financing). They can petition the court to open a rehabilitative procedure where creditors fail to act,<sup>66</sup> or when creditors have voted for the winding-up of a special entity.<sup>67</sup>

While the insolvency law does not have a standalone state oversight procedure for special entities, it has certain provisions on increased state engagement in their insolvency proceedings. These provisions cover participation rights of state executive bodies and

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<sup>61</sup> Budget Code, art 168.5(1).

<sup>62</sup> Commercial Procedure Code of the Russian Federation dated 24 July 2002 No 95-FZ, art 5.

<sup>63</sup> Convention for the Protection of Human Rights and Fundamental Freedoms, 1950, art 6.

<sup>64</sup> Information Letter of the Presidium of the Higher Commercial Court of the Russian Federation dated 20 December 2005 No 97 "Review of Cases Related to Disputes Arising from Conclusion, Approval and Termination of Settlement Agreements in Insolvency (Bankruptcy) Cases", para 6.

<sup>65</sup> It should be clarified that public-law entities (eg, a municipality) do not fall within the category of "special entities" as referred to in this paper (see the discussion in this regard below). Public-law entities are not subject to provisions of the Bankruptcy Act, whereas special entities are.

<sup>66</sup> Bankruptcy Act, arts 171(1) and 194(1).

<sup>67</sup> *Idem*, art 194(2).

municipalities in insolvency proceedings,<sup>68</sup> their involvement in the appointment of insolvency practitioners,<sup>69</sup> their analysis of debtor's viability and prospects for its financial rehabilitation,<sup>70</sup> and the granting of certain preferential purchasing rights to the state.<sup>71</sup> For example, a municipality may petition the court to open external administration in relation to a city-forming enterprise under the condition that it provides a guarantee.<sup>72</sup> In the insolvency of a natural monopoly entity, a municipality can suspend the sale of assets directly used in the production of goods and the provision of services for a period not exceeding three months in order to develop proposals for rescue and restructuring.<sup>73</sup>

As mentioned above, public-law entities, such as municipalities, can be subject to a unique debt resolution mechanism which is not incorporated in the Bankruptcy Act, but in the Budget Code, namely interim financial administration. It is available only to federal subjects and municipalities (hence, local public entities, but not hybrid ones). The interim financial administration is the federal executive body (or the executive body of a federal subject) authorised by the Russian Government (or the higher executive body of a federal subject) to prepare and implement measures to restore financial soundness of a federal subject or of a municipality and to grant assistance in implementing budget-related obligations.<sup>74</sup> The interim financial administration of a municipality may be imposed on the application of the higher executive body of the federal subject, the representative body of the municipality or the head of the respective municipality.<sup>75</sup>

The interim financial administration prepares a draft rehabilitation plan within two months from its opening. Upon consultation with participating parties, this plan is submitted to the court for approval. In certain cases, where debts exceed an established threshold, the plan needs to be approved by the legislative (representative) body of the federal subject or of municipality.<sup>76</sup> In the latter case, the head of the federal subject (head of municipality) enters into an agreement with the Ministry of Finance (or the financial body of the federal subject) on measures to restore the solvency of the federal subject (municipality).<sup>77</sup> The term of this agreement must not exceed five years.

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<sup>68</sup> *Idem*, arts 170, 192 and 198.

<sup>69</sup> *Idem*, art 193.

<sup>70</sup> *Idem*, art 194(1).

<sup>71</sup> *Idem*, arts 195 and 201.

<sup>72</sup> *Idem*, art 171(1).

<sup>73</sup> *Idem*, art 201(5).

<sup>74</sup> Budget Code, art 168.1.

<sup>75</sup> *Idem*, art 168.2(1).

<sup>76</sup> *Idem*, art 168.4(4).

<sup>77</sup> See also Rules on Conclusion of Agreements on Measures to Restore Solvency of Federal Subject, adopted by the Decree of the Russian Government dated 31 December 2019 No 1951.

### 3.2.3 *Insolvency practitioners*

According to the Bankruptcy Act, an insolvency practitioner is a Russian citizen who is a member of a self-regulatory organisation of insolvency practitioners<sup>78</sup> The rights, powers and tasks of insolvency practitioners depend on the insolvency procedure to which they have been appointed. Remuneration of an insolvency practitioner consists of a fixed sum per month (depending on the insolvency procedure), and of a certain percentage, calculated on the basis of the recovery rate. If the insolvent estate cannot cover the costs of the insolvency proceedings (insolvent insolvency), including insolvency practitioner remuneration, the insolvency proceedings shall be terminated,<sup>79</sup> unless creditors agree to cover such costs. The Bankruptcy Act does not contain special remuneration rules applicable to hybrid LPEs. The financing of the interim financial administration in respect of a federal subject or a municipality shall be established by the Russian Government or the chief executive body of the federal subject.<sup>80</sup>

Additional requirements for insolvency practitioners may be imposed for special entities. For example, in insolvency of strategic enterprises, an insolvency practitioner should have a graduate degree in law, economics or in the area of the debtor's activity. The insolvency practitioner should also have at least five years of work experience (of them at least one year in management) at enterprises in the defense-industrial sector or at other strategic enterprises.<sup>81</sup> As special entities (for example, strategic enterprises) oftentimes deal with state secrets, an insolvency practitioner may need a special permit to have access to state secrets.<sup>82</sup> Also, the necessity to ensure operational continuity of special entities and in order to preserve employment leads to limitations on the powers of insolvency practitioners. As an example, in the insolvency of a natural monopoly entity, an insolvency practitioner shall not refuse performance under certain agreements with consumers.<sup>83</sup>

For public-law entities, the role similar to an insolvency practitioner is played by the interim financial administrator, who is appointed in line with the instructions of the higher executive body of the federal subject (in case of a municipality). If the chief of the financial body of the federal subject or a municipality impedes the interim financial administration or infringes the rights and interests of the federal subject or municipality or its creditors, the head of the interim financial administration can file a petition with the court to remove the chief of the financial body of the federal subject or municipality, and to assign the respective authority to him.<sup>84</sup>

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<sup>78</sup> Bankruptcy Act, art 2.

<sup>79</sup> *Idem*, art 57(1).

<sup>80</sup> Budget Code, art 168.2(6).

<sup>81</sup> The Decree of the Russian Government "On the requirements for insolvency practitioners in insolvency proceedings of strategic enterprises and organisations" dated 19 September 2003 No 586.

<sup>82</sup> Bankruptcy Act, art 20.2(1).

<sup>83</sup> *Idem*, art 200(1).

<sup>84</sup> Budget Code, art 168.6(7).

### 3.2.4 Creditors

As noted earlier, creditors are one of the primary decision-makers in insolvency. They can influence insolvency proceedings in different ways individually (*inter alia*, by filing petitions), through a creditors' committee or by way of a creditors' meeting. They also vote on the issue of the adoption of a restructuring plan. This plan can be negotiated and agreed upon in the course of any insolvency procedure – in financial rehabilitation (financial rehabilitation plan), external administration (external administration plan) and even in insolvency winding-up – in the form of a settlement agreement. According to the Bankruptcy Act, it is the exclusive competence of the creditors' meeting to agree on a restructuring plan or a settlement agreement.<sup>85</sup>

While only creditors can vote at creditors' meetings, other parties may attend them. Among the latter are a representative of shareholders or a representative of the asset owner in a unitary legal entity. These representatives may take part in the negotiations of a restructuring plan but they cannot vote on it. They can also file a motion with the court to open a procedure of financial rehabilitation, subject to the provision of a bank guarantee as a security for the performance of the debtor's obligations in accordance with the debt repayment schedule.<sup>86</sup> In such a case, the court may open the procedure of financial rehabilitation, even when the creditors have voted for external administration or insolvency winding-up.

The rehabilitation plan for a public-law entity is drafted by the interim financial administration within two months from its opening. This plan shall be discussed with the parties involved.<sup>87</sup> The rehabilitation plan needs to be approved by the court. It is not entirely clear whether creditors should be involved in the approval of the rehabilitation plan. The limited case law suggests that such involvement is not necessary and that the agreement between the municipality and the head of the federal subject should suffice, as long as court approval is secured.<sup>88</sup> The court will not approve a rehabilitation plan if such a plan does not provide for a complete debt repayment within the plan's term and does not lead to financial rehabilitation of a local public entity.

### 3.2.5 Directors

The role and powers of the debtor's management vary depending on the applicable insolvency procedure. While at the initial stage of insolvency (supervision) the debtor's management stays in power with certain limitations imposed by the law,<sup>89</sup> and the opening

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<sup>85</sup> Bankruptcy Act, art 12(2).

<sup>86</sup> *Idem*, art 75(3).

<sup>87</sup> Budget Code, art 168.4(3).

<sup>88</sup> Decision of the Federal Commercial Court of the Far Eastern District dated 28 March 2014 in case No A16-99/2013.

<sup>89</sup> Bankruptcy Act, art 64(1), (2) and (3). The following transactions should be approved by an insolvency practitioner: disposition of property with value exceeding 5% of the value of the debtor's assets; receiving

of the insolvency winding-up terminates the powers of debtor's officers, directors and other governing bodies.<sup>90</sup> All such powers are transferred to an insolvency practitioner. In external administration, the powers of a debtor's management are terminated, while other governing bodies retain certain rights and can make decisions on the increase of the share capital by issuing additional ordinary shares, on the replacement of debtor's assets, on the petition for the sale of debtor's business, on election of shareholders' representative, etcetera.<sup>91</sup> In financial rehabilitation, the debtors' management and governing bodies retain their powers. At the same time, the debtor must receive an approval from the creditors' meeting or the committee of creditors in order to dispose of the debtor's property with a value exceeding 5% of the value of debtor's assets, grant a loan or a guarantee, and initiate a corporate reorganisation.<sup>92</sup> Certain actions need an approval by an insolvency practitioner (for example, receipt of a loan, assignment of a claim and debt transfer).<sup>93</sup>

In a recent case concerning the insolvency of a municipal unitary enterprise that provided heat supply services to consumers (thus being a hybrid local public entity), the Supreme Court gave important guidance on the issue of a director's and owner's liability.<sup>94</sup> Since its establishment, the enterprise had been unprofitable, in part due to the imposed (allegedly economically unreasonable) tariffs which it had to charge consumers. The creditor brought a claim against the owner of the debtor's assets (municipality) and the debtor's director, arguing that he should have filed for insolvency much earlier. The lower courts held the director accountable, but refused to extend the liability to the owner of its assets (municipality). They ruled that there was no evidence of the causal relationship between the actions of the municipality and insolvency. The Supreme Court disagreed. Firstly, it held that no reasonable director of an enterprise, created in the middle of the heating season to provide socially significant services, would have filed for insolvency shortly after the creation of such an enterprise. A competent manager would have started the analysis of the current situation and, possibly, drafted of a restructuring plan. In the case at hand, the director had requested subsidies from the regional budget and attempted to change the tariffs. The courts should have examined these steps when judging the reasonableness of the director's conduct. Secondly, the Supreme Court highlighted some inconsistencies in the analysis concerning the liability of the municipality. The latter should have been aware of the situation of the controlled enterprise, and yet it contributed to the creation of the company's deficit. This is why it should not be exempted from liability. The decision of the Supreme Court confirmed that LPEs, such as municipalities, can be held liable for the activities of hybrid LPEs created by them.

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or granting loans, extending surety or a guarantee; assignment of claims; and transfer of debt. The debtor's management is not allowed to take decisions concerning: corporate reorganisation or liquidation, creation of subsidiaries and offices, payment of dividends, and issuance of bonds and other securities.

<sup>90</sup> *Idem*, art 126(2).

<sup>91</sup> *Idem*, art 94(2).

<sup>92</sup> *Idem*, art 82(3).

<sup>93</sup> *Idem*, art 82(4).

<sup>94</sup> Decision of the Supreme Court dated 21 May 2021, No 302-ЭC20-23984.

### 3.3 Technical rules and procedure

#### 3.3.1 Separation of creditors into classes and cross-class cram down

Russian insolvency law does not provide for the separation of creditors into classes. It only establishes priority of claims, so that a higher tier of creditors is satisfied in full before a lower tier can receive any payment.<sup>95</sup> Among the privileged categories of claims are post-petition claims (claims arising during the insolvency proceedings), personal injury claims, claims of employees and copyright holders, and insolvency practitioner's fees.<sup>96</sup> No priority is established for consumers. If the termination of the debtor's activity may cause environmental harm or loss of life, costs related the prevention of such negative consequences obtain high priority.<sup>97</sup>

Secured creditors enjoy a privileged status to the extent that they are paid from the proceeds of the sale of pledged or mortgaged assets before other creditors. At the same time, a certain percentage of such sale proceeds (20% under a credit agreement and 30% in all other cases) is used to satisfy higher ranking claims, such as compensation for personal injury.<sup>98</sup> A number of decisions in insolvency proceedings can only be taken with the agreement of secured creditors. For example, a settlement agreement can be reached only if all secured creditors have voted in its favour.<sup>99</sup>

Voting rights of certain categories of creditors are impaired by law. For example, subordinated creditors (usually debtor's shareholders) can attend creditors' meetings but cannot vote. Interestingly, the Supreme Court has clarified that claims of public-law entities should not be subordinated (which would otherwise be the case for any private party), because participation of such entities in corporations and unitary legal entities pursues public interest and ensures performance of public law obligations arising from state functions.<sup>100</sup>

Since creditors cannot be separated into classes, no cross-class or intra-class cram down is available. However, certain decisions can be imposed by the majority of creditors on the dissenting minority. For example, a settlement agreement may be adopted at any stage of the insolvency proceedings, provided that it has been approved by a simple majority of unsecured creditors and all secured creditors. A settlement agreement, however, cannot

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<sup>95</sup> Russian Civil Code, art 309.1(1). The order of priorities is set by law and courts cannot change this order. However, creditors can voluntarily agree on the order of satisfaction of their claims. Such an agreement does not create obligations for non-participating parties, including the debtor. Importantly, an inter-creditor agreement does not affect insolvency proceedings and cannot change the statutory order of claims as established by the Bankruptcy Act.

<sup>96</sup> Bankruptcy Act, art 134(1) and (4).

<sup>97</sup> *Idem*, art 134(1).

<sup>98</sup> *Idem*, art 138(1) and (2).

<sup>99</sup> *Idem*, art 150(2).

<sup>100</sup> Review of Cases Related to Disputes Arising from Claims of Controlling and Affiliated Parties, adopted by the Presidium of the Supreme Court on 29 January 2020, para 13.

discriminate or worsen the position of dissenting creditors compared to that of the supporting creditors.<sup>101</sup> In practice, settlement agreements are rare, because they require an approval of all secured creditors.

### 3.3.2 *Enforcement stays, protection of special assets and LPE liability*

The Bankruptcy Act does not contain any special rules regarding a stay of enforcement actions applicable in the proceedings involving hybrid local public entities. Thus, the general rules apply. According to these rules, once a debtor has entered an insolvency proceeding, no execution can be levied on its assets.<sup>102</sup> Debtor's pre-insolvency obligations become due and debts shall be repaid subject to the priority established by law.

In addition to granting insolvency immunity to certain legal entities (see the discussion below), Russian law may exempt certain assets from creditors' enforcement actions and restrict liability of public-law entities for debts of certain hybrid entities.

For example, valuable movable property and immovable property in operational management of a budget institution are placed out of the creditors' reach.<sup>103</sup> The law also provides that the asset owner in a budget institution (such as the Russian Federation or a municipality) shall bear subsidiary liability only for personal injury caused by the budget institution.<sup>104</sup> As a result, asset owners of budget institutions have continuously not been held liable for any other kinds of debt, including debts arising from non-performance of contracts.<sup>105</sup> In a recent decision, the Russian Constitutional Court considered this outcome unsatisfactory to the extent that it created the risk for abuse and allowed public owners to shield themselves from most business-related liability.<sup>106</sup> According to the Constitutional Court, this situation disturbed the balance between the interests of debtors and creditors. The law must now be amended to address the concerns of the Constitutional Court.<sup>107</sup>

The Budget Code does not have an analogue of the stay of enforcement actions against a local public entity. However, it establishes the general rule protecting public funds – budget immunity, which means that enforcement actions in respect of a budget are permitted only on the basis of a court decision (with some exceptions).<sup>108</sup> Moreover, court enforcement officers (bailiffs) cannot take enforcement actions against budgets of the

<sup>101</sup> Bankruptcy Act, art 156(3).

<sup>102</sup> *Idem*, arts 63(1), 81(1), 94(1) and 126(1).

<sup>103</sup> Russian Civil Code, art 123.22(5).

<sup>104</sup> *Ibid.*

<sup>105</sup> Decision of the Commercial Court of the East Siberian District dated 7 April 2021 No Ф02-1085/2021; Decision of the Commercial Court of the Far Eastern District dated 14 April 2017 No Ф03-623/2017; and Decision of the Commercial Court of the Moscow District dated 31 August 2017 No Ф05-12649/2017.

<sup>106</sup> Decision of the Constitutional Court of the Russian Federation dated 12 May 2020 No 23-П.

<sup>107</sup> For the respective bill, see [here](#).

<sup>108</sup> Budget Code, art 239(1).



budget system of the Russian Federation outside a few cases established in the Budget Code.<sup>109</sup> The special legal nature of budgets which constitute the financial basis for the functioning of the Russian Federation and municipalities, is premised on the fact that the budget should be spent on societal needs and in the interests of all Russian citizens. The restrictions on enforcement actions contained in the Budget Code aim to impede uncontrolled enforcement actions against budgets and to ensure targeted use of public funds.<sup>110</sup> However, this regulation is general and is not restricted to situations of financial distress.

### **3.3.3 Interim and new financing**

Russian insolvency law distinguishes between claims that arose before an insolvency petition is accepted by the court, and claims arising after that date. The law treats such claims differently. The former (реестровые требования) are rarely satisfied in full. However, the situation is quite different for the claims of the second type (post-petition claims). Claims which arise after the insolvency petition has been accepted (текущие требования) are satisfied before pre-petition creditors. The Bankruptcy Act establishes a separate ranking for the post-petition claims.<sup>111</sup> It should be noted that Russian law does not have an analogue of super-priority financing existing in a number of foreign jurisdictions, such as the United States and Singapore.

According to the Bankruptcy Act, claims of tax authorities are treated as unsecured claims, if they have arisen before the acceptance of the insolvency petition.<sup>112</sup> Here the critical moment is the date of the ending of the tax period, in which the debt has arisen. If the tax period ended after the insolvency petition had been accepted, the tax claim is granted priority over unsecured claims.<sup>113</sup> Insurance claims related to mandatory pension insurance are treated as employment claims (privileged claims).<sup>114</sup>

## **4. Dealing with local public entities in distress - law in practice**

As noted in the previous sections, local public-law entities such as municipalities are not subject to the rules of the Bankruptcy Act. Yet they may be subject to the special procedure of interim financial administration under the Budget Code.

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<sup>109</sup> *Idem*, art 239(2).

<sup>110</sup> Resolution of the Plenum of the Supreme Court "On some issues relating to the application the norm of the Budget Code of the Russian Federation related to enforcement of judicial acts against budgets of the budget system of the Russian federation", dated 28 May 2019 No 13, para 1.

<sup>111</sup> Bankruptcy Act, art 134(2).

<sup>112</sup> *Idem*, art 134(4).

<sup>113</sup> Review of Case Law on Issues Relating to Participation of Competent State Authorities in Insolvency Cases, adopted by the Presidium of the Supreme Court on 20 December 2016, para 6.

<sup>114</sup> *Idem*, para 14.

The use of an interim financial administration in Russia is very rare. Nevertheless, there are a few cases in which it was applied. The interim financial administration was used in 2013 with respect to the municipality of Valdgeym rural settlement (*Валдгеймское сельское поселение*) in Birobidzhansky District of the Jewish Autonomous Oblast, located in the eastern part of Russia. In this case, the financial rehabilitation plan for the municipality was approved by the lower court. The creditors appealed because in their view the approved financial rehabilitation plan did not provide sufficient information on how the financial rehabilitation of the municipality could be achieved. The appellate court denied the appeal, but the Federal Commercial Court of the Far Eastern District agreed with the creditors and pointed out that the lower courts should have inquired whether the solvency of the municipality could be restored and how its obligations to creditors could be fulfilled.<sup>115</sup> After all, the financial rehabilitation plan of the municipality was not approved and the interim financial administration had not succeeded. It is also worth noting that the courts concluded that the period of the interim financial administration prescribed in the Budget Code (of up to one year) could not be extended.<sup>116</sup>

In January 2018, the interim financial administration was introduced with respect to the municipal urban settlement of Severomuyskoye (*городское поселение Северомуйское*) in Muiskey district of the Republic of Buryatia in the eastern part of Russia.<sup>117</sup> In this case, the financial rehabilitation plan of the municipality for 2018-2022 was approved by the court in April 2018.<sup>118</sup> The plan contained provisions for the repayment of overdue debts exceeding RUB 28 million (approximately EUR 335,000 at the December 2021 rate) over the five-year period and engagement of the respective federal subject (the Republic of Buryatia) to support municipal recovery. In fact, the major source of financing needed to pay creditors under the plan was the budget of the Republic of Buryatia rather than the own profits of the municipal urban settlement.

After the plan approval, it became clear that the amount of debt accounted for in the plan was lower than the actual debt burden. The interim financial administration tried to negotiate with the creditors an out-of-court agreement, but the creditors were unwilling to compromise on their claims. They did not agree to give up their claim for interest. In November 2018, the interim financial administration asked the court to approve the revised financial rehabilitation plan. By its decision from 17 December 2018, the court approved the revised plan.<sup>119</sup>

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<sup>115</sup> Decision of the Federal Commercial Court of the Far Eastern District dated 28 March 2014 No Ф03-564/2014.

<sup>116</sup> Decision of the 6th Appellate Court dated 21 January 2015 No 06АП-6339/2014.

<sup>117</sup> For an overview of this case (in Russian), see [here](#).

<sup>118</sup> Decision of the Commercial Court of the Republic of Buryatia dated 5 April 2018 in Case No A10-7465/2017.

<sup>119</sup> Decision of the Commercial Court of the Republic of Buryatia dated 17 December 2018 in Case No A10-7465/2017.

## Local public entities in distress - a critical analysis of the South African approach

By Geo Quinot\*

This contribution explores the law governing local public entities (LPEs) in distress in South Africa. It shows that multiple regulatory frameworks potentially apply in such scenarios, depending on the exact nature of the LPE and of the financial distress. This chapter starts by setting out the general legal framework governing insolvency in South Africa. This is followed by a discussion of what constitutes LPEs in South Africa and the various categories of LPEs. The frameworks governing LPEs in distress are consequently explored, which include the dedicated set of rules focusing on municipal public finance management as well as general business rescue and liquidation frameworks. Finally, the application of these frameworks is discussed in practical terms leading to conclusions about the failures of the dedicated set of rules governing LPEs, primarily municipalities, in distress.

### 1. General context of insolvency law

The two main legal instruments governing insolvency in South Africa are the Companies Act 71 of 2008 (the Companies Act 2008) and the Insolvency Act 24 of 1936 (the Insolvency Act). It follows that South Africa has a fragmented legal framework in respect of insolvency in that the law draws a distinction between insolvency in relation to companies and natural persons.

The insolvency of companies is primarily governed by the Companies Act 2008 that came into operation in 2011. However, the provisions pertaining to the winding-up and liquidation of companies under the previous Companies Act 61 of 1973 (Companies Act 1973) continue to apply as determined in schedule 5 of the Companies Act 2008. The insolvency of natural persons is primarily governed by the Insolvency Act since July 1936. Since 2003, these instruments are supplemented by the Cross-Border Insolvency Act 42 of 2000, effectively a South African version of the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency. In addition to these statutes, there are also insolvency rules emanating from common law that supplement the statutory provisions.<sup>1</sup>

There is no dedicated insolvency regulator in South Africa. Certain regulatory functions in respect of insolvency proceedings are fulfilled by the Master of the High Court and the Companies and Intellectual Property Commission.<sup>2</sup> The Master of the High Court is a

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<sup>1</sup> *Du Plessis and Another NNO v Rolfes Ltd* 1997 (2) SA 354 (A); E Bertelsmann *et al*, *Mars: The Law of Insolvency in South Africa* (10<sup>th</sup> ed, Juta, Claremont, 2019) at 17; and J Calitz, "Historical Overview of State Regulation of South African Insolvency Law", *Fundamina* (2010) 16(2) 1 at 25.

<sup>2</sup> J Calitz and A Boraine, "The Role of the Master of the High Court as Regulator in a Changing Liquidation Environment: A South African Perspective", *Journal of South African Law* (2005) 728.

statutory office within the Department of Justice and Constitutional Development, staffed by civil servants, with regulatory powers in relation to a range of matters relating to the administration of justice.<sup>3</sup> It is not a judicial office. The Companies and Intellectual Property Commission is likewise a statutory body, created by the Companies Act 2008, to provide regulatory oversight over all matters relating to companies.<sup>4</sup> Neither of these offices has a dedicated insolvency mandate.

Insolvency proceedings, flowing from the Insolvency Act, have as their primary object the benefit of creditors.<sup>5</sup> South Africa is thus traditionally viewed as a pro-creditor insolvency system.<sup>6</sup> However, since the 2000s there have been significant reforms of the law, which had the result of progressively shifting away from a pro-creditor position. Various statutes have been enacted to protect debtors, such as the National Credit Act 34 of 2005 and the Consumer Protection Act 68 of 2008.<sup>7</sup> Furthermore, the Companies Act 2008 introduced business rescue into South African corporate law. This marked an important step towards establishing a more debtor-friendly insolvency system, at least in the corporate context.<sup>8</sup> This development created a new system for corporate rescue in cases of financial distress aimed at restoring the company to profitability and avoiding liquidation.

An insolvent company can be wound up on either a compulsory or a voluntary basis.<sup>9</sup> A compulsory winding up is done by way of a court application initiated by the company, a creditor, and / or members of the company,<sup>10</sup> which must also be served on the Master of the High Court.<sup>11</sup> Upon such application, the court may either grant a provisional or final winding-up order.<sup>12</sup> It is customary for the court to first grant a provisional winding-up order with a set return date when all interested parties will be afforded the opportunity to

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<sup>3</sup> *Ibid.*

<sup>4</sup> Companies Act 71 of 2008, s 185.

<sup>5</sup> *Ex part Pillay; Mayet v Pillay* 1955 (2) SA 309 (N); R Sharrock, *Hockley's Insolvency Law* (9<sup>th</sup> ed, Juta, Cape Town, 2012) at 4; and E Bertelsmann *et al*, *Mars: The Law of Insolvency in South Africa* (10<sup>th</sup> ed, Juta, Claremont, 2019) at 4.

<sup>6</sup> E Bertelsmann *et al*, *Mars: The Law of Insolvency in South Africa* (10<sup>th</sup> ed, Juta, Claremont, 2019) at 6; R Bradstreet, "The New Business Rescue: Will Creditors Sink or Swim?", *South African Law Journal* (2011) 128(2) at 352; R D Sharrock, "Insolvency" in M Kühne (ed), *The Law of South Africa* (Vol 11, 2<sup>nd</sup> ed, LexisNexis, Durban, 2008) at para 199; E Levenstein, *South African Business Rescue Procedure* (1<sup>st</sup> ed, LexisNexis, Durban, 2020) at paras 2.1 and 2.3; F H I Cassim (ed), *Contemporary Company Law* (2<sup>nd</sup> ed, Juta, Cape Town, 2012) at 866; and A Boraïne, R G Evans, M Roestoff and L Steyn, "The Pro-Creditor Approach in South African Insolvency Law and the Possible Impact of the Constitution", *Nottingham Insolvency and Business Law e-Journal* (2015) 3 5 at 60.

<sup>7</sup> See J Calitz and A Boraïne, "Some consequences of the National Credit Act 34 of 2005 on the proof of claims in insolvency law", *Journal of South African Law* (2010) at 797.

<sup>8</sup> R Bradstreet, "The New Business Rescue: Will Creditors Sink or Swim?", *South African Law Journal* (2011) 128(2) at 352; F H I Cassim (ed), *Contemporary Company Law* (2<sup>nd</sup> ed, Juta, Cape Town, 2012) at 862 and 866; and E Levenstein, *South African Business Rescue Procedure* (1<sup>st</sup> ed, LexisNexis, Durban, 2020) at paras 2.1 and 2.3.

<sup>9</sup> Companies Act 61 of 1973, ss 346(1), 343 and 349.

<sup>10</sup> *Ibid.*

<sup>11</sup> *Idem*, s 346(4).

<sup>12</sup> *Idem*, s 347.

be heard on the application while protecting the interests of creditors in the interim.<sup>13</sup> The court retains broad discretionary powers to intervene in the liquidation process after the winding-up order has been granted.<sup>14</sup> Once a winding-up order has been granted, the property of the company is placed under the control of the Master until the Master has appointed a liquidator,<sup>15</sup> as nominated by the creditors and members at their respective first meetings.<sup>16</sup> The Master retains an oversight function over the work of the liquidator.<sup>17</sup>

A voluntary winding-up is done by way of resolution by the company itself.<sup>18</sup> Such a resolution must be registered with the Companies and Intellectual Property Commission and will take effect once registered.<sup>19</sup> As with a compulsory winding-up, the Master will summon meetings of the creditors and members once the winding-up takes effect, and appoint a liquidator.<sup>20</sup>

Business rescue of companies is governed by chapter 6 of the Companies Act 2008. A company can be placed in business rescue either by way of a resolution passed by the company's board of directors, that is voluntary, or by an application to court, that is compulsory.<sup>21</sup> Any affected person (that is, a creditor, shareholder, trade union, employee or employee representative) may apply to a court to place a company in business rescue.<sup>22</sup> The application must also be served on the Companies and Intellectual Property Commission.<sup>23</sup> The court may grant the application, thereby placing the company in business rescue. Alternatively, the court may refuse the application and in this case, the court may make an order to place the company in liquidation. This happens, for instance, if the court is not satisfied that there is a reasonable prospect of rescuing the company.<sup>24</sup> The applicant must identify the business rescue practitioner in the court papers, but the appointment must be ratified by the first meeting of the creditors should the court grant the order.<sup>25</sup> In the case of a voluntary business rescue, the board resolution must be filed with the Companies and Intellectual Property Commission and the company must appoint a business rescue practitioner.<sup>26</sup>

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<sup>13</sup> R Sharrock, *Hockley's Insolvency Law* (9<sup>th</sup> ed, Juta, Cape Town, 2012) at 250.

<sup>14</sup> R C Williams, "Companies" in M Kühne (ed), *The Law of South Africa* (Vol 4(3), 2<sup>nd</sup> ed, LexisNexis, Durban, 2014) at para 136.

<sup>15</sup> Companies Act 61 of 1973, s 361.

<sup>16</sup> *Idem*, s 369.

<sup>17</sup> *Idem*, s 381.

<sup>18</sup> *Idem*, s 349.

<sup>19</sup> *Idem*, ss 350-352.

<sup>20</sup> *Idem*, s 369.

<sup>21</sup> Companies Act 71 of 2008, ss 129 and 131.

<sup>22</sup> *Idem*, ss 128 and 131.

<sup>23</sup> *Idem*, s 131.

<sup>24</sup> *Ibid.*

<sup>25</sup> *Ibid.*

<sup>26</sup> *Idem*, ss 129 and 132.

A reform process to bring about a unified insolvency regime has been ongoing for a number of years.<sup>27</sup> The South African Law Reform Commission has published various working and discussion papers and draft bills in this regard.<sup>28</sup> However, no law to this effect has been introduced into Parliament to date.

## 2. Local public entities

A number of definitions are used in the South African legal framework relating to public entities. The most general definition is that of “organ of state” and is found in section 239 of the Constitution of the Republic of South Africa, 1996 (the Constitution). It defines organs of state to include all state departments (at all three levels of government), thus including municipalities, as well as other functionaries and institutions that exercise powers in terms of the Constitution or perform public functions in terms of legislation.

It is evident that this definition includes both institutional and functional approaches to the conceptualisation of public entities in law. Under the first part of the definition, a range of entities are deemed organs of state purely based on their institutional character and their formal status within the constitutional framework. The second part of the definition expands the concept of an organ of state on functional grounds by adding a range of entities based on their functions regardless of their institutional identity. Local governments qualify as organs of state under the first, institutional part of the definition, that is an “administration in the ... local sphere of government”. This would cover basic LPEs. Additionally, entities created by local governments to fulfil public functions, such as local water boards, may qualify as organs of state under the second, functional part of the definition. This second part of the definition would cover hybrid LPEs, which is an entity, other than a municipality, that carries out public services and that is under the control and responsibility of a municipality.

The Constitution, in section 151, states that the “local sphere of government consists of municipalities”. The Constitution also determines that there are three categories of municipalities, namely category A (“a municipality that has exclusive municipal executive and legislative authority in its area”), category B (“a municipality that shares municipal executive and legislative authority in its area with a category C”) and category C (“a municipality that has municipal executive and legislative authority in an area that includes more than one municipality”).<sup>29</sup> These are labelled as metropolitan municipalities

<sup>27</sup> A Keay, “To Unify or Not to Unify Insolvency Legislation: International Experience and the Latest South African Proposals”, *De Jure* (1999) 32 at 62; M Havenga, “Simplification and Unification in Corporate and Insolvency Law - Are We Making Any Progress?”, *South African Mercantile Law Journal* (2001) 13(3) at 408; J Calitz, “Historical Overview of State Regulation of South African Insolvency Law”, *Fundamina* (2010) 16(2) at 1; A Boraine and M Roestoff, “Revisiting the state of consumer insolvency in South Africa after twenty years: The courts’ approach, international guidelines and an appeal for urgent law reform (2)”, *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* (2014) 77(4) at 527; and A Boraine, “Formal Debt-Relief, Rescue and Liquidation Options for External Companies in South Africa”, *BRICS Law Journal* (2020) 7(4) 85 at 121-122.

<sup>28</sup> See South African Law Commission, Project 63, Commission Paper 582 *Review of the Law of Insolvency* (2000) Vols 1 and 2.

<sup>29</sup> Constitution of the Republic of South Africa, 1996, s 155.

(category A), local municipalities (category B) and district municipalities (category C) by the Local Government: Municipal Structures Act 117 of 1998, which terminology is consistently applied through the legal framework.<sup>30</sup>

The Local Government: Municipal Systems Act 32 of 2000 (Systems Act) provides a more detailed definition of a municipality. The essential elements of the definition are that a municipality is an organ of state with legislative and executive authority in a set jurisdictional area with its own legal personality, and is constituted by the elected (political) structure, the administration and the community.<sup>31</sup>

Municipalities, as the paradigmatic LPE in South Africa, are primarily governed by an elected municipal council, led by a mayor.<sup>32</sup> The administration of the municipality is headed by the municipal manager, who is an appointed official accountable to the municipal council.<sup>33</sup> For purposes of financial management, the municipal manager is the accounting officer who carries the primary responsibility for financial management in terms of the law.<sup>34</sup>

The Systems Act also defines the concept of a “municipal entity”.<sup>35</sup> This can be a private company established by one or more municipalities or in which one or more municipalities hold an interest as set out in the Systems Act, a service utility or a multi-jurisdictional service utility. A municipality may, by way of by-law, create a service utility for a specific, stated purpose.<sup>36</sup> A multi-jurisdictional service utility is, as the name suggests, a service utility established jointly by two or more municipalities to function across the jurisdictions of those municipalities.<sup>37</sup> It is not a requirement that the full interest or even a majority interest in a private company established by a municipality must be held by the municipality. However, effective control of such private companies must always be in the hands of an organ of state, whether local or at provincial or national level.<sup>38</sup> If the effective control of the private company is held by one or more municipalities, that company will qualify as a municipal entity.<sup>39</sup> The defining element that all municipal entities thus share is that of control by a municipality or combination of municipalities.

Another noteworthy definition in the Systems Act, is that of “parent municipality”. This term captures the relationship between municipalities and municipal entities, whether in the form of a private company or service utility, indicating the responsibility of the municipality

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<sup>30</sup> Local Government: Municipal Structures Act 117 of 1998, s 1.

<sup>31</sup> Local Government: Municipal Systems Act 32 of 2000, s 2.

<sup>32</sup> Constitution of the Republic of South Africa, 1996, s 151(2).

<sup>33</sup> Local Government: Municipal Systems Act 32 of 2000, ss 54A and 55.

<sup>34</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 60.

<sup>35</sup> Local Government: Municipal Systems Act 32 of 2000, s 1.

<sup>36</sup> *Idem*, s 86H.

<sup>37</sup> *Idem*, s 87.

<sup>38</sup> *Idem*, s 86C.

<sup>39</sup> *Idem*, s 86D.

for the municipal entity comparable to the relationship between a holding company and a subsidiary.

In addition to the concept of a municipal entity, the Companies Act of 2008 defines the concept of a “state-owned company”. This includes a company registered under the Companies Act 2008 and owned by a municipality. It follows from these definitions that a municipal entity that is registered as a company will simultaneously be a state-owned company.

Municipal entities are subject to the control of the parent municipalities. Such control is typically exercised through the board of directors of the relevant municipal entity, which is the direct controlling body over the entity.<sup>40</sup> The board of directors in turn appoint the chief executive officer to head the administration of the entity.<sup>41</sup> The chief executive officer is the accounting officer of the municipal entity, responsible for financial management of the entity.<sup>42</sup>

There is no single mission statement for LPEs in South African law. The Constitution provides the following broad objects for municipalities:

- “(a) to provide democratic and accountable government for local communities;
- (b) to ensure the provision of services to communities in a sustainable manner;
- (c) to promote social and economic development;
- (d) to promote a safe and healthy environment; and
- (e) to encourage the involvement of communities and community organisations in the matters of local government.”<sup>43</sup>

The powers of municipalities are restricted to the administration of those subject matter areas listed in schedules to the Constitution.<sup>44</sup> South African courts have held that the provision of basic municipal services is the key mission of local government.<sup>45</sup>

As noted above, when a municipality creates a municipal entity in the form of a service utility, the by-law that creates that entity must specify its mandate. The Systems Act also restricts the activities of municipal entities that are private companies to “the purpose for which it is used by its parent municipality” and determines that a municipal entity (of any type) “has no competence to perform any activity which falls outside the functions and powers of its parent municipality”.<sup>46</sup> The Systems Act provides that a municipality may only

<sup>40</sup> Local Government: Municipal Systems Act 32 of 2000, s 93E.

<sup>41</sup> *Idem*, s 93J.

<sup>42</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 93.

<sup>43</sup> Constitution of the Republic of South Africa, 1996, s 152.

<sup>44</sup> *Idem*, Schedules 4B and 5B.

<sup>45</sup> See *Joseph v City of Johannesburg* 2010 (4) SA 55 (CC) at para 34.

<sup>46</sup> Local Government: Municipal Systems Act 32 of 2000, s 86D.



establish a municipal entity in the form of a private company “if there is a need to perform that function or power in accordance with business practices in order to achieve the strategic objectives of the municipality more effectively; and the company would benefit the local community”.<sup>47</sup>

Financial results of LPEs are primarily governed by the Local Government: Municipal Finance Management Act 56 of 2003 (MFMA). This statute contains detailed rules on financial management, including reporting, by municipalities and all municipal entities. At the heart of these rules is the requirement for municipalities to prepare and table annual budgets for approval by the relevant municipal council. The roles, responsibilities and procedures for drafting, finalising, tabling, approving and implementing the annual budget are prescribed in detail. At a high level, the Constitution prescribes that municipal budgets and budgetary processes must promote transparency, accountability and the effective financial management of the economy, debt and the public sector.<sup>48</sup> To this end, the MFMA requires that budgets must be realistic and credible and must include comparisons with the previous years’ budget and actual expenditure.<sup>49</sup> The budget must also be aligned with the municipality’s key strategic plan, known as the integrated development plan, and must be accompanied by a service delivery and budget implementation plan.<sup>50</sup> Municipalities must publish monthly budget statements reporting against the implementation plan and must table quarterly budget implementation reports to its council.<sup>51</sup> Municipalities must also submit financial reports to the relevant provincial treasury. These reports include the monthly budget statements<sup>52</sup> and reports on failures by a municipal council to adopt or implement budgetary policies.<sup>53</sup> The municipal mayor is also obliged to report to the provincial government any serious financial problems that may emerge.<sup>54</sup>

Compliance with the local government financial management rules is annually audited by the Auditor-General in terms of section 188 of the Constitution, the MFMA and the Public Audit Act 25 of 2004. The Auditor-General submits its findings in an annual audit report to the national Parliament, which includes findings on irregular expenditure by municipalities and the state of local government finances.

The regulatory framework provides for a number of consequences in case of failures to comply with the municipal finance management rules. One of the most extreme measures is intervention by either the relevant provincial government or national government.<sup>55</sup> Such intervention may involve placing the municipality under administration. Where the

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<sup>47</sup> *Idem*, s 86E.

<sup>48</sup> Constitution of the Republic of South Africa, 1996, s 215.

<sup>49</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 17.

<sup>50</sup> *Idem*, ss 17, 21 and 53.

<sup>51</sup> *Idem*, ss 52 and 71.

<sup>52</sup> *Idem*, s 71.

<sup>53</sup> *Idem*, s 73.

<sup>54</sup> *Idem*, s 54.

<sup>55</sup> Constitution of the Republic of South Africa, 1996, s 139.

Auditor-General finds material irregularities in the finances of a municipality, it must issue recommendations to the municipality to address such irregularities.<sup>56</sup> If the municipality fails to implement these, the Auditor-General must take appropriate remedial action, which, in the case of such irregularities involving financial loss to the state, must include a directive to the municipal manager to recover the loss from the responsible person.<sup>57</sup> If the municipal manager fails to implement such directive, the Auditor-General may issue a certificate of debt to the municipal manager requiring the manager to repay such amount as determined by the Auditor-General.<sup>58</sup>

The sources of income of LPEs are restricted in law and derive primarily from an equitable share of revenue raised nationally; additional allocations made by national and provincial governments and income generated by rates on property and surcharges on fees for services provided.<sup>59</sup> Additional municipal taxes may be authorised by national government, but these may not include income tax, value-added tax, general sales tax or customs duty.<sup>60</sup> Property taxes and surcharges on fees may be capped by national government.<sup>61</sup> The powers of LPEs to take loans or subscribe in financial instruments are also restricted.

Generally, municipalities may only raise loans for capital expenditure.<sup>62</sup> Municipalities may only incur short-term debt for non-capital expenditure and must repay such debt within the financial year and may not refinance such debt.<sup>63</sup> Municipalities may only incur long-term debt for capital expenditure or to refinance existing long-term debt.<sup>64</sup> In terms of the Municipal Regulations on Debt Disclosure, 2007, municipalities have extensive and ongoing disclosure obligations regarding all debt. These include simple loan agreements as well as municipal debt instruments, which are defined as “any note, bond, debenture or other evidence of indebtedness issued by a municipality or municipal entity, including dematerialised or electronic evidence of indebtedness intended to be used in trade”.<sup>65</sup> These disclosure obligations serve to ensure that municipalities do not take on any debt if they are not in good financial standing. Disclosure furthermore enables prospective lenders to confirm that all statutory requirements have been met prior to entering into the transaction. A *bona fide* failure in disclosure will not impact the validity of the lending transaction.<sup>66</sup> A failure to adhere to the substantive statutory requirements, especially the limits on lending, may, however, lead to the invalidity of the transaction. The basic position

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<sup>56</sup> Public Audit Act 25 of 2004, s 5A.

<sup>57</sup> *Ibid.*

<sup>58</sup> *Idem*, s 5B.

<sup>59</sup> Constitution of the Republic of South Africa, 1996, ss 227 and 229.

<sup>60</sup> *Idem*, s 229(1)(b); and Municipal Fiscal Powers and Functions Act 12 of 2007, s 4.

<sup>61</sup> Local Government: Municipal Property Rates Act 6 of 2004, s 20; and Municipal Fiscal Powers and Functions Act 12 of 2007, s 8.

<sup>62</sup> Constitution of the Republic of South Africa, 1996, s 230A; and Local Government: Municipal Finance Management Act 56 of 2003, ss 18, 19 and 46.

<sup>63</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 45.

<sup>64</sup> *Idem*, s 46.

<sup>65</sup> Municipal Regulations on Debt Disclosure, 2007, reg 1.

<sup>66</sup> *Idem*, reg 25.

in South African law is that organs of state “are constrained by the principle that they may exercise no power and perform no function beyond that conferred upon them by law”.<sup>67</sup> When they do act beyond the limits of statutory power, such action is open to review and setting aside by the High Court.<sup>68</sup> Whether the transaction will in fact be set aside by the court upon an application for review is within the court’s discretion.<sup>69</sup> Since the court has a wide discretion to “make any order that is just and equitable”,<sup>70</sup> the court may set the transaction aside *ex tunc*, *ex nunc* or not at all (that is, keep the transaction in place).

### 3. Dealing with local public entities in distress – legal framework

#### 3.1 Principles and framework

LPEs in financial distress are primarily dealt with in terms of the MFMA, which contains a general chapter (chapter 13) entitled “Resolution of Financial Problems”. This chapter applies both to municipalities and municipal entities.

The legislative framework’s point of departure is that municipalities are primarily responsible for identifying and resolving their own financial problems within their (albeit limited) powers to generate revenue and manage expenditure.<sup>71</sup> Only if municipalities are truly unable to resolve their own financial distress will provincial governments intervene or, failing such provincial intervention, will national government step in.<sup>72</sup> Provincial intervention may involve the preparation of a financial recovery plan and, in serious cases, the appointment of an administrator to take over the functions of the municipal council. In cases of serious or persistent material breach of financial commitments,<sup>73</sup> the provincial government is obliged to intervene<sup>74</sup> and the recovery plan must be prepared by the Municipal Financial Recovery Service,<sup>75</sup> which forms part of the National Treasury.<sup>76</sup>

In the case of municipal entities, the board of directors is primarily responsible for addressing any financial distress. If the board fails to do so, the parent municipality must step in.<sup>77</sup> The parent municipality may impose a financial recovery plan, equivalent to the

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<sup>67</sup> *Fedsure Life Assurance Ltd v Greater Johannesburg Transitional Metropolitan Council* 1999 (1) SA 374 (CC) at para 58.

<sup>68</sup> *Ibid.*

<sup>69</sup> *Bengwenyama Minerals (Pty) Ltd v Genorah Resources (Pty) Ltd* 2011 (4) SA 113 (CC) at para 85.

<sup>70</sup> Constitution of the Republic of South Africa, 1996, s 172.

<sup>71</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 135.

<sup>72</sup> Constitution of the Republic of South Africa, 1996, s 139.

<sup>73</sup> See Local Government: Municipal Finance Management Act 56 of 2003, s 140 for the criteria to determine what constitutes serious or persistent material breach of financial commitments.

<sup>74</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 139.

<sup>75</sup> *Ibid.*

<sup>76</sup> *Idem*, s 157.

<sup>77</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 109.

recovery plan that a provincial government may impose on a municipality in distress.<sup>78</sup> Alternatively, the parent municipality may liquidate the municipal entity.<sup>79</sup>

Municipalities cannot be liquidated under South African law,<sup>80</sup> but at worst be placed under administration. Municipal entities may, however, be liquidated.<sup>81</sup> There is some doubt as to whether municipalities can be sequestrated in terms of the Insolvency Act, in a manner similar to individuals. That is, whether a sequestration order may be granted in respect of a municipality under the Insolvency Act that would essentially have the same effect as a liquidation of a company. However, it seems highly unlikely that this is possible.<sup>82</sup> Both municipalities and municipal entities may be subjected to financial recovery plans. The details regarding a financial recovery plan are set out in the MFMA (discussed below).

An important aim of the legislative framework dealing with municipal entities in distress, primarily under the Systems Act and MFMA, is to secure the continuation of public services despite the financial distress.<sup>83</sup> This is obviously distinct from the rules governing general corporate insolvency frameworks. This aim is, for example, clearly illustrated in the rule that entities may not dispose of a capital asset needed to provide the minimum level of basic municipal services, regardless of their financial distress. Such assets are excluded from the entire framework dealing with financial distress, such as those providing for financial recovery plans and restructuring of debt.

The framework dealing with LPEs in distress under the MFMA is only applicable to entities in the local government sphere. The courts have held that there is no duty on other levels of government (national or provincial government) to provide funds to local governments to enable it to pay their debts.<sup>84</sup>

Municipal entities that are companies are also subject to the provisions governing business rescue of all corporate entities under the Companies Act 2008. In terms of these rules, the board of a municipal entity in distress may place the entity in business rescue. These proceedings are identical to business rescue of private corporate entities, and these

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<sup>78</sup> *Ibid.*

<sup>79</sup> *Ibid.*

<sup>80</sup> R Roos and L Stander, "Insolvent municipalities? An analysis of the debt relief mechanisms at the disposal of municipalities and the disappearance of the 'advantage of creditors'", *SA Public Law* (2007) 22 166 at 182.

<sup>81</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 109; and Local Government: Municipal Systems Act 32 of 2000, ss 93B and 93C.

<sup>82</sup> R Roos and L Stander, "Insolvent municipalities? An analysis of the debt relief mechanisms at the disposal of municipalities and the disappearance of the 'advantage of creditors'", *SA Public Law* (2007) 22 166 at 188.

<sup>83</sup> M Z Makoti and O K Odeku, "Intervention into Municipal Affairs in South Africa and its Impact on Municipal Basic Services", *African Journal of Public Affairs* (2018) 10(4) 68 at 77.

<sup>84</sup> *Member of the Executive Council for Local Government, Mpumalanga v Independent Municipal and Allied Trade Union and Others* 2002 (1) SA 76 (SCA).

entities will furthermore be subject to the normal rules governing winding-up of companies.

### 3.2 Parties

As noted above, the primary responsibility for dealing with distress resides with the council of a municipality or the board of directors of a municipal entity. Only when they fail to take appropriate action would either provincial government or national government step in and effectively take over the process, essentially in terms of an intervention under section 139 of the Constitution.

The financial recovery plan for an LPE in distress may be prepared by “any suitable person”, but in cases of serious or persistent material breach of financial commitments, the recovery plan must be prepared by the Municipal Financial Recovery Service,<sup>85</sup> which is a national government entity under the National Treasury.<sup>86</sup>

The preparation of a financial recovery plan for a municipality must involve consultation with the municipality, the municipality's principal suppliers and creditors, the relevant provincial government and organised labour, which consultation must involve taking into account any plans that such parties may propose.<sup>87</sup> The proposed plan must also be submitted to these parties for comment before finalisation.<sup>88</sup> The final plan must be approved by the provincial government and submitted to the municipality, national government, the Auditor-General and organised local government in the province.<sup>89</sup>

Once approved, the LPE must implement the financial recovery plan and report monthly to the provincial government on such implementation.<sup>90</sup> If it fails to do so, the provincial government may dissolve the municipal council and appoint an administrator to oversee the management of the municipality until a new council is elected.<sup>91</sup>

Where a financial recovery plan involves an application to court for restructuring of debt, notice of such application must be served on the relevant provincial government, national government, organised labour and all persons to whom the LPE owes an amount in excess of ZAR 100 000 (approximately GBP 5000) that can reasonably be located.<sup>92</sup>

Creditors are given no special powers in relation to dealing with LPEs in distress under the framework contained in the Systems Act and the MFMA. This differs significantly from the rules governing “ordinary” business rescue proceedings under the Companies Act 2008

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<sup>85</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 141.

<sup>86</sup> *Idem*, s 157.

<sup>87</sup> *Idem*, s 141.

<sup>88</sup> *Ibid.*

<sup>89</sup> *Idem*, s 143.

<sup>90</sup> *Idem*, ss 145-146.

<sup>91</sup> *Ibid.*

<sup>92</sup> *Idem*, s 152.

and winding-up proceedings under the Companies Act 1973. Where an LPE is a private company and is subjected to business rescue or winding-up in terms of the Companies Act (whether that of 2008 or 1973), creditors enjoy the same powers as those of all other creditors in relation to corporations in insolvency or business rescue proceedings. In this instance, creditors are directly involved in the appointment of the business rescue practitioner or the liquidator. Creditors play a prominent role in the business rescue proceedings under the Companies Act 2008 with no distinction between different creditor classes. They have a right to participate in the court hearing to place a company in compulsory business rescue,<sup>93</sup> must be notified of all relevant events and have the right to participate.<sup>94</sup> Importantly, creditors have the right to vote to amend, approve or reject a proposed business rescue plan and if rejected, to propose the development of an alternative plan.<sup>95</sup> Dissenting creditors (or those who did not vote) are bound by an approved business rescue plan.<sup>96</sup> Thus, once adopted, the plan is “crammed down” on the company, all creditors and shareholders. If a plan is voted down, any affected person may make a binding offer to purchase the voting interests of one or more persons who opposed adoption of the business rescue plan, at liquidation value,<sup>97</sup> following which the business rescue practitioner must put the plan to vote again with the vote now based on the changed voting interests.<sup>98</sup> This forced sale of voting interests is another way in which a business rescue plan can be “crammed down” on dissenting voters.

When a company is wound up, the Insolvency Act provides for the following fixed order of payment of claims over which creditors have no power:

- (i) secured claims: secured creditors are protected in that their claims must be paid in priority to any other claims from the proceeds of the property constituting the security; and
- (ii) preferred claims: a number of claims are given preference in statutory provisions, namely:
  - outstanding fees and expenses of business rescue practitioners where liquidation followed unsuccessful business rescue proceedings;
  - remuneration and certain other moneys due to former employees;

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<sup>93</sup> *Cape Point Vineyards (Pty) Ltd v Pinnacle Point Group Ltd and another (Advantage Projects Managers (Pty) Ltd intervening)* 2011 (5) SA 600 (WCC).

<sup>94</sup> Companies Act 71 of 2008, s 145; and F H I Cassim (ed), *Contemporary Company Law* (2<sup>nd</sup> ed, Juta, Cape Town, 2012) at 902-904.

<sup>95</sup> *Ibid.*

<sup>96</sup> Companies Act 71 of 2008, s 154.

<sup>97</sup> *Idem*, s 153.

<sup>98</sup> *Ibid.*

- specific statutory claims, such as payments due to the Workmen’s Compensation Commissioner or to the Unemployment Insurance Fund as employer;
- taxes due;
- claims against preferred, but unsecured bonds; and
- concurrent (that is, non-preferent) claims.

As is the case with creditors, employees of LPEs do not enjoy any special protection in financial recovery procedures under the MFMA. In fact, the MFMA contemplates the “discharge” of all municipal employees “except those affordable in terms of reasonably projected revenues as set out in the approved financial recovery plan” as part of debt restructuring.<sup>99</sup> In contrast, both the business rescue framework and winding-up rules make specific provision for the protection of employees.

Employees are treated as preferential creditors in relation to remuneration and other money due to them for services rendered during the course of business rescue proceedings.<sup>100</sup> Employees will be preferred unsecured creditors in respect of all remuneration and other moneys due to employees for services rendered before commencement of the business rescue proceedings and that have not been paid.<sup>101</sup> Like creditors, employees of a company under business rescue have explicit rights of participation.<sup>102</sup> They must also be notified of all relevant events, may participate in court proceedings, may form a committee of employees’ representatives to formally engage with the business rescue practitioner and must be consulted on the development of the business rescue plan.<sup>103</sup>

It is evident that affected parties’ legal entitlements to participate in business rescue proceedings in the case of corporate entities under the Companies Act 2008 are much more extensive than those provided for in the framework for dealing with LPEs in distress by way of a financial recovery plan under the MFMA.

There are marked differences between the positions of the persons in charge of the various mechanisms to deal with LPEs in distress and ordinary business rescue and insolvency cases. These persons are respectively: the person(s) responsible for preparing a financial recovery plan for an LPE, an administrator appointed to oversee implementation of a recovery plan, a trustee appointed to prepare a distribution scheme under the MFMA, a business rescue practitioner, and an insolvency practitioner.

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<sup>99</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 155(1).

<sup>100</sup> Companies Act 71 of 2008, s 144; and F H I Cassim (ed), *Contemporary Company Law* (2<sup>nd</sup> ed, Juta, Cape Town, 2012) at 899-902.

<sup>101</sup> *Ibid.*

<sup>102</sup> *Ibid.*

<sup>103</sup> *Ibid.*

In less serious cases of financial distress, the MFMA provides that “any suitably qualified person” may be appointed by the provincial government to prepare the financial recovery plan.<sup>104</sup> No further requirements apply regarding the qualifications, appointment or remuneration of such person. In cases of serious financial distress, the financial recovery plan must be prepared by the Municipal Financial Recovery Service,<sup>105</sup> which is a national government entity under the National Treasury.<sup>106</sup> The head of the Municipal Financial Recovery Service is appointed by the Minister of Finance and is accountable to the Director-General of the National Treasury. It thus constitutes a unit within the public administration. Its basic powers and functions are set out in the MFMA.<sup>107</sup> There are no rules on who may be appointed as an administrator to ensure implementation of a financial recovery plan where a municipal council has failed to do so, or who may be appointed as trustee to prepare a distribution scheme in a debt restructure. The administrator is appointed by the provincial government and his powers are set out by way of notice in the relevant provincial gazette.<sup>108</sup> The administrator subsumes the assigned powers of the municipal council. The administrator does not replace the municipal administration, which remains in the hands of the municipal manager.<sup>109</sup> The administrator must thus steer the implementation of the financial recovery plan via the municipal manager.

In stark contrast with the scant regulation of the relevant actors under the MFMA framework, business rescue practitioners are regulated in significant detail in the Companies Act 2008.<sup>110</sup> There are specific requirements on the qualifications of these practitioners, including the licensing of persons to act as practitioners by the CPIC,<sup>111</sup> their appointment and removal,<sup>112</sup> their powers and duties,<sup>113</sup> and their remuneration.<sup>114</sup> Similarly, liquidators for the winding-up of entities are regulated in detail under the Companies Act 1973 (together with relevant provisions of the Insolvency Act). These rules include provisions on appointment and removal of liquidators,<sup>115</sup> costs and remuneration,<sup>116</sup> and their powers and duties.<sup>117</sup> Business rescue practitioners are remunerated in terms of a tariff prescribed under the Companies Act 2008.<sup>118</sup> This is a time-based remuneration fee as opposed to the commission-based fee structure paid to liquidators in the case of winding-up.<sup>119</sup> The remuneration of business rescue practitioners

<sup>104</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 141.

<sup>105</sup> *Ibid.*

<sup>106</sup> *Idem*, s 157.

<sup>107</sup> *Idem*, s 158.

<sup>108</sup> Local Government: Municipal Structures Act 117 of 1998, s 35.

<sup>109</sup> *Ngaka Modiri Molema District Municipality v Moto-Tech (Pty) Ltd* [2017] ZANWHC 54.

<sup>110</sup> Companies Act 71 of 2008, chap, 6 part B.

<sup>111</sup> *Idem*, s 138; and Companies Regulations, 2011, regs 126-127.

<sup>112</sup> Companies Act 71 of 2008, s 139.

<sup>113</sup> *Idem*, ss 140-142.

<sup>114</sup> *Idem*, s 143; and Companies Regulations, 2011, reg 128.

<sup>115</sup> Companies Act 61 of 1973, ss 367-380.

<sup>116</sup> *Idem*, ss 383-384.

<sup>117</sup> *Idem*, ss 386-411.

<sup>118</sup> Companies Regulations, 2011, reg 128.

<sup>119</sup> Regulations for the Winding-up and Judicial Management of Companies, 1973, reg 24.



for state-owned companies is set at the same level as that for large companies, that is at the highest level.<sup>120</sup>

Courts play distinct roles in all three frameworks governing LPEs in distress. South Africa has a unitary judicial system so that the same courts deal with all matters, regardless of the cause of action (with a few exceptions that are not relevant in the current context). The High Court thus deals with all proceedings relating to LPEs in distress in the same way that it deals with corporate entities in distress. The High Court has specific powers in relation to the general liquidation and business rescue legal frameworks and the specialised framework for municipal entities in distress.

In the case of the winding-up of a company under the general rules governing liquidation under the Companies Act 1973, the Master of the High Court retains a general oversight function over the work of the liquidator and needs to provide consent for certain actions of liquidators, for example termination of lease agreements or sale of immovable property prior to convening a general meeting of creditors.<sup>121</sup> A liquidator is obliged to file with the Master an account of receipts and payments and a distribution plan.<sup>122</sup> Objections to this account may be lodged with the Master and the Master may sustain a complaint and direct the liquidator to amend the account.<sup>123</sup> The Master may also, in the absence of a complaint, direct the liquidator to adjust the account.<sup>124</sup> Once all adjustments have been made, the Master must confirm the account and such confirmation has the effect of a final judgment.<sup>125</sup> Only after such confirmation may the liquidator distribute the assets.<sup>126</sup> Once the entire process has been finalised, that is, the company has been finally wound-up, the Master must lodge a certificate with the Companies and Intellectual Property Commission to that effect and the Companies and Intellectual Property Commission must record the dissolution of the company.<sup>127</sup>

### 3.2 Technical rules / procedures

The aim of a financial recovery plan under the MFMA must be to secure the entity's ability to meet its obligations to provide basic services or its financial commitments.<sup>128</sup> The plan must identify the financial problems and the strategy for addressing those problems in order to place the entity in a sound and sustainable financial condition.<sup>129</sup> The plan may also provide for the liquidation of specific assets, although those may not include assets

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<sup>120</sup> Companies Regulations, 2011, reg 128.

<sup>121</sup> Companies Act 61 of 1973, ss 381 and 386.

<sup>122</sup> *Idem*, s 403.

<sup>123</sup> *Idem*, s 407.

<sup>124</sup> *Ibid*.

<sup>125</sup> *Idem*, s 408.

<sup>126</sup> *Idem*, s 409.

<sup>127</sup> Companies Act 71 of 2008, s 82.

<sup>128</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 142.

<sup>129</sup> *Ibid*.

needed for the provision of the minimum level of basic municipal services and for debt restructuring or debt relief.<sup>130</sup>

The rules pertaining to debt restructuring under the MFMA allows an LPE in distress to apply to court for an order:<sup>131</sup>

- staying (up to a maximum of 90 days at a time) all legal process (including execution) by creditors;
- suspending the entity's financial obligations to creditors (or any portion thereof) until the entity can meet those obligations; or
- terminating the entity's financial obligations to creditors and to settle claims in terms of a distribution scheme.

The suspension or termination of debt may only be ordered if a financial recovery plan has been implemented, is unlikely to succeed without such order and if liquidation of all non-essential assets will be insufficient to cover the debt.<sup>132</sup> Furthermore, for a termination order, it must also be shown that all employees have been discharged except those affordable in terms of reasonably projected revenues as set out in the financial recovery plan.<sup>133</sup> In case of termination, the subsequent distribution scheme must be approved by the court.<sup>134</sup>

If an LPE that is a company is liquidated, the ordinary rules pertaining to enforcement actions apply. For LPEs that are companies, the Companies Act 1973 provides that all civil proceedings against the entity shall be suspended until the liquidator is appointed.<sup>135</sup> All attachment or execution proceedings initiated after the winding-up will be void.<sup>136</sup> Creditors wishing to pursue claims against the entity post commencement of the winding-up must notify the liquidator within four weeks after their appointment or will be considered having abandoned the proceeding.<sup>137</sup>

Similar provisions apply in the case of business rescue proceedings under the Companies Act 2008, which would apply to LPEs placed under business rescue. In such a case, once the business rescue proceedings commence, section 133(1) of the Companies Act 2008 provides that no legal proceedings may be commenced or proceeded with against the company except under strictly prescribed conditions.

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<sup>130</sup> *Ibid.*

<sup>131</sup> *Idem*, ss 152 and 153.

<sup>132</sup> *Idem*, ss 154 and 155.

<sup>133</sup> *Idem*, s 155(1)(c).

<sup>134</sup> *Idem*, s 155(4).

<sup>135</sup> Companies Act 61 of 1973, s 359.

<sup>136</sup> *Ibid.*

<sup>137</sup> *Ibid.*

Under the special rules of the Systems Act and the MFMA, there is no automatic stay of enforcement actions. The MFMA specifically provides that the debt restructuring measures set out in the Act do not affect the rights of (i) any creditor against an entity and any person's access to ordinary legal process in accordance with the common law and relevant legislation, or (ii) a municipality or municipal entity, or of the parties to a contract with a municipality or municipal entity; to alternative dispute resolution mechanisms, notice procedures and other remedies, processes or procedures.<sup>138</sup> As noted above, a court may grant upon application either a stay or suspension of legal process against an entity.

There are no special rules governing new and interim financing for LPEs in distress. As noted above, South African courts have held that there is no duty on other levels of government (national or provincial government) to provide funds to local governments to enable it to pay its debts.<sup>139</sup> The general rules on business rescue under the Companies Act 2008 provide for post-commencement finance to be secured against any assets of the company not already encumbered and to be repaid as a preferential claim.<sup>140</sup> This may only occur after payment of the business practitioner's remuneration and expenses and other costs arising from the business rescue proceedings and of claims by employees for services rendered during the business rescue proceedings.<sup>141</sup>

#### **4. Dealing with local public entities in distress - law in practice**

The phenomenon of LPEs in distress is a very common one in South Africa, especially relating to municipalities.<sup>142</sup> In 2004, the Auditor-General questioned the ability of municipalities to continue as going concerns in the face of massive increases in municipal debt, with a rise of 12% between the years 2002 and 2003 alone.<sup>143</sup> The position has only worsened since then. In the 2019-2020 general audit report on local government, the Auditor-General stated that:

"local government finances continue to be under severe pressure ... The financial position of just over a quarter of municipalities is so dire that there is significant doubt that they will be able to continue operating as a going concern in the near future ... Almost half of the other municipalities are

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<sup>138</sup> Local Government: Municipal Finance Management Act 56 of 2003, s 151.

<sup>139</sup> *Member of the Executive Council for Local Government, Mpumalanga v Independent Municipal and Allied Trade Union and Others* 2002 (1) SA 76 (SCA).

<sup>140</sup> Companies Act 71 of 2008, s 135.

<sup>141</sup> *Ibid.*

<sup>142</sup> See T Ajam *et al*, "Towards a municipal financial and operational sustainability strategy for the Western Cape. A report for the Western Cape Department of Local Government" (2021), available [here](#); and T Ajam, "A radical reconfiguration of the local government fiscal framework is required, not incremental tinkering", *Local Government Bulletin* (2021) 16(4) at 1.

<sup>143</sup> C Peel and A Issa, "Municipal Debts Are Rising", *Local Government Bulletin* (2004) 6(5) at 4.

exhibiting indicators of financial strain, including low debt recovery, an inability to pay creditors, and deficits.”<sup>144</sup>

In its most recently published financial data on local governments (quarter 3 of 2020-2021), the National Treasury reports that 85.2% of municipalities (that is 219 out of 278 municipalities in the country) met at least one trigger for determining serious financial problems in terms of the MFMA.<sup>145</sup> Given these levels of financial distress, it is not surprising that municipalities are heavily indebted. National Treasury indicates that as of 31 December 2020, municipalities owed their creditors ZAR 67.3 billion (approximately GBP 3.34 billion), which is an increase of ZAR 19.8 billion (approximately GBP 1 billion) from the first quarter of 2020-2021.<sup>146</sup> National aggregated municipal revenue stood at ZAR 484 billion (approximately GBP 24 billion) at 31 December 2020, while national aggregated municipal expenditure stood at ZAR 489 billion (approximately GBP 24.3 billion).<sup>147</sup> It is furthermore not surprising that interventions into LPEs, especially municipalities, have become common in South Africa.<sup>148</sup> Between 1998 and 2017, there were 140 instances of interventions in 143 municipalities under section 139 of the Constitution.<sup>149</sup> In 2020 alone, about one in five municipalities was under administration.<sup>150</sup> A very large proportion of these interventions was premised on financial distress.<sup>151</sup> The use of financial recovery plans to address municipalities in distress has accordingly become a common feature of South African local government. These interventions are not restricted to smaller, less well-resourced LPEs, but have, for example, included major cities, such as the Mangaung Metropolitan Municipality (one of eight metropolitan municipalities in the country).

Following serious financial distress, a voluntary financial recovery plan was prepared for the Mangaung Metropolitan Municipality in 2018. However, the municipal council repeatedly failed to effectively implement the plan and the provincial government

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<sup>144</sup> Auditor-General of South Africa, *Consolidated General Report on the Local Government Audit Outcomes MFMA 2019-20* (2021) at 8.

<sup>145</sup> National Treasury, “Municipalities Meeting Criteria for Determining Serious Financial Problems in Terms of Section 138 & 140 of the MFMA – Q3 2020/21” (2021), available [here](#). See M D Glasser and J Wright, “South African municipalities in financial distress: what can be done?”, *Law, Democracy and Development* (2020) 24 413 at 419 for a discussion on what these triggers entail.

<sup>146</sup> National Treasury, “Media StatementK – Local Government Revenue And Expenditure: Second Quarter Local Government Section 71 Report For The Period: 1 July 2020 - 31 December 2020” (2021), available [here](#).

<sup>147</sup> *Ibid.*

<sup>148</sup> J De Visser and J November, “Overseeing the Overseers. Assessing Compliance with Municipal Intervention Rules in South Africa”, *Hague Journal on the Rule of Law* (2017) 9 109 at 114.

<sup>149</sup> T Ledger and M Rampedi, *Mind the gap: section 139 interventions in theory and in practice* (1<sup>st</sup> ed, Public Affairs Research Institute, Johannesburg, 2019) at 4. Also see J De Visser and J November, “Overseeing the overseers: assessing compliance with municipal intervention rules in South Africa”, *Hague Journal on the Rule Law* (2017) 9(1) at 109.

<sup>150</sup> J Griffiths, “The decline and fall: One in five municipalities in a state of collapse”, *Daily Maverick* (6 October 2020), available [here](#).

<sup>151</sup> J De Visser and J November, “Overseeing the Overseers. Assessing Compliance with Municipal Intervention Rules in South Africa”, *Hague Journal on the Rule of Law* (2017) 9 109 at 117-118.

consequently undertook a mandatory intervention under section 139 of the Constitution.<sup>152</sup> This involved the appointment of a team of administrators to guide the process of developing and implementing a revised financial recovery plan. While the team was appointed in January 2020, their terms of reference were only finalised in May 2020 and a plan was only finalised by December 2020.<sup>153</sup> The South African Local Government Association (SALGA) has accordingly questioned the efficacy of the intervention, including the intervention mechanism under section 139 of the Constitution.<sup>154</sup> SALGA has, for example, pointed out that while the provincial government decided to intervene in Mangaung Metropolitan Municipality in December 2019, the provincial government owed Mangaung Metropolitan Municipality about ZAR 630 million (approximately GBP 31.3 million) at the end of June 2020.<sup>155</sup> SALGA accordingly pointedly asked “[h]as provincial government not contributed to the financial collapse of Mangaung Metro?”.<sup>156</sup> These comments reflect the ostensible disconnect between the powers of provincial governments to intervene in LPEs in distress and the obligations of provincial governments to financially assist LPEs in distress.

A range of practical issues have emerged around interventions in municipalities, specifically relating to the appointed administrator. These include the fact that there are no qualification requirements for such administrators resulting in the appointment of inappropriate and often inexperienced and unqualified persons.<sup>157</sup> This stands in stark contrast to the regulatory frameworks governing business rescue and liquidators that are subjected to extensive qualification criteria. Another problem is the refusal of municipal administrations to co-operate with administrators, including to the extent of refusing them access to municipal premises and information.<sup>158</sup> These difficulties may be partly due to the fact that the administrator steps into the shoes of the municipal council while the municipal administration, under the leadership of the municipal manager, remains in place.<sup>159</sup> It thus seems that the appointment of an administrator may be insufficient if the senior municipal officials remain in place. This is supported by various case studies. For example, the success of the intervention in the Cederberg Municipality was partly ascribed to the appointment of an acting municipal manager during the first phases of the

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<sup>152</sup> Ministry of Finance Republic of South Africa, “Media Statement - Mangaung Intervention in terms of section 139(5)(a) & (c)” (2020), available [here](#).

<sup>153</sup> South African Local Government Association, “A SALGA reflection on section 139 interventions” (2020), available [here](#).

<sup>154</sup> *Ibid.*

<sup>155</sup> *Ibid.*

<sup>156</sup> *Ibid.*

<sup>157</sup> T Ledger and M Rampedi, *Mind the gap: section 139 interventions in theory and in practice* (1<sup>st</sup> ed, Public Affairs Research Institute, Johannesburg, 2019) at 11; and D M Mohale, “Placement of municipalities under administration. A comparative case study of Masilonyana and Nala Local Municipalities in the Free State Province in South Africa”, (unpublished thesis, University of the Witwatersrand, Johannesburg, 2013) at 144-116, available [here](#).

<sup>158</sup> *Ibid.*; and *Executive Council of the Western Cape Province v Kannaland Local Municipality* [2021] ZAWCHC 51.

<sup>159</sup> See South African Local Government Association, “Municipal Support and Intervention Framework” (2020) at 53, available [here](#).

intervention.<sup>160</sup> In contrast, research into the questionable efficacy of interventions in the Masilonyana and Nala Local Municipalities doubted the wisdom of retaining failed leadership in the municipalities.<sup>161</sup>

A further regular point of criticism of interventions by provincial governments is that interventions often have little to do with financial distress and much with political agendas.<sup>162</sup> While these claims are certainly contested, Ledger and Rampedi conclusively found in their extensive study of provincial interventions that the legislative framework is unevenly applied and that interventions are in practice entirely within provincial executives' discretion.<sup>163</sup> De Visser and November have furthermore found material uncertainty regarding the appropriate basis for interventions.<sup>164</sup>

Overall, it does not seem that the dedicated legal framework for assisting LPEs in distress is particularly successful. Ledger and Rampedi found that the majority of interventions under section 139 of the Constitution could not be viewed as long-term successes.<sup>165</sup> This conclusion was largely premised on financial data, that is, on analyses of the relevant municipalities' financial positions before, during and two years after the intervention.<sup>166</sup> Worse still, the research indicated that "the worse the state of the municipality prior to the intervention - financial collapse, complete breakdown in governance structures, collapse of infrastructure, etc. - the less likely it is to be able to return to a stable financial and operating position".<sup>167</sup>

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<sup>160</sup> Western Cape Provincial Government Department of Local Government and Housing, "Case study of a provincial intervention at a municipality as a result of a financial crisis" (2006), available [here](#).

<sup>161</sup> D M Mohale, "Placement of municipalities under administration. A comparative case study of Masilonyana and Nala Local Municipalities in the Free State Province in South Africa", (unpublished thesis, University of the Witwatersrand, Johannesburg, 2013) at 116, available [here](#).

<sup>162</sup> T Ledger and M Rampedi, *Mind the gap: section 139 interventions in theory and in practice* (1<sup>st</sup> ed, Public Affairs Research Institute, Johannesburg, 2019) at 9; NCOP Cooperative Governance and Traditional Affairs, Water and Sanitation and Human Settlements Select Committee, "Joint Workshop with National and Provincial Legislatures on the Application of Section 139 of the Constitution and the need for legislation in terms of Sections 139(8)" (2010), available [here](#); N Twalo, "An analysis of the efficacy of placing ailing municipalities under administration: A case of Mnquma Local Municipality in the Eastern Cape", (unpublished thesis, University of Fort Hare, Alice, 2015) at 36; M Z Makoti and O K Odeku, "Intervention into Municipal Affairs in South Africa and its Impact on Municipal Basic Services", *African Journal of Public Affairs* (2018) 10(4) 68 at 74; and W Greffrath and G Van der Waldt, "Section 139 interventions in South African local government, 1994-2015", *New Contree* (2006) 75 at 135.

<sup>163</sup> T Ledger and M Rampedi, *Mind the gap: section 139 interventions in theory and in practice* (1<sup>st</sup> ed, Public Affairs Research Institute, Johannesburg, 2019) at 10. Also see M Z Makoti and O K Odeku, "Intervention into Municipal Affairs in South Africa and its Impact on Municipal Basic Services", *African Journal of Public Affairs* (2018) 10(4) 68 at 76.

<sup>164</sup> J De Visser and J November, "Overseeing the Overseers. Assessing Compliance with Municipal Intervention Rules in South Africa", *Hague Journal on the Rule of Law* (2017) 9 109 at 125.

<sup>165</sup> T Ledger and M Rampedi, *Mind the gap: section 139 interventions in theory and in practice* (1<sup>st</sup> ed, Public Affairs Research Institute, Johannesburg, 2019) at 13.

<sup>166</sup> *Ibid.*

<sup>167</sup> *Ibid.*

These findings suggest that the dedicated regulatory framework is ineffective in case of LPEs that are in serious financial distress, equivalent to an insolvent enterprise. Given that municipalities cannot be wound-up like insolvent enterprises, there seems to be some shortcomings in the South African legal framework dealing with LPEs in distress.

## Local public entities in distress - a critical analysis of the Ugandan approach

By Hamiisi Junior Nsubuga\*

In Sub-Saharan Africa, few countries have provisions in their legal frameworks dealing with municipal or local public entities in distress.<sup>1</sup> Uganda is one of those countries lacking comprehensive rules in the area.

Pursuant to the Ugandan insolvency framework, there are no special rules applicable to local public entities in distress or insolvency. Insolvency and bankruptcy proceedings only apply to individuals and companies. Nevertheless, some of these procedures could apply to what could be termed as hybrid local public entities, as will be evidenced later in this chapter.

This chapter explores and analyses the subject of local public entities' insolvencies in Uganda's legal system (especially its insolvency framework), the provisions for the governance and regulation of local public entities in financial difficulties, and more in general the challenges that the subject presents to the legal system and extant stakeholders.

### 1. General context of insolvency law

#### 1.1 Existing insolvency law framework

The principal legislation governing insolvency in Uganda is the Insolvency Act 2011,<sup>2</sup> which regulates formal insolvency procedures such as administration,<sup>3</sup> voluntary arrangements,<sup>4</sup> receivership,<sup>5</sup> liquidation<sup>6</sup> and cross-border insolvency proceedings.<sup>7</sup> The Insolvency Act 2011 is supplemented by the Insolvency Regulations 2013, which provide a series of administrative rules for running insolvency proceedings. The other legislation in this area is the Companies Act 2012,<sup>8</sup> which includes provisions that deal with corporate insolvency and financial distress. For example, the Companies Act 2012 includes rules on

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<sup>1</sup> M Glasser, "Municipal Bonds in Three Countries: India, South Africa and the United States", *Journal of Comparative Urban Law and Policy* (2020) 4(1) at 96; and M D Glasser and J Wright, "South African municipalities in financial distress: what can be done?", *Law, Democracy, and Development* (2020) 24 413 at 441.

<sup>2</sup> Insolvency Act 2011 (Act 14 of 2011).

<sup>3</sup> *Idem*, ss 140-162.

<sup>4</sup> *Idem*, ss 125-137.

<sup>5</sup> *Idem*, Pt VII, ss 180-197.

<sup>6</sup> *Idem*, ss 56-124.

<sup>7</sup> *Idem*, Pt IX, ss 212-252.

<sup>8</sup> Companies Act 2012 (Act 1 of 2012).



creditor compromises and arrangements,<sup>9</sup> reconstructions and amalgamation,<sup>10</sup> and voluntary winding-up.<sup>11</sup>

In addition, the Financial Institutions Act 2004<sup>12</sup> (as amended) deals with banks and financial institutions experiencing financial difficulties. The procedures under the Financial Institutions Act 2004<sup>13</sup> may include a purchase of assets and assumption of liability transaction,<sup>14</sup> or a statutory takeover by appointment of a statutory manager to oversee the rescue proceedings.<sup>15</sup>

These statutes are also complemented by some other regulations pertinent to insolvency proceedings that aim to professionalise and improve transparency and efficiency in the insolvency field. These regulations include the:

- Insolvency Practitioners Regulations (Number 55 of 2017), which provide for registration and regulation of insolvency practitioners with the official receiver;
- Insolvency (Investigations and Prosecutions) Regulations (Number 4 of 2018), which set out the procedure for investigating and prosecuting insolvency practitioners, directors, shareholders and contributories, and all present and past members of the insolvent company involved in insolvency proceedings; and
- Insolvency Fees (Amendment) Regulations (Number 5 of 2018), which prescribe the fees payable in insolvency matters as provided for under the Insolvency Act 2011.

Uganda's insolvency system may be described as being debtor-friendly and it adopts a fragmented approach.<sup>16</sup> One of the reasons for this debtor-friendly approach is the lack of statutory requirements for filing for insolvency. For instance, section 58 of the Insolvency Act 2011 allows, but does not mandate, the debtor to file for voluntary liquidation upon a special resolution by its shareholders, provided that the company cannot continue to operate by reason of its liabilities. However, company directors may be sanctioned for failure to cease trading where a company is insolvent and the sanction carries a disqualification from assuming office as a director for a period of three years.<sup>17</sup>

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<sup>9</sup> *Idem*, s 234.

<sup>10</sup> *Idem*, ss 236-245.

<sup>11</sup> *Idem*, Pt XI, ss 268-272.

<sup>12</sup> Financial Institutions Act 2004, s 54.

<sup>13</sup> Financial Institutions Act 2004, Pt IX, ss 82-93.

<sup>14</sup> *Idem*, s 89(1) and (2).

<sup>15</sup> *Idem*, s 88. See further on this aspect: H J Nsubuga, "The Role of the Central Bank in Financial Distress Management and Resolution in Developing Economies", *Journal of International Banking Law and Regulations* (2020) 35(5) at 208.

<sup>16</sup> On this aspect see generally, H J Nsubuga, "Reinvigorating Corporate Rescue in Developing Economies - a Ugandan Perspective", *Insolvency Intelligence* (2021) 34(4) 95 at 102.

<sup>17</sup> Companies Act 2012, s 199(1)(r).

Beside liquidation procedures, most rescue processes prescribed by the Insolvency Act 2011 and the Companies Act 2012 are perceived as more protective towards the debtor than its creditors. On the one hand, the administration procedure, although seen as an inclusive procedure as it considers creditor interests as a whole, affords significant protections to the debtors through mechanisms such as a moratorium on executory actions from the creditors for a set period of time.<sup>18</sup> Receivership, on the other hand, favours the interests of those creditor(s) holding qualifying floating charges against the debtor's assets. However, receivership is not a collective procedure. Voluntary arrangements are also debtor-driven, with provisions to bind creditors and classes of creditors where certain resolutions are passed with the majorities prescribed by the law.<sup>19</sup> Finally, liquidation proceedings also tend to favour the debtor as most powers are left to him.<sup>20</sup>

## 1.2 Current insolvency law reforms

Currently, there are no ongoing general insolvency law reforms on either corporate and / or municipal insolvencies or personal insolvencies. In 2016, the Government spent USD 300 million for the bailout of distressed companies that were considered viable and capable of contributing to the economy. However, this initiative was labelled as being "politically motivated" and insufficient to address the problems of the economy.<sup>21</sup>

## 2. Local public entities in context

### 2.1 Generic definitions or *ad hoc* mission statements of local public entities

Uganda's main insolvency laws, the Insolvency Act 2011 and Companies Act 2012, contain no specific sections, statements or references to public entity or local public entity insolvency. This is because insolvency or bankruptcy law only apply to individuals and companies. Subject to minor exceptions, the following entities are exempted from insolvency procedures:<sup>22</sup>

- local governments / cities / municipalities;
- non-governmental organisations;
- the Government itself;
- national / social security funds;

<sup>18</sup> Insolvency Act 2011, ss 139(4) and 164.

<sup>19</sup> Companies Act 2012, s 234.

<sup>20</sup> See, for instance, Insolvency Act 2011, ss 25 and 70.

<sup>21</sup> DW "Uganda Company Bailouts Politically Motivated" (28 July 2016), available [here](#).

<sup>22</sup> These are corporations established by a Government statutory instrument with a special purpose mandate. They are either owned partly, or supported by, the Government with a Government mandate to provide certain public services.

- public trusts and public-private partnerships; and
- national parastatal entities (with minor exceptions to statutory corporations).

There is no doubt that the enactment of the Insolvency Act 2011 and the Companies Act 2012 introduced much-needed reforms to Uganda's corporate and insolvency law. Prior to the enactment of these acts, the existing laws at the time (the Bankruptcy Act 1931 and Companies Act 1961) were enacted in early 1940s and 1960s. They were modelled on the English Bankruptcy Act 1914 and the English Companies Act 1948, respectively. Therefore, reform of the law was long overdue to become streamlined with more recent international trends.<sup>23</sup>

The introduction of simplified corporate insolvency mechanisms, such as provisional administrations<sup>24</sup> with moratorium,<sup>25</sup> a simplified company voluntary arrangement procedure,<sup>26</sup> receiverships,<sup>27</sup> and the insertion of a schedule on cross-border insolvency law provisions in the Insolvency Act 2011<sup>28</sup> have been hailed as welcome changes. However, the subject of municipal insolvency was totally overlooked. To date, no laws regulate the treatment of local public entities in financial difficulties.

It is envisaged that an efficient modern insolvency model would provide a sense of purpose geared towards serving the needs of local public entities in financial difficulties, alongside corporate and personal insolvencies. The absence of a clear vision and purpose in Uganda's current insolvency framework on the treatment of local public entities in financial difficulties remains a concern. There is, therefore, scope for the Insolvency Act 2011 or the Companies Act 2012 to be revised to include a schedule on the treatment of local public entities in distress in order to safeguard extant stakeholder interests.

### 3. Dealing with local public entities in distress

#### 3.1 The legal framework

Uganda's legal framework does not prescribe a "stand-alone" system for dealing with local public entities in distress. Local public entities in Uganda are corporations operating in both the private and public sector that are either totally or partially owned, or otherwise supported by the Government, with a mandate to provide certain public services. Examples of these entities include municipalities, councils, cities and other public utility entities, such as the National Water and Sewerage Corporation, the Uganda Post Office, Uganda Telecom, and Uganda Railways Corporation.

<sup>23</sup> C Nyombi, A Kibandama and D Bakibinga, "The Motivation Behind Uganda's Insolvency Act 2011", *Journal of Business Law* (2014) (8) 651 at 666.

<sup>24</sup> Insolvency Act 2011, Pt VI, ss 139-161.

<sup>25</sup> *Idem*, ss 139(4) and 164.

<sup>26</sup> *Idem*, ss 125-137.

<sup>27</sup> *Idem*, Pt VII, ss 180-197.

<sup>28</sup> *Idem*, Pt IX, ss 212-252.

These local public entities are excluded from filing for insolvency proceedings themselves. When such entities are financially struggling, the Government has the mandate to intervene by either taking over these entities and placing them under statutory receivership, or by converting their debts into equity. This is analysed further in paragraph 4 of this chapter.

### **3.2 Differences between local public entities and the “general” corporate insolvency framework**

The ultimate objective of insolvency law is to support corporate rescue and to avoid unnecessary or avoidable liquidations. In Uganda, local public entities are treated differently from other corporations. While the provisions and processes of general corporate rescue laws are clearly provided for in legislation,<sup>29</sup> provisions on local public entities in distress and their rescue objectives are not. However, the Government has the power to intervene in the insolvency of local public entities and use procedures such as administration,<sup>30</sup> receivership or as a last resort liquidation to offer an orderly process that is fair to all stakeholders.<sup>31</sup> Additionally, the Government has the power through the official receiver to appoint professional insolvency practitioners, such as administrators, receivers or statutory managers to run the financially struggling local public entity to enable it back to solvency.

### **3.3 Liquidation of local public entities**

Ultimately, local public entities are allowed to be liquidated under liquidation provisions in the Insolvency Act 2011 and Companies Act 2012 where attempts at rescue are unsuccessful. Any decision in the area needs to obtain the preliminary approval from the Government. Where there is a need for liquidation, proceedings are initiated via court on application by the insolvency practitioner under the supervision and oversight of a Government-appointed official receiver. It is the role of the official receiver to appoint the liquidator into office to oversee the liquidation proceedings. However, local public entities can also be restructured through the appointment of an administrator by the official receiver’s office, and the administrator has to observe the duties and objectives as established for administration proceedings in the Insolvency Act 2011.<sup>32</sup>

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<sup>29</sup> See, eg, Insolvency Act 2011, Pt IV, ss 56-118 for all provisions on liquidation; Pt V, ss 119-135 on arrangements; Pt VI, ss 138-174 on administration proceedings; and Pt VI, ss 175-195 on receivership. Also see Companies Act 2012, ss 234-250 on arrangements and reconstruction; and Pt IX, ss 268-272 on winding-up provisions.

<sup>30</sup> I Khisa, “UTL on Route to Recovery following Administration”, *The Independent* (Kampala, 20 November 2017), available [here](#).

<sup>31</sup> R Mugabe, “URSB takes charge of UTL”, *New Vision* (29 April 2017), available [here](#).

<sup>32</sup> Insolvency Act 2011, s 140.

### 3.4 State oversight and financial assistance of local public entities

Unlike other developed jurisdictions of the world, the topic of municipal insolvency has so far received little attention in developing jurisdictions such as Uganda.<sup>33</sup> Perhaps, this topic is considered to bear little practical importance to attract the attention of insolvency scholars, practitioners, policymakers and politicians in Uganda. This may partially be attributed to the fact that although local public entities in Uganda can enter into private contractual undertakings with extant stakeholders, these contractual undertakings are mainly borne by the State, as local public entities are under the regulation and oversight of the Ugandan Government. As such, these contracts may be viewed as being based on the theoretical underpinnings of the principle of agency. A local public entity is considered as an agent of the State in negotiating and entering into contractual undertakings on behalf of the State, which is the principal in this equation. The State then bears liabilities arising out of these contracts.

Perhaps, Picker and McConnell's exploration of the topic of municipal bankruptcy can shed some light on Uganda's treatment of local public entities in distress. According to Picker and McConnell, a municipality or city can be viewed as a political subdivision of the sovereign State or as the agent of the private citizens who inhabit it.<sup>34</sup> They contend that if viewed as an arm of the State, municipal bankruptcy should be treated as an occasion for consolidating the distressed municipality into larger units of Government. For larger units, the State should bear some responsibility for the debts incurred by the entity.<sup>35</sup>

Alternatively, if viewed as the agent of its private citizens, the bankruptcy framework should allow for the dissolution of the municipal corporation or local public entity into its constituent parts, followed by voluntary reorganisation into more efficient and effective units. The former viewpoint of a local public entity or municipality as an agent of the State, better suits the socio-political structure of Uganda's centralised approach. In Uganda, the Government has the utmost mandate to intervene in the insolvency of cities, municipalities, districts and corporations through the official receiver, since local public entities cannot file for insolvency proceedings on their own initiative.

### 3.5 Influence by international organisations: the World Bank and UNCITRAL

International organisations, such as the World Bank and the United Nations Commission on International Trade Law (UNCITRAL), have had some influence in shaping Uganda's insolvency law. For example, while drafting the Insolvency Act 2011, Ugandan legislators and policy makers were influenced by the UNCITRAL Model Law on Cross-Border Insolvency 1997, and its provisions were adopted into the Insolvency Act 2011.

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<sup>33</sup> On this aspect, see D L Dubrow, "Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?", *Urban Law* (1992) 24 at 539; and E Vaccari, "Municipal Bankruptcy Law: A Solution Which Should Not Become a Problem", *Nottingham Insolvency and Business Law e-Journal* (2017) 5 at 1.

<sup>34</sup> R C Picker and M W McConnell, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy", *University of Chicago Law Review* (1993) 60 425 at 427.

<sup>35</sup> *Ibid.*

Specifically, Part IX of the Insolvency Act 2011<sup>36</sup> sets out these cross-border provisions by mandating the Minister to make a declaration on reciprocating states that have enacted laws for reciprocity in insolvency which have the same effect as those under Part IX of the Insolvency Act 2011. Where this is the case, the Minister may by statutory instrument declare such a state to be a reciprocating state and any court having jurisdiction on insolvency issues will be a reciprocating court for purposes of the Insolvency Act 2011.<sup>37</sup>

### 3.6 Parties to the restructurings and insolvencies of local public entities

#### 3.6.1 The official receiver

The insolvency regulator in Uganda is the official receiver of the Government of Uganda whose appointment is mandated under section 198 of the Insolvency Act 2011. The official receiver is the custodian and holder of the official receiver's seal that certifies, commissions and authenticates official deeds in insolvency proceedings in the country.<sup>38</sup>

The powers and functions of the official receiver are outlined under section 199 of the Insolvency Act 2011, and these include *inter alia*, the power to:

- (a) investigate all forms of directorial or shareholder impropriety, fraud and similar acts committed by past and present officers, directors, and shareholder in relation to the company undergoing insolvency proceedings;
- (b) investigate insolvency practitioners and to prosecute where offences are committed during proceedings; and
- (c) take all necessary steps and actions considered fit for the enforcement of the provisions under the Insolvency Act 2011.<sup>39</sup>

The official receiver also plays a key role in cross-border insolvency proceedings, if these proceedings are taking place in a reciprocating state. For instance, the official receiver in Uganda has the power to ask the official receiver in a reciprocating state, such as Kenya or Tanzania, to act as their agent and undertake all of the duties that the official receiver in Uganda would have undertaken. This may include agreeing on creditor settlements or taking possession of assets or properties subject to relief or discharge.<sup>40</sup>

<sup>36</sup> Insolvency Act 2011, Pt IX, ss 213 and 214.

<sup>37</sup> See further, H J Nsubuga, "The Call for Harmonisation of Cross-border Insolvency Laws to enable Cross-border Filing and Litigation in the East African Community", *International Company and Commercial Law Review* (2019) 30 (12) 659 at 665.

<sup>38</sup> Insolvency Act 2011, s 200.

<sup>39</sup> *Idem*, s 199 sets out a full list of the powers and functions of the official receiver.

<sup>40</sup> *Idem*, ss 218 and 224.

### 3.6.2 Court jurisdiction over local public entities in distress

In both domestic and cross-border procedures, courts play a key role. However, since local public entities are not subject to special rules, no specialist court is mandated to deal with proceedings involving local public entities. Therefore, the court with jurisdiction over local public entities in distress is the same court that has jurisdiction over general insolvency matters. Under the Insolvency Act 2011, the High Court of the Republic of Uganda is given the mandate of jurisdiction over all matters concerning company insolvency proceedings.<sup>41</sup> The same court is afforded absolute discretion to make the necessary orders for cross-border insolvency proceedings involving companies with foreign creditors.<sup>42</sup>

Where a local public entity enters into insolvency, a Government-appointed regulator in that sector, such as the Uganda Communications Commission (regulating all communication and broadcasting companies including private and / or public and other national parastatals and statutory companies) can apply to court to have a receiver appointed to take over the management of the financially struggling local entity.

In addition, during liquidation proceedings involving local public entities, the court has the power to appoint or remove a liquidator,<sup>43</sup> confirm or amend a creditor arrangement where it is just to do so,<sup>44</sup> and approve a company resolution for voluntary liquidation,<sup>45</sup> among other things. The court also plays a key role in the supervision of liquidation proceedings. For instance, on the application of the liquidator, the court may (i) give directions on any matter arising during the course of the liquidation, (ii) confirm, reverse or modify any act or decision of the liquidator, or (iii) order an audit of the accounts of the liquidation.<sup>46</sup> In addition, the court also has the power to supervise or enforce the liquidators' duties in any case of non-compliance. Finally, the court has the power to either call the liquidator to order or sanction the liquidator's removal from office.<sup>47</sup>

In administration proceedings, once formal insolvency proceedings are initiated by the financially struggling company or entity,<sup>48</sup> the court plays a key role in hearing and granting protection against the creditors' executory actions. A successful claim for a moratorium affords the financially struggling company the breathing space needed to execute its rehabilitation endeavours.

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<sup>41</sup> *Idem*, s 254(1).

<sup>42</sup> *Idem*, Pt IX, ss 235 and 245 (on cross-border insolvency proceedings).

<sup>43</sup> *Idem*, s 81.

<sup>44</sup> *Idem*, s 83.

<sup>45</sup> *Idem*, ss 87, 89 and 93.

<sup>46</sup> *Idem*, s 117(1).

<sup>47</sup> *Idem*, s 118.

<sup>48</sup> *Idem*, s 139(ii).

### 3.6.3 *Directors and creditors in local public entity proceedings*

The directors' powers in a local entity in distress are significantly restricted upon filing formal insolvency proceedings. The directors and senior officers can no longer exercise managerial powers, which are transferred to the appointed insolvency practitioner. However, they may be called upon by the insolvency practitioner to offer advice, opinions or assistance reasonably required by the insolvency practitioner in carrying out his functions.

Creditors in insolvencies involving local entities are treated the same as in general formal insolvency proceedings. Where the procedure aims at rescuing the company, such as administration and voluntary arrangements, creditors are entitled to lodge a claim against the debtor and the general rules for the insolvency practitioner and the automatic stay apply.<sup>49</sup> However, where no formal insolvency procedures are opened, the creditors may revert to private law remedies to seize the debtors' assets or obtain other contractual remedies such as liens to recover their debts.

If the court grants permission to seize its assets, local public entities would be treated as a mere quasi-private corporate entity. This will be the situation regardless of whether the entity is fully or only partially owned by the State. Local public entities which carry out business activities are usually seen as being no different from any corporations, thus enjoying the benefits of the doctrine of separate legal personality.

The debt enforcement and recovery mechanism (of asset seizure) may be contrary to one of the pillars of insolvency law – the principle of collectivity.<sup>50</sup> Pursuant to this principle, the interests of all creditors should be given equal weight and consideration, and individual enforcement actions should be prohibited. This is because individual enforcement mechanisms may dissipate value that may otherwise be available to all creditors as a group.<sup>51</sup> However, the absence of a special regime to regulate insolvent local public entities has the effect of diminishing the importance of the collectivity principle in insolvency.

Through liens, a creditor of a local public entity may be able to obtain a garnish order (such as obtaining a lien on the debtor's future income) from the court. This could aid the recovery of the creditor's debt at the expense of other creditors. This is, for instance, what happened in the recent administration procedure involving Uganda Telecoms Limited.<sup>52</sup>

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<sup>49</sup> See generally, Insolvency Act 2011, Pts VI and VIII respectively.

<sup>50</sup> T H Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge, Harvard University Press, 1986); D R Korobkin, "Contractarianism and the Normative Foundations of Bankruptcy Law", *Texas Law Review* (1993) 71 at 98; and H J Nsubuga, "Corporate Insolvency and Employment Protection: A Theoretical Perspective", *Nottingham Insolvency and Business Law e-Journal* (2016) 4(1) at 4.

<sup>51</sup> R C Picker, "Security Interests, Misbehaviour, and Common Pools", *University of Chicago Law Review* (1992) 59 at 645; and V Finch, "Corporate Rescue: A Game of Three Halves", *Legal Studies* (2012) 32(2) at 302.

<sup>52</sup> *Uganda Telecom Limited v Ondama Samuel t/a Alaka & Co* (Miscellaneous Application No 12 of 2018).



In this case, an application was made by Uganda Telecoms Limited (while in administration) under section 164(1) of the Insolvency Act 2011 against its former lawyers, for an order to set aside a garnishee order *nisi*. The purpose of the request was to obtain a declaration that the respondent lawyers were bound by Uganda Telecoms Limited's administration deed and costs. The respondent lawyers claimed that Uganda Telecoms Limited had engaged them to undertake legal work during its insolvency proceedings but had failed to honour the request for payment, and they were seeking to recover their debt by way of garnishee proceedings. However, the application for a garnishee order *nisi* was set aside by the judge and the claim was held to be bound by Uganda Telecoms Limited's administration deed and cost. This was pursuant to section 143(1)(f)(ii) of the Insolvency Act 2011, that immediately ringfences a company and its assets upon filing for administration proceedings so that no creditor can commence or continue any action to recover its debts.

In addition, a creditor can pursue a cross-border arbitral award arising from breach of contract where the local public entity has gone into insolvency proceedings. A good example of this instance was when Uganda Telecoms Limited was able to pursue a cross-border claim against an Australian corporation during an arbitral procedure whilst Uganda Telecoms Limited was undergoing administration proceedings.<sup>53</sup>

In this case, Foster J presided over a hearing for a claim for enforcement of a foreign award made for breach of contract by the Centre for Arbitration and Dispute Resolution in Kampala, pursuant to an arbitration agreement contained in a telecommunications contract between Uganda Telecom Limited and Hi-Tech Telecom Proprietary Limited (an Australian corporation). In this case, an order was made by Foster J for Uganda Telecoms Limited to be paid USD 140,000 for recognition and enforcement of an arbitral award.<sup>54</sup>

### 3.7 The role of the State in local public entity insolvencies

In developing economies, especially in Sub-Saharan Africa, municipal bankruptcies are a relatively new phenomenon. In Uganda, local public services are delegated to local authorities (comprising of city councils, municipal councils and district councils) who provide services such as road maintenance, public health, local hospitals and health centres, local schools, markets, etcetera. Funding is provided to the local public entities by the Government through the central Government's financial allocation scheme, which is sometimes supplemented by local revenue raised by means of local tax levies. Therefore, when these entities experience financial difficulties, they do not have a formal legal framework within which to initiate restructuring or recovery mechanisms. They can only rely on the Government's intervention, usually in the form of recapitalisation or transfer of additional or supplementary funds.

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<sup>53</sup> *Uganda Telecom Limited v Hi-Tech Telecom Pty Ltd* [2011] FCA 131.

<sup>54</sup> *Idem*, at paras 138 and 140.

An example of such approach is the establishment of the Kampala Capital City Authority in 2010, courtesy of the Kampala Capital City Authority Act 2010.<sup>55</sup> The City Authority is the governing body of Kampala and has the mandate to administer Kampala's affairs under the direct supervision of the central Government. The central Government appoints the executive director, who answers to the Minister of Kampala Capital City Authority alongside a politically elected city mayor.

The City Authority is a legal entity and has *locus standi* to enter into contractual undertakings. It can sue and be sued, acquire properties and exercise other similar powers. However, all contractual undertakings, social or economic, including but not limited to tenders for residential and commercial waste collection, maintenance of roads and social employment contracts, are not taken or controlled by the City Authority. They are governed and / or controlled by the Government's Public Service Commission. From this perspective, the City Authority, although a body corporate, may be seen as non-independent entity but an agency of the central Government.

Liabilities arising from these contracts, although enforceable against the City Authority as a corporate entity, are usually borne by the central Government. The central Government stands *in loco parentis* and is responsible for any legal remedies, such as damages, arising from the contracts signed by the local authority. Therefore, where a local public entity faces financial difficulties, it is not important whether they can file for insolvency procedures. The central Government has the mandate to intervene by either taking over these entities and placing them under statutory receivership or by converting their debts into equity.

### 3.8 Technical rules and / or procedures in local public entity insolvencies

#### 3.8.1 General rules on insolvency practitioners and automatic stay on enforcement actions

Following the enactment of the Insolvency Act 2011, it is now a requirement under this Act that all insolvency practitioners, such as administrators, are licenced practitioners and subject to a regulatory body which may guide and sanction practitioners in cases of professional misconduct.<sup>56</sup> The individuals allowed to register and work as professional insolvency practitioners include those that are members of professional bodies or organisations such as certified accountants, auditors or lawyers.<sup>57</sup> Insolvency practitioners are regulated by the official receiver of the Government of Uganda, which has the mandate to prosecute all cases of professional misconduct and procedural impropriety. The Insolvency Practitioners Regulations (SI 55-2017) that came into force on 22 June 2017, provide for the official receiver to maintain an updated register of the insolvency practitioners that is open to public inspection and enquiries.

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<sup>55</sup> Kampala Capital City Authority Act 2010 (Act 1 of 2011).

<sup>56</sup> Insolvency Act 2011, Pt VIII, ss 203-209.

<sup>57</sup> *Idem*, ss 198-211.

#### 4. Dealing with local public entities in distress – case studies

This section covers the treatment of two Ugandan local public entities established with a mandate to provide certain local public services. Both local public entities experienced serious financial difficulties.

##### 4.1 Uganda Telecom Limited

Uganda Telecom Limited is a Government-owned information and communication technology and network corporation. It is a Government parastatal entity formed following the enactment of the Communications Act 1997. This Act also led to the formation of the Uganda Communications Commission (as the official regulator) of the communications industry.

To improve the services it provided, Uganda Telecom Limited was privatised in 2000 when the Ugandan Government sold 51% of the shareholding to a foreign consortium led by Ucom, while retaining a 49% stake in the company.<sup>58</sup> In July 2011, Uganda Telecom Limited became a joint venture between LAP Green of Libya, which owned 69% of the company, and the Ugandan Government, which owned the remaining 31%.

However, between 2011 and 2016, reports of Uganda Telecom Limited's financial difficulties hit the media platforms.<sup>59</sup> Following these media reports, internal management changes were undertaken and although signs of instability remained, Uganda Telecom Limited continued to operate until 2017 when severe financial difficulties were once again reported by the media, thus prompting a second Government intervention.<sup>60</sup>

In May 2017, Uganda Telecom Limited was placed in administration. The official receiver was appointed by the Government to act as its administrator to supervise the implementation of the procedure and to steer Uganda Telecom Limited back to solvency. By this time, Uganda Telecom Limited's total debt was over 709bn Shillings (equivalent to USD 197 million) with an estimated asset value of 148bn Shillings (equivalent to USD 41 million). The official receiver's office invoked protection against executory actions from the creditors<sup>61</sup> in a bid to save the financially struggling company.

As creditors' meetings and negotiations took place, it also transpired that other Government agencies that supplied utilities such as water and electricity were among the largest creditors in the procedure. Additionally, it emerged that Uganda Telecom Limited failed to make any statutory payments, such as employee pension contributions and other tax bills, to the Uganda Revenue Authority. The growing demands for debt settlements made it clear that more financial support was needed from the Government as the main

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<sup>58</sup> S Odeu, "UTL Clarifies Orascom Telecom Sale Of 80% Stake", *New Vision* (Kampala, 20 August 2001), available [here](#).

<sup>59</sup> E Angumya, "UTL in Turnaround Restructuring", *The Observer*, (Kampala, 14 May 2013), available [here](#).

<sup>60</sup> R Mugabe, "URSB Takes Charge of UTL", *New Vision* (Kampala, 29 April 2017), available [here](#).

<sup>61</sup> Insolvency Act 2011, ss 139(4) and 164.

objective of administration – rescuing Uganda Telecom Limited as a going concern – was becoming increasingly unlikely to achieve.<sup>62</sup> Therefore, the Government decided to stop other Government agencies from recovering their debts and bills from Uganda Telecom Limited. The Government mandated the official receiver to convert these debts into equity shares as a way of temporarily off-setting them.<sup>63</sup>

The administrator, with the support of the Government, secured new investment for Uganda Telecom Limited thanks to a Nigerian company, Taleology Holdings GIB Limited. This company accepted to own a 67% share in Uganda Telecom Limited for the following 20 years as part of a deal reached with the Government in October 2018.<sup>64</sup> However, Taleology Holdings GIB Limited failed to secure the funding necessary, and the deal collapsed. The collapse also meant that Uganda Telecom Limited’s administration proceedings failed and the company was put into receivership by the official receiver.<sup>65</sup> In January 2020, the Government, on recommendation of the official receiver, and the Financial Intelligence Agency mandated Justice Lydia Mugambe of the Civil Division of the High Court of the Republic of Uganda to appoint Ruth Sebatindira as receiver. At the time of writing (July 2022), Uganda Telecom Limited remains in receivership.

The case of Uganda Telecom Limited’s administration proceedings was the first involving a local public entity in Uganda since the enactment of the Insolvency Act 2011. It further highlights the difficulties caused by the lack of a streamlined insolvency framework to regulate and govern local public entities in financial difficulties. It may be argued that Uganda Telecom Limited’s administration failed due to its large debt structures and absence of a formal insolvency framework with mechanisms such as a scheme of arrangement. In other countries, these mechanisms have proven successful in dealing with insolvency restructurings of corporations with large debts.<sup>66</sup>

## 4.2 Uganda Commercial Bank

Uganda Commercial Bank was established by an Act of Parliament (the Uganda Commercial Bank Act, 1965) to fill the void created by the collapse of Uganda Credit and Savings Bank in the early 1960s. Throughout the 1970s to the 1990s, Uganda Commercial Bank provided banking, saving and investment services to millions of Ugandans, especially in rural areas, implementing a business model relying on local branches spread across the country.

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<sup>62</sup> *Idem*, s 140(b)(i). Please also note that the term “going concern” is used in this context to refer to the value of the company as a going entity for the foreseeable future as opposed to being liquidated. See also E Penrose, *The Theory of the Growth of the Firm* (Basil Blackwell, Oxford 1959).

<sup>63</sup> Y Mugerwa, “Museveni Writes off Shs200b UTL Debts”, *Daily Monitor* (Kampala, 29 January 2018), available [here](#).

<sup>64</sup> T Butagira and M Kahungu, “Nigerian Company Buys UTL at Shs268 billion”, *Daily Monitor* (Kampala, 15 October 2018)2, available [here](#).

<sup>65</sup> J Businge, “Back to the Drawing Board – UTL’s Prospective Investor Fails to Raise Capital”, *The Independent* (Kampala 19 February 2019), available [here](#).

<sup>66</sup> J Payne, “Schemes of Arrangement, Takeovers and Minority Shareholder Protection”, *Journal of Corporate Law Studies* (2011) 11(1) at 67.

However, in the early 1990s, the Ugandan Government embarked on a privatisation scheme known as the Private Sector Development Scheme. The purpose of the scheme was to privatise some State-owned corporations while retaining a controlling stake in these entities. Uganda Commercial Bank was part of the scheme.<sup>67</sup>

In late 1997, Uganda Commercial Bank experienced financial difficulties and in a bid for turnaround, a 51% stake in the bank was sold to a Malaysian conglomerate, Westmont Land Asia Bhd. However, the new buyer failed to raise the funds needed to complete the sale, which led to the collapse of the deal. Further attempts to rescue the bank resulted in the sale of 81% of its shares to a South-African based investment bank, Standard Bank.<sup>68</sup> In 2001, Standard Bank merged the newly acquired Uganda Commercial Bank with its existing bank, Stanbic Bank Uganda Limited, to complete the takeover.

The sale was completed without the need to use formal insolvency procedures. The Government relied on their executive powers to sanction the sale. This may be due to a variety of reasons, including the lack of a modern insolvency framework capable of dealing efficiently with financially struggling local public entities in Uganda. The fact that the Uganda Commercial Bank was prevented from filing formal insolvency proceedings did not facilitate the restructuring process.

At the time of the sale of the Uganda Commercial Bank, the main legislation dealing with insolvency issues was the Bankruptcy Act 1931. The main procedure available to companies in distress was receivership. Alternatively, Uganda Commercial Bank could have relied on the schemes of arrangement regulated by the Companies Act 1961. However, both statutes had been transplanted from the English legal system due to Uganda's colonial ties with the United Kingdom.<sup>69</sup> For example, section 2 of the Bankruptcy Act 1931 provided that English insolvency law should be adopted and applied in Uganda where necessary.<sup>70</sup>

The lack of experienced professionals capable of effecting a merger or reorganisation by means of a scheme led the parties to look for alternative solutions, namely the Government's intervention described above.<sup>71</sup> Moreover, the statutes were also outdated. Therefore, the case suggested the urgency of implementing statutory reform, which mirrored best international trends.<sup>72</sup>

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<sup>67</sup> M Brownbridge, "Resolving Bank Failures in Uganda: Policy Lessons from Recent Bank Failures", *Development Policy Review* (2002) 20(3) at 279.

<sup>68</sup> BBC World News, "Uganda's Largest Bank for Sale" *BBC News Online* (17 October 2001), available [here](#).

<sup>69</sup> C Nyombi, A Kibandama and D Bakibinga, "The Motivation Behind Uganda's Insolvency Act 2011", *Journal of Business Law* (2014) (8) 651 at 666.

<sup>70</sup> Bankruptcy Act 1931, s 2.

<sup>71</sup> Uganda Law Reform Commission, *A Study Report on Company Law*, ULRC Pub No 35 (2004) 7.

<sup>72</sup> J D Bakibinga, "Company Law and Business Development in Uganda", *Uganda Living Law Journal* (2004) 2 at 31; and C Nyombi, "The Development of Corporate Rescue Laws in Uganda and UK", *International Journal of Law and Management* (2015) 57(2) at 214.

## 5. Concluding remarks

These two case studies and the other challenges analysed in this chapter highlight the need for Uganda's insolvency framework to include special provisions on the treatment of local public entities in distress. Such regulation would support and facilitate their rehabilitation and rescue endeavours. This chapter also shows the urgent need to regulate other constituents that provide public services. The treatment of local public entities in distress should be legislatively regulated as they play a key role in the functioning of localities and the economy at large.

## Local public entities in distress - a critical analysis of the US approach

By Laura N Coordes\*

### 1. Introduction

The financial distress of local public entities (LPEs) raises unique and challenging issues across the United States (US) and the rest of the world. This chapter paints a picture of the US legal framework available to rehabilitate distressed LPEs.

To understand the legal treatment of distressed LPEs in the US, it is helpful to have a basic understanding of US bankruptcy law. The following subsections introduce the US Bankruptcy Code 1978 (Bankruptcy Code or Code) (part 1.2) and describe the role of bankruptcy courts in the US (part 1.3).

#### 1.1 The Bankruptcy Code

In the US, bankruptcy law is governed by federal statute. The Bankruptcy Code, enacted in 1978, is the source of substantive US bankruptcy law.<sup>1</sup> In addition, the Federal Rules of Bankruptcy Procedure govern the process of a bankruptcy case.<sup>2</sup> Finally, each bankruptcy court has developed so-called local rules that specify the governing procedures for each particular court and judge.<sup>3</sup>

The Bankruptcy Code is divided into chapters. Chapters 1, 3, and 5 contain general information applicable to bankruptcy cases. Chapters 7, 9, 11, 12, 13 and 15 each provide specific procedures for certain types of debtors or cases. Chapter 7 is the liquidation chapter; both consumers and businesses can liquidate via Chapter 7.<sup>4</sup> Chapter 11 allows individuals or businesses to reorganize their debts while continuing to operate.<sup>5</sup> Chapter 12 provides special procedures available only to certain family farmers or fishermen.<sup>6</sup> Chapter 13 provides a reorganization mechanism for individual consumers with regular income.<sup>7</sup> Chapter 15 serves debtors with cross-border cases.<sup>8</sup> Chapter 9, discussed in much greater detail below, provides a process for municipal debt adjustment.

Although the current Bankruptcy Code has been in effect since 1978, it has been amended several times. Two significant sets of amendments are those found in the Bankruptcy

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<sup>1</sup> Bankruptcy Code, ss 101 *et seq.*

<sup>2</sup> Federal Rules of Bankruptcy Procedure 1983, r 1001 *et seq.*

<sup>3</sup> See, eg, Local Rules of Bankruptcy Procedure for the District of Arizona 2018.

<sup>4</sup> Bankruptcy Code, ss 701 *et seq.*

<sup>5</sup> *Idem*, ss 1101 *et seq.*

<sup>6</sup> *Idem*, ss 1201 *et seq.*

<sup>7</sup> *Idem*, ss 1301 *et seq.*

<sup>8</sup> *Idem*, ss 1501 *et seq.*

Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005<sup>9</sup> and the Small Business Reorganization Act (SBRA) of 2019.<sup>10</sup> BAPCPA introduced new provisions for small business debtors as well as substantial reforms to parts of the Code addressing individual, consumer bankruptcy cases. The SBRA, which came into effect in February of 2020, creates a new subchapter V within Chapter 11, which provides a more streamlined procedure for small business reorganizations.

The US generally takes a unified approach to bankruptcy law, in the sense that all laws related to bankruptcy are contained within the Bankruptcy Code. However, recently, the US Congress created a set of bankruptcy laws specifically for Puerto Rico and its territorial instrumentalities via the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA).<sup>11</sup> As of this writing, PROMESA has only been used to address Puerto Rico's financial crisis, and it remains to be seen whether and how PROMESA will influence further developments in bankruptcy law.

Reasonable minds can differ over whether the Bankruptcy Code is debtor- or creditor-friendly. The Code was designed to balance the competing interests and goals of debtors, creditors and other stakeholders.<sup>12</sup> Some believe, however, that BAPCPA was passed in response to concerns that the Code was too debtor-friendly.<sup>13</sup> Indeed, some of the amendments of BAPCPA have led some scholars to question whether certain portions of the Code are now too creditor-friendly.<sup>14</sup>

## 1.2 Bankruptcy courts and case management

In the US, bankruptcy cases are filed in special tribunals designated as "bankruptcy courts". Bankruptcy courts are so-called article I courts under the US Constitution, meaning that they are created by Congress for the specific purpose of hearing and deciding bankruptcy cases and controversies.<sup>15</sup> US bankruptcy judges are appointed by the federal circuit courts of appeals and serve 14-year renewable terms.<sup>16</sup>

Filing a bankruptcy case does not necessarily result in a change in management. Indeed, in many if not most Chapter 11 cases, the debtor's management typically remains in place throughout the case and may continue to operate the business in the ordinary course or, with court approval, even outside of the ordinary course.<sup>17</sup> In contrast, in a Chapter 7 case, a bankruptcy trustee is appointed to liquidate the debtor's assets for the benefit of

<sup>9</sup> Bankruptcy Abuse Prevention and Consumer Protection Act 2005.

<sup>10</sup> Small Business Reorganization Act 2019.

<sup>11</sup> Puerto Rico Oversight, Management and Economic Stability Act 2016.

<sup>12</sup> "Bankruptcy Basics: A Primer", *Congressional Research Service* (2018).

<sup>13</sup> L Ponoroff, "A Contemporary Approach to Ride-Through, Ipso Facto Clauses, the Nondefaulting Debtor", *Nevada Law Journal* (2020) 21 209 at 210.

<sup>14</sup> *Ibid.*

<sup>15</sup> Constitution of United States of America 1789, art I, s 8, cl 4.

<sup>16</sup> Judiciary Act 1789, s 152.

<sup>17</sup> Bankruptcy Code, ss 1107 and 1108.



creditors.<sup>18</sup> In terms of debtor management, a Chapter 9 case is more like a Chapter 11 case, in that municipal officials remain in charge of the municipality's affairs while the case progresses through bankruptcy. Indeed, the bankruptcy court is explicitly prohibited from interfering with a municipal debtor's political or governmental powers, property, or revenue.<sup>19</sup>

### 1.3 Covid-19-related reforms

Congress has made temporary reforms to the Bankruptcy Code in response to the financial impacts of the Covid-19 pandemic. However, these provisions are set to expire within 2022 and do not affect LPEs in distress.<sup>20</sup> As of this writing, there are no contemplated statutory reforms that will specifically impact the treatment of distressed LPEs in bankruptcy proceedings.

## 2. Local public entities

The determination of what constitutes an LPE for purposes of bankruptcy eligibility is the subject of some debate in the US. It should first be noted that the Bankruptcy Code defines the term "municipality" as a "political subdivision or public agency or instrumentality of a State".<sup>21</sup> This statutory definition is the basis for any court decision determining whether a given entity qualifies for Chapter 9, which is only available to "municipalities" as defined in the Code.<sup>22</sup> Importantly, however, non-bankruptcy state and federal statutes may define a municipality differently than the Code. For example, the State of Florida defines a "municipality" as "any city, town, or village duly incorporated under the laws of the state".<sup>23</sup> This conception of a municipality is substantially narrower than that found in the Bankruptcy Code.

As discussed more fully below, courts disagree on the exact contours of a "municipality", as defined in the Bankruptcy Code. However, it is generally agreed that the definition of "municipality" in the Code is broad enough to encompass both "general-purpose" LPEs, such as cities, towns, and counties, as well as "special-purpose" entities, such as hospitals, transportation authorities, and utility districts.<sup>24</sup>

Municipalities, whether general-purpose or special-purpose, are subdivisions of the state, and although many municipalities have their own local government structures, including home rule, the state in which the municipality is located is the source of its power and

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<sup>18</sup> *Idem*, s 704.

<sup>19</sup> *Idem*, s 904.

<sup>20</sup> COVID-19 Bankruptcy Relief Extension Act 2021.

<sup>21</sup> Bankruptcy Code, s 101(40).

<sup>22</sup> *Idem*, s 109(c).

<sup>23</sup> See, eg, Florida Statute 2013, s 180.01.

<sup>24</sup> M McConnell and R Picker, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy", *University of Chicago Law Review* (1993) 60 (Spring) 425 at 470 (describing special purpose entities as making up the majority of municipal debtors).

authority.<sup>25</sup> The extent of a state’s oversight of an LPE’s finances varies depending on the state and on the entity type.<sup>26</sup> Some states, such as North Carolina, take a proactive approach, strictly monitoring their local governments’ financial health with an eye toward intervention if a municipality shows early signs of distress.<sup>27</sup> Other states are more hands-off. Generally speaking, state oversight of general-purpose municipalities appears more comprehensive than state oversight of special-purpose municipalities. This may be due in part to the fact that special-purpose entities are not required to include their financial reports in the reports of the general-purpose municipality in which they are located.<sup>28</sup>

Case law provides that a key component of an “instrumentality” of a state is whether the entity in question has a public purpose, as well as the level of control the state or its agents exert over the entity’s activities in furtherance of that public purpose.<sup>29</sup> In the US, there is a growing trend of private, non-profit entities being created in order to carry out traditional government tasks and functions.<sup>30</sup> As this practice proliferates, the line between an LPE and a private entity may well become more difficult to discern.

Thus, when it comes to special-purpose entities, it is often not clear whether the entity will qualify for Chapter 9 bankruptcy. There is significant disagreement among the courts as to when a “special-purpose” entity, such as a hospital, school, or utility provider, constitutes a “municipality” under bankruptcy law and therefore qualifies for Chapter 9. Although courts will look to state law for guidance as to whether a given entity is a “municipality” for bankruptcy purposes, the state’s classification of an entity is not dispositive.<sup>31</sup> Typically, courts will assess the entity’s eligibility for municipal bankruptcy using a multi-factor test, examining whether an entity has powers typically associated with sovereign government, whether the entity has a public purpose, and the extent of the state’s control over the entity.<sup>32</sup>

Thus, although the law contains no singular mission for LPEs, they typically must perform some government function in order to qualify for Chapter 9 bankruptcy. Examples of such functions may include taxation, law enforcement, civil authority, and provision of basic public services, such as water and waste management.

Importantly, even if an LPE qualifies as a “municipality” for purposes of a bankruptcy filing, LPEs may not file for bankruptcy without specific state authorization.<sup>33</sup> This means that the state has expressly provided that the municipality, either by name or by type, may file for

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<sup>25</sup> <https://www.nlc.org/resource/cities-101-delegation-of-power>.

<sup>26</sup> *Ibid.*

<sup>27</sup> North Carolina General Statutes, Ch 159.

<sup>28</sup> R Eger and J Hermis, “Capital Structure and Performance Implications of Special-Purpose Governments” (2020) at 5, available [here](#).

<sup>29</sup> *In re Las Vegas Monorail Co*, 429 BR 770 (Bankr D Nev 2010).

<sup>30</sup> D Halbfinger, “City Sets Up a Corporation to Oversee Its Tech Projects”, *New York Times* (2012).

<sup>31</sup> *In re Las Vegas Monorail Co*, 429 BR 770 (Bankr D Nev 2010).

<sup>32</sup> *Ibid.*

<sup>33</sup> Bankruptcy Code, s 109(c)(2).

bankruptcy.<sup>34</sup> Because of the many hurdles standing between a municipality and eligibility for bankruptcy, the bankruptcy eligibility of LPEs, and particularly general-purpose LPEs, often receives substantial scrutiny from the court and creditors, as well as from the state in which the LPE is located.<sup>35</sup>

Outside of the bankruptcy process, distressed LPEs may be subject to oversight from the state government in the form of financial control boards or an emergency manager.<sup>36</sup>

Finally, LPEs may receive financing from a variety of sources. Many receive funds through taxation as well as intergovernmental (state) aid.<sup>37</sup> Caps on tax collection rates are state-specific.<sup>38</sup> Generally speaking, LPEs may issue debt.<sup>39</sup> Two of the most common forms of municipal debt are general obligation (GO) debt, secured by the municipality's full faith and credit, and revenue debt, which is guaranteed by specific revenues from the municipality.<sup>40</sup> In many cases, an LPE may be limited in terms of how much debt it can issue, for example by state law or through voter approvals.<sup>41</sup> LPEs may continue to borrow even if they become financially distressed, although such distress may trigger state oversight or concern about default.<sup>42</sup> Municipal bonds are often held by individual investors through mutual funds and exchange-traded funds.<sup>43</sup>

### 3. The legal framework for addressing local public entity distress

#### 3.1 Introduction to Chapter 9

As stated above, Chapter 9 of the Bankruptcy Code provides for municipal debt adjustment.<sup>44</sup> In addition, individual US states have provided for various mechanisms to assist financially distressed LPEs without resort to the federal bankruptcy system. For example, the State of Pennsylvania allows the Governor to declare a fiscal emergency with respect to an LPE and to petition for the appointment of a receiver to develop a recovery plan.<sup>45</sup> As another example, distressed LPEs in California are required to mediate (or, as the statute puts it, engage in a "neutral evaluation process") with "interested parties" prior to seeking Chapter 9 bankruptcy relief.<sup>46</sup> However, these state mechanisms and

<sup>34</sup> *Ibid.*

<sup>35</sup> L Coordes, "Gatekeepers Gone Wrong: Reforming the Chapter 9 Eligibility Rules", *Washington University Law Review* (2017) 94 at 1191.

<sup>36</sup> Michigan Public Act 72 1990 (authorizing the state to intervene when a local government experiences a financial emergency).

<sup>37</sup> L Coordes and T Reilly, "Predictors of Municipal Bankruptcies and State Intervention Programs: An Exploratory Study", *Kentucky Law Journal* (2016-2017) 105 493 at 505.

<sup>38</sup> *Idem*, at 506.

<sup>39</sup> See, eg, <https://mrsc.org/Home/Explore-Topics/Finance/Debt/Types-of-Municipal-Debt.aspx>.

<sup>40</sup> *Ibid.*

<sup>41</sup> *Ibid.*

<sup>42</sup> N Querolo, "Distressed Muni Borrowers Are Still Piling Up in Pandemic's Wake", *Bloomberg* (2021).

<sup>43</sup> Municipal Securities Rulemaking Board, "Trends in Municipal Bond Ownership" (2021).

<sup>44</sup> Bankruptcy Code, ss 901 *et seq.*

<sup>45</sup> Pennsylvania Municipalities Financial Recovery Act 1987.

<sup>46</sup> California Government Code 2013, s 53760.3.

procedures are not a substitute for bankruptcy, and if an LPE seeks to adjust its debt over the objection of creditors, it will need to use the federal bankruptcy process.

As a general principle, LPEs cannot be liquidated. This means that nearly all existing legal frameworks contemplate the continuation of the LPE after its distress has been addressed and, hopefully, resolved. In rare cases, LPEs may be consolidated or merged with other LPEs or, in even rarer cases, dissolved.<sup>47</sup> For various reasons, including the need for voter approval, the transfer of outstanding debt, and technical difficulties, consolidation, merger, and dissolution of an LPE is often highly disfavored or even impossible to achieve. Instead, to address an LPE's financial distress, the state in which the LPE is located may provide resources in the form of bailout funds or a debt restructuring mechanism, either as a substitute for or a supplement to, Chapter 9 bankruptcy access.

Because a distressed LPE's end-goal is generally not liquidation, "[t]he purpose of chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts".<sup>48</sup> Such debt adjustment usually occurs "by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan".<sup>49</sup> Chapter 9 of the Bankruptcy Code provides for limited oversight for municipalities seeking the protection of federal bankruptcy court, and many states have laws governing the oversight of distressed LPEs.<sup>50</sup>

The purpose of municipal bankruptcy, then, is not significantly different from the purpose of "general" corporate bankruptcy law, which seeks to provide breathing space to a corporation from its creditors and allow the corporation the ability to restructure debt.<sup>51</sup> The similarity in purpose between municipal and corporate bankruptcy is likely due to the fact that Chapter 9 borrows many of its provisions from Chapter 11, the chapter of the Bankruptcy Code that addresses corporate reorganizations. Indeed, many of Chapter 11's provisions apply, to varying degrees, in Chapter 9.<sup>52</sup> Some scholars have observed that each time that Congress has amended Chapter 9, it has become more like Chapter 11.<sup>53</sup> While there are many differences between Chapters 9 and 11,<sup>54</sup> Chapter 9 "applies a version of Chapter 11's toolkit to municipalities".<sup>55</sup>

Of course, there are also significant differences between Chapter 9 and other chapters of the Bankruptcy Code that address corporate debt. Because liquidation of municipalities is

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<sup>47</sup> For a fuller discussion of these issues, see L Coordes, "When Borders Dissolve", *Chicago-Kent Law Review* (2018) 93 at 649; and M Wilde Anderson, "Dissolving Cities", *Yale Law Journal* (2012) 121 at 1364.

<sup>48</sup> <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics>.

<sup>49</sup> *Ibid.*

<sup>50</sup> See L Coordes and T Reilly, "Predictors of Municipal Bankruptcies and State Intervention Programs: An Exploratory Study", *Kentucky Law Journal* (2016-2017) 105 at 493.

<sup>51</sup> L Coordes, "Bespoke Bankruptcy", *Florida Law Review* (2021) 73 (March) 359 at 367.

<sup>52</sup> *Idem*, at p 370.

<sup>53</sup> J Tatum, "To Disappear a City", *Syracuse Law Review* (2019) 69 105 at 110.

<sup>54</sup> M Bruckner, "Special Purpose Municipal Entities and Bankruptcy: The Case of Public Colleges", *Emory Bankruptcy Developments Journal* (2020) 36 341 at 349-53.

<sup>55</sup> L Coordes, "Bespoke Bankruptcy", *Florida Law Review* (2021) 73 (March) 359 at 375.

not permitted by Chapter 9, the goal of a Chapter 9 proceeding might be expressed as allowing the municipality itself to continue providing the basic public services within its purview. Thus, unlike Chapter 11, Chapter 9 does not provide “the ability to negotiate a sale of substantially all of [a debtor’s] assets to a private buyer”.<sup>56</sup>

### 3.2 Chapter 9’s place in the broader legal system

As discussed in more detail above, other chapters of the Bankruptcy Code provide relief to most businesses and individuals, so some variant of the Chapter 9 framework is available to many types of entities that do not qualify as LPEs. Importantly, state remedies, such as composition or receivership, supplement the federal relief available through the Bankruptcy Code. While not part of the Bankruptcy Code, the Dodd-Frank Act provides for the oversight and restructuring of systemically important financial institutions (SIFIs).<sup>57</sup> In short, although some entities remain entirely ineligible for bankruptcy relief in the US, through the Bankruptcy Code, other federal law, and state laws, a vast number of entities are eligible for some form of financial restructuring in the US.

Importantly, US bankruptcy law, and Chapter 9 in particular, has not shown much susceptibility to influence from international organizations or international laws. With respect to Chapter 9 specifically, although there have been amendments and updates over the years, the first US municipal bankruptcy legislation was enacted in 1934,<sup>58</sup> ten years before the establishment of the World Bank,<sup>59</sup> over 30 years prior to the establishment of the United Nations Commission on International Trade Law,<sup>60</sup> and almost 60 years prior to the founding of the European Union.<sup>61</sup> Thus, US municipal bankruptcy law predates many of the international organizations that might seek to influence it. Chapter 9 has not been materially amended in response to output from any international organizations, although there have been proposals for other provisions of the Bankruptcy Code to be amended based on international practice.<sup>62</sup>

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<sup>56</sup> D Dick, “Public Hospital Bankruptcies and an Evolving Functional Interpretation of the Bankruptcy Code”, *Bankruptcy Law Letter* (2019) 39(8) at 1.

<sup>57</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act 2010.

<sup>58</sup> Act of May 24, 1934 (“There is hereby found, determined, and declared to exist a national emergency caused by increasing financial difficulties of many local governmental units, which renders imperative the further exercise of the bankruptcy powers of the Congress of the United States.”).

<sup>59</sup> <https://www.worldbank.org/en/about/history>.

<sup>60</sup> General Assembly Resolution 2205(XXI) 1966.

<sup>61</sup> Maastricht Treaty on European Union 1992.

<sup>62</sup> See, eg, National Bankruptcy Conference, “Letter Re: Revisions to Chapter 15 of the Bankruptcy Code” (2018) (proposing a number of revisions to Chapter 15 of the Code so that it can function consistently with application of statutes adopted by foreign jurisdictions).

### 3.3 Chapter 9 bankruptcy proceedings: key players

This subsection provides an overview of some of the key players in a Chapter 9 case, namely: bankruptcy courts, municipal officials, state-appointed managers or boards, state government officials, mediators, creditors, and other stakeholders.

As discussed above, Chapter 9 cases are brought in bankruptcy courts, which are the same courts that have jurisdiction over other insolvency-related proceedings, such as Chapter 11 reorganizations or Chapter 7 liquidations. Bankruptcy courts are tasked with two primary roles in a Chapter 9 case: determining the eligibility of the LPE for bankruptcy, and confirming the plan produced by a distressed LPE. Bankruptcy judges are independent from the officials that manage the municipality. When an LPE files for Chapter 9, the chief judge of the circuit court of appeals in the relevant district selects the bankruptcy judge who will oversee the case.<sup>63</sup> Although state agencies and state-appointed officials, such as emergency managers, may participate in a municipal bankruptcy case and may even be instrumental in drafting the LPE's plan of adjustment, only the bankruptcy court may confirm the plan.<sup>64</sup> Nevertheless, in practice, it would be nearly impossible for an LPE to confirm a plan that lacked the state's approval or one to which the state had sustained an objection. The court must assess whether to confirm the plan using specific criteria listed in the Bankruptcy Code. These criteria include an assessment of whether the plan is in the best interests of creditors and whether it is feasible.<sup>65</sup>

Chapter 9 does not provide for the removal of local officials, and so those in charge of the distressed LPE generally remain in charge during the bankruptcy proceedings. A bankruptcy court may only appoint a trustee for very limited purposes; in practice, Chapter 9 trustees are exceedingly rare.<sup>66</sup> In addition, the bankruptcy court is prohibited from interfering with the debtor's operations, use of its property, and revenues.<sup>67</sup>

Specifically, sections 903 and 904 of the Bankruptcy Code indicate that the bankruptcy court's powers are limited in a Chapter 9 case. Pursuant to section 904, the bankruptcy court may not interfere with "(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property" without the debtor's consent.<sup>68</sup> The debtor may continue to operate in the ordinary course of business without court approval and may borrow money without court approval. In general, the court may only appoint a trustee in limited circumstances,<sup>69</sup> and the court cannot convert a Chapter 9 case to a liquidation.

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<sup>63</sup> Bankruptcy Code, s 921(b).

<sup>64</sup> See, eg, *In re City of Detroit*, 524 BR 147 (Bankr ED Mich 2014) (repeatedly referencing the state-appointed emergency manager's role in the case and detailing the plan confirmation process and requirements).

<sup>65</sup> Bankruptcy Code, s 943(b).

<sup>66</sup> *Idem*, s 926(a).

<sup>67</sup> *Idem*, ss 903 and 904.

<sup>68</sup> *Idem*, s 904.

<sup>69</sup> *Idem*, s 926.

Despite their limited role on paper, in practice bankruptcy courts are often heavily involved in Chapter 9 cases. Indeed, one municipal bankruptcy case can take up a substantial amount of a bankruptcy judge's time. This is in part because the case law in Chapter 9 is sparse, and many of the provisions imported from Chapter 11 into Chapter 9 do not work as well in the Chapter 9 context, leaving the court to gap-fill.<sup>70</sup> The court overseeing the City of Detroit's bankruptcy is an example of an especially active court. Arguably, the judge changed the entire course of Detroit's bankruptcy proceedings by insisting that the parties go to mediation while in bankruptcy and by appointing an experienced mediator who orchestrated the Grand Bargain – a deal that enabled Detroit to exit bankruptcy on better terms than it otherwise would have.<sup>71</sup>

Chapter 9 debtors may also employ professionals without court approval; however, at plan confirmation, the court must determine the reasonableness of any professional fees incurred.<sup>72</sup> The United States Trustee (UST), the government "watchdog," similarly plays a limited role in a Chapter 9 case.<sup>73</sup> The UST may appoint a creditors' committee; however, it may not move to appoint a trustee or examiner or move to convert the case to another chapter of the Bankruptcy Code.<sup>74</sup> Unlike in a Chapter 11 case, in a Chapter 9 case, the UST does not supervise case administration, monitor the debtor's financial operations, or review professional fees.<sup>75</sup>

As discussed above, states sometimes appoint emergency managers or oversight boards to assist distressed municipalities. If an LPE is under the oversight of a board or manager when it files for bankruptcy, that board or manager may continue to assist the LPE while it is in bankruptcy. For example, the Governor of Michigan appointed an emergency manager for the City of Detroit prior to Detroit filing for Chapter 9 bankruptcy.<sup>76</sup> Upon appointment, Detroit's emergency manager, Kevyn Orr, gained control over all of Detroit's financial matters, as well as the ability to recommend that the city file for Chapter 9.<sup>77</sup> Orr played a significant role in the bankruptcy proceedings when Detroit eventually filed.<sup>78</sup> Orr was a bankruptcy attorney; however, state law governs particular qualifications for emergency managers, oversight boards, and other similar entities, and it is not necessarily the case that only attorneys would be considered for the role of emergency manager or oversight board member.

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<sup>70</sup> L Napoli Coordes, "Restructuring Municipal Bankruptcy", *Utah Law Review* (2016) 2016 307 at 309.

<sup>71</sup> For a fuller discussion of this case, see L Coordes, "Formalizing Chapter 9's Experts", *Michigan Law Review* (2018) 116 at 1249.

<sup>72</sup> See generally, Bankruptcy Code, ss 903 and 904.

<sup>73</sup> Two states have bankruptcy administrators rather than USTs. In this regard, see [here](#). References in this chapter to USTs apply equally to bankruptcy administrators.

<sup>74</sup> <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics>.

<sup>75</sup> *Ibid*.

<sup>76</sup> "Snyder Appoints Emergency Manager for Detroit", *Dbusiness* (2013).

<sup>77</sup> Michigan Public Act No 436 (2012).

<sup>78</sup> L Coordes, "Formalizing Chapter 9's Experts", *Michigan Law Review* (2018) 116 1249 at 1266 (describing Orr's role as "critical" to Detroit's bankruptcy success).

Mediators are often employed in municipal bankruptcies to assist the parties with negotiations.<sup>79</sup> These mediators are often judges appointed as mediators in the case by the bankruptcy judge.<sup>80</sup> The debtor may pay for a mediator as one of the professionals that assists it with its case; however, notably, in the case of Detroit, the lead mediator was not compensated by the city.<sup>81</sup> The role of a Chapter 9 mediator is primarily to facilitate negotiations; in practice, mediators have brokered significant deals in Chapter 9 bankruptcies, such as the Grand Bargain, discussed above.<sup>82</sup>

Affected parties, including creditors and other stakeholders, are typically involved in the negotiations for a restructuring plan as well. Often, official or *ad hoc* committees of stakeholders are appointed. The Bankruptcy Code provides that the UST must appoint a committee of unsecured creditors and may appoint additional committees as appropriate in Chapter 11 cases.<sup>83</sup> These provisions are incorporated into Chapter 9, although there is some dispute over the extent to which they are incorporated.<sup>84</sup> Even courts that have found that these provisions are not fully incorporated, however, have suggested that the UST may still appoint a committee in a Chapter 9 case.<sup>85</sup> Thus, creditors' committees do exist in Chapter 9 cases and may be involved in the negotiating process.

On paper, creditors have fewer powers in Chapter 9 than in other chapters of the Bankruptcy Code. For example, creditors may not involuntarily place a municipality into bankruptcy.<sup>86</sup> In practice, however, creditors can play a significant role in a Chapter 9 case. For example, the Bankruptcy Code provides that one of the conditions an LPE must meet to be eligible for bankruptcy is to negotiate with its creditors, and creditors have used this negotiation requirement to dispute the debtor's eligibility for Chapter 9.<sup>87</sup> However, unlike in other types of bankruptcy cases, there is no meeting of creditors at which the UST examines the debtor in a Chapter 9 case. In addition, creditors are prohibited from proposing competing debt restructuring plans, as only the LPE debtor may file a plan.<sup>88</sup> A Chapter 9 debtor is also empowered to "cram down" a plan over creditor objections; however, the bankruptcy court must still find that such a plan is in the best interests of

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<sup>79</sup> *Idem*, at 1254 (noting that "judges often turn to experts such as specialists and mediators to facilitate the plan confirmation process").

<sup>80</sup> *Idem*, at 1265 and 1266 (discussing mediation in Detroit's bankruptcy).

<sup>81</sup> N Bomey, J Guillen and B Snavely, "Detroit paid advisers \$170 million in bankruptcy", *Detroit Free Press* (2014).

<sup>82</sup> L Coordes, "Formalizing Chapter 9's Experts", *Michigan Law Review* (2018) 116 1249 at 1266.

<sup>83</sup> Bankruptcy Code, s 1102(a)(1).

<sup>84</sup> *Idem*, s 901(a). The focus of the dispute is over whether s 1102(a)(1) is incorporated into Chapter 9.

<sup>85</sup> See *In re Coalinga Regional Medical Center*, 608 BR 746 (Bankr ED Cal 2019); and *In re City of Detroit, Mich*, 519 BR 673 (Bankr ED Mich 2014). Both cases found that s 1102(a)(1) does not apply in a Chapter 9 case but suggested that the UST could appoint a committee under s 1102(a)(2).

<sup>86</sup> <https://www.troutman.com/insights/a-primer-on-municipal-bankruptcy.html>.

<sup>87</sup> Bankruptcy Code, s 109(c); and L Coordes, "Gatekeepers Gone Wrong: Reforming the Chapter 9 Eligibility Rules", *Washington University Law Review* (2017) 94 1191 at 1240.

<sup>88</sup> Bankruptcy Code, s 941.



creditors.<sup>89</sup> In Chapter 9, this requirement generally means that the debtor's plan must be better than the alternative of dismissal of the case.<sup>90</sup>

With respect to the general treatment of creditors and creditor voting, Chapter 9 looks similar to Chapter 11. Creditors are separated into classes for purposes of voting, and if the debtor's plan proposes to impair a class of creditors, that class must vote to accept the plan.<sup>91</sup> However, as long as at least one impaired creditor class votes to accept the plan, the bankruptcy court may allow the debtor to cram down the plan over dissenting creditors' objections.<sup>92</sup>

Creditors holding special revenue bonds are treated akin to secured creditors, and Chapter 9 provides that the automatic stay does not apply to special revenue debt.<sup>93</sup> This means that special revenue bonds continue to be secured and must be paid in the ordinary course during the Chapter 9 case.<sup>94</sup>

Consumers or employees of the LPE hold no special priority in a Chapter 9 case. In practice, however, many bankruptcy courts have been reluctant to impose cuts on employee and retiree pensions in municipal bankruptcy cases. In particular, two courts have held that pensions may be cut in bankruptcy; however, only one court – that in Detroit – ultimately cut pensions.<sup>95</sup> Even in that case, however, the cuts to pensions were not as extensive as they could have been.<sup>96</sup>

The state government performs a gatekeeper role in Chapter 9 proceedings, as LPEs may not access bankruptcy without specific state authorization. In a US Chapter 11 case, management typically retains control of the company as "debtor in possession", and there is no insolvency practitioner.<sup>97</sup> This concept carries over to Chapter 9, in that local government officials remain in place during a Chapter 9 proceeding, and there is no requirement that they be removed or replaced.<sup>98</sup> However, state law may require that an emergency manager or board exercise oversight of the municipality as a pre-condition of filing for Chapter 9.<sup>99</sup>

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<sup>89</sup> *Idem*, s 943(b).

<sup>90</sup> J Hunt, "Taxes and Ability to Pay in Municipal Bankruptcy", *Washington Law Review* (2016) 91 (June) 515 at 555-561 (discussing this requirement).

<sup>91</sup> Bankruptcy Code, ss 901(a), 943(b)(1) and 1129.

<sup>92</sup> *Idem*, s 1129(b).

<sup>93</sup> *Idem*, s 922(d).

<sup>94</sup> *Idem*, s 928.

<sup>95</sup> L Coordes and T Reilly, "Predictors of Municipal Bankruptcies and State Intervention Programs: An Exploratory Study", *Kentucky Law Journal* (2016-2017) 105 493 at 519 (discussing the Detroit case) and 537 (discussing Stockton).

<sup>96</sup> See F Shafroth, "Protecting the Ability to Provide Essential Public Services", *GMU Municipal Sustainability Project* (2015).

<sup>97</sup> Bankruptcy Code, s 1101.

<sup>98</sup> *Idem*, ss 903, 904 and 926.

<sup>99</sup> "The State Role in Local Government Financial Distress," *Pew Charitable Trusts* (2013) (discussing various state conditions to filing for Chapter 9).

### 3.4 Chapter 9 bankruptcy proceedings: key provisions and processes

Importantly, although bankruptcy is a federal scheme in the US, municipal bankruptcy is unique in that it involves significant interaction with state and local law. The tensions between the Tenth Amendment of the US Constitution, which reserves substantial powers to the states, and the Constitution's Bankruptcy Clause, which authorizes the US Congress to enact bankruptcy laws, are on full display in a Chapter 9 case and affect the abilities of the court and other non-LPE parties to shape the outcome of the case.

The bankruptcy automatic stay applies in Chapter 9 cases, as it does in a Chapter 11 case.<sup>100</sup> As in a Chapter 11 case, the stay prohibits all collection actions against the debtor and its property upon the filing of the bankruptcy petition.<sup>101</sup> Additional protections apply in Chapter 9, which prohibit actions against officers and inhabitants of the debtor if the action in question seeks to enforce a claim against the debtor.<sup>102</sup> For example, the Chapter 9 automatic stay would prohibit a creditor from bringing a mandamus action against a municipal officer on account of a prepetition debt.<sup>103</sup> It would also prohibit "a creditor from bringing an action against an inhabitant of the debtor to enforce a lien on or arising out of taxes or assessments owed to the debtor".<sup>104</sup> However, as discussed above, a Chapter 9 petition does not stay application of pledged special revenues to payment of indebtedness secured by those revenues.<sup>105</sup> "Thus, an indenture trustee or other paying agent may apply pledged funds to payments coming due or distribute the pledged funds to bondholders without violating the automatic stay."<sup>106</sup>

In practice, bankruptcy courts tend to be hesitant to lift or otherwise provide an exception to the automatic stay in Chapter 9 cases. For example, in *In re City of San Bernardino*,<sup>107</sup> the court held that an allegation that the city committed an intentional tort was not sufficient to grant an exception to the automatic stay. The court reasoned that even requesting an injunction against the alleged conduct would amount to the exercise of control over the city's property. Because the purpose of the automatic stay is to prevent the dismembering of the estate, the court found that granting the requested relief would contravene that purpose. Other courts have refused to lift the stay for similar reasons.<sup>108</sup>

<sup>100</sup> Bankruptcy Code, ss 362 and 901(a).

<sup>101</sup> *Idem*, s 362.

<sup>102</sup> *Idem*, s 922(a).

<sup>103</sup> <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics>.

<sup>104</sup> *Ibid*.

<sup>105</sup> Bankruptcy Code, s 922(d).

<sup>106</sup> <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics>.

<sup>107</sup> *In re City of San Bernardino*, 558 BR 321 (CD Cal 2016).

<sup>108</sup> See, eg, *In re New Magma Irr & Drainage Dist*, 193 BR 528 (Bankr D Ariz 1994) (holding that the automatic stay bars counties from assessing or levying any tax against the municipality, when the tax was solely for the purpose of repaying pre-petition indebtedness); *In re County of Orange*, 179 BR 185 (Bankr CD Cal 1995) (holding that the automatic stay could not be lifted to allow claims to proceed in state court because the municipality would not have time to breathe and reorganize, in contravention of the purpose of the automatic stay); *In re City of Detroit, Mich*, 501 BR 702 (Bankr ED Mich 2013) (extending the automatic stay to a state entity on the grounds that a lawsuit against that entity directly threatened the City of Detroit's ability to continue its bankruptcy case); and *In re Jefferson County, Alabama*, 491 BR 277 (Bankr ND Ala

Although many Chapter 9 proceedings open with an extensive hearing on the municipality's eligibility for bankruptcy, the commencement of a Chapter 9 bankruptcy does not require a formal investigation or report on the causes of the LPE's financial crisis. Municipal officers may submit affidavits in support of the municipality's eligibility for bankruptcy relief, and if creditors challenge the debtor's eligibility, the bankruptcy court will conduct a hearing where the causes of the municipality's financial distress will almost certainly be examined.<sup>109</sup> Although bankruptcy law requires that a municipality be "insolvent" as a condition of filing for Chapter 9,<sup>110</sup> there is no formal power bestowed upon the bankruptcy court or any other party to investigate the causes of the crisis. State law, however, may provide that an emergency manager or board may so investigate.<sup>111</sup> Similarly, political authorities are generally not held "responsible" for the municipality's financial failure unless they have engaged in other misconduct for which they may be found separately culpable. The Bankruptcy Code does not provide for the removal of municipal officials or other authorities in charge of the LPE.

The Bankruptcy Code does not provide specific financing rules for LPEs. Generally speaking, LPEs may raise taxes subject to any limitations imposed by the state in which they are located. Municipalities may borrow money, including from the state government, during a Chapter 9 case and treat the obligation to repay as an administrative expense, which must be paid prior to the debtor's exit from bankruptcy.<sup>112</sup> However, the court does not authorize the amount of debt the municipality incurs. If the municipality borrows money as an administrative expense, that money must be repaid in full on the effective date of any confirmed debt adjustment plan.<sup>113</sup>

Notwithstanding the above, at least one court has denied allowance of administrative expense claims on the ground that a Chapter 9 debtor's property "does not inure into a bankruptcy estate" and that therefore, "there can be no administrative expenses for 'the actual and necessary costs of preserving the estate' as contemplated by section 503(b)(1)(A) of the Bankruptcy Code".<sup>114</sup>

Chapter 9 provides no rules for a state or federal government assuming a municipality's debts. There is nothing stopping a state or federal government from doing so, but there is nothing mandating it, either. Such assumption of debt would be exceedingly rare, as the

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2013) (holding that an action against a non-debtor defendant was stayed where application of the automatic stay furthered the purpose behind the stay because the bankrupt county had indemnified the non-debtor); but see *In re City of Stockton, Cal*, 499 BR 802 (ED Cal 2013) (holding that a lawsuit challenging the wording of a ballot initiative could proceed if the movant promised not to seek any monetary awards from the bankrupt city).

<sup>109</sup> L Coordes, "Gatekeepers Gone Wrong: Reforming the Chapter 9 Eligibility Rules", *Washington University Law Review* (2017) 94 at 1191.

<sup>110</sup> Bankruptcy Code, s 109(c)(3).

<sup>111</sup> "The State Role in Local Government Financial Distress," *Pew Charitable Trusts* (2013) (discussing an audit by the state of North Carolina into the town of Princeville's budget deficit).

<sup>112</sup> Bankruptcy Code, ss 364 and 901(a).

<sup>113</sup> *Idem*, ss 507(a)(2) and 943(b)(5).

<sup>114</sup> *In re New York City Off-Track Betting Corp*, 434 BR 131, 141-42 (Bankr SDNY 2010).

prevailing view is that it would encourage moral hazard, or the careless assumption of too much debt.

Neither creditors nor the court may seize or sell an LPE's assets without the LPE's consent.<sup>115</sup> Instead, creditors must abide by the bankruptcy court process, which typically means that they must adhere to whatever plan the LPE proposes. There is no specific timeframe for a Chapter 9 case to be completed. In practice, Chapter 9 cases may range from a few months in length (for special-purpose LPEs) or several years (for general-purpose LPEs).<sup>116</sup>

#### 4. The law in practice

Two fairly recent, large cases help illustrate some aspects of the law in practice. The first is the City of Detroit. Detroit filed for bankruptcy in July of 2013.<sup>117</sup> At the time, it was the largest municipal bankruptcy case in the US.<sup>118</sup> When it filed, Detroit had approximately USD 18 billion in debt.<sup>119</sup> Detroit's bankruptcy took 17 months, which, given its size, was very quick.<sup>120</sup> To achieve such a quick exit, Detroit reached numerous settlements with creditors and other groups through a mediation process. The hallmark of these settlements was the Grand Bargain, which was brokered in mediation and took the cooperation of the State of Michigan and several philanthropic organizations.<sup>121</sup> The bankruptcy judge overseeing Detroit's case did not oversee the mediation process himself but instead appointed a district judge to serve as mediator.<sup>122</sup> The Detroit case also involved the work of numerous specialists, most notably an emergency manager appointed by the State of Michigan prior to Detroit's bankruptcy filing.<sup>123</sup> Although Detroit's use of mediation and specialists was relatively unprecedented and not explicitly provided for in the Bankruptcy Code, it is highly likely that Detroit would not have emerged from bankruptcy without these features. The Detroit bankruptcy illustrates that judges can use creative mechanisms, such as mediation, within a Chapter 9 case to more quickly conclude the case and allow the municipality to return to providing essential public services to its constituents.

Recently, the US territory of Puerto Rico and several of its instrumentalities have begun Title III proceedings under PROMESA.<sup>124</sup> PROMESA provides bankruptcy relief to Puerto

<sup>115</sup> <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics> (further noting that the assets of a municipality may not be liquidated to pay creditors).

<sup>116</sup> <https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2011/11/22/municipal-bankruptcy-explained-what-it-means-to-file-for-chapter-9> (describing the city of Vallejo, California's bankruptcy, which took several years).

<sup>117</sup> N Bomey *et al*, "Detroit Becomes Largest US City to Enter Bankruptcy", *USA Today* (2013).

<sup>118</sup> *Ibid*.

<sup>119</sup> *Ibid*.

<sup>120</sup> "Detroit on Track to Exit Bankruptcy in Record Time," *Guardian* (2016).

<sup>121</sup> A Scurria, "Detroit Wins Confirmation of \$7B Debt-Cutting Plan," *Law360* (2014).

<sup>122</sup> *In re City of Detroit*, 524 BR 147, 168 (Bankr ED Mich 2014).

<sup>123</sup> *Idem*, at p 189.

<sup>124</sup> <https://www.abi.org/feed-item/the-puerto-rico-%E2%80%9Ccbankruptcy%E2%80%9D-a-cheat-sheet>.

Rico and its territorial instrumentalities through a process separate from, but quite similar to, Chapter 9.<sup>125</sup> The Title III proceedings are overseen by a district judge rather than a bankruptcy judge, and some scholars have criticized this, claiming that district judges lack the specialized expertise of bankruptcy judges to handle these cases.<sup>126</sup>

Although Puerto Rico's use of Title III is not strictly "bankruptcy" under the Bankruptcy Code, PROMESA provides the island and its instrumentalities with a substantially larger toolkit than they would receive under the Bankruptcy Code, including a mechanism for bond modification via collective creditor action and the imposition of an oversight board to direct the island's financial affairs.<sup>127</sup> Congress has justified these tools on the grounds that they are necessary to provide Puerto Rico with debt relief, as the Bankruptcy Code does not provide for territorial-level debt restructuring.<sup>128</sup> However, others have questioned whether imposition of an oversight board is constitutionally permissible and have sought to challenge the board's appointment.<sup>129</sup> The Supreme Court has upheld the appointment of the oversight board but one concurring justice raised serious questions about the overall permissibility of the board in light of other longstanding agreements between Puerto Rico and the US.<sup>130</sup> Puerto Rico's use of PROMESA may influence Chapter 9 proceedings, as the distinctions between Title III of PROMESA and Chapter 9 of the Code are minimal.

## 5. Conclusion

The US has a fairly robust and well-developed system for addressing LPE distress through the bankruptcy process. This process is supplemented by state laws providing various forms of oversight and assistance to distressed LPEs. Although Chapter 9 is far from perfect, it is rooted in a process that is nearly a century old and that has withstood the test of time. As different types of LPEs face new challenges, Chapter 9's utility will continue to be tested and, hopefully, strengthened.

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<sup>125</sup> L Coordes, "Bespoke Bankruptcy", *Florida Law Review* (2021) 73 (March) 359 at 385 (noting that Title III of PROMESA is based on Chapter 9).

<sup>126</sup> See, eg, M Jacoby, "Presiding Over Municipal Bankruptcies: Then, Now, and Puerto Rico", *American Bankruptcy Law Journal* (2017) 91 (Spring) 375 at 390.

<sup>127</sup> L Coordes, "Bespoke Bankruptcy", *Florida Law Review* (2021) 73 (March) 359 at 385-387 (describing these components of the law).

<sup>128</sup> *Idem*, at 388.

<sup>129</sup> *Idem*, at 391-392.

<sup>130</sup> *Financial Oversight and Management Board for Puerto Rico v Aurelius Investment, LLC*, 140 S Ct 1649 (2020).



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