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Adequate Protection for Secured Creditors in the Context of the Proposed EC Directive on Preventive Restructuring

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Acknowledgement

INSOL International is pleased to present a technical paper titled “Adequate Protection for Secured Creditors in the Context of the Proposed EC Directive on Preventive Restructuring” by Krijn Hoogenboezem, *Fellow, INSOL International,* Dentons Boekel N.V., Netherlands.

On 22 November 2016, the European Commission published a proposal for a directive “on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures”. This paper focuses on certain aspects of the provisions in the proposal dealing with preventive restructuring frameworks, more particularly the stay of enforcement proceedings by secured creditors against assets of the debtor and the protection that secured creditors may be entitled to in respect of such a stay. This paper looks at the provisions in chapter 11 of the US Bankruptcy Code dealing with “adequate protection” for secured creditors, as well as recent amendments to the Singapore Companies Act and assesses whether the European legislator should consider introducing the concept of “adequate protection” in the proposal.

INSOL International sincerely thanks Krijn Hoogenboezem for writing this thought-provoking technical paper.

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Adequate Protection for Secured Creditors in the Context of the Proposed EC Directive on Preventive Restructuring*

By
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I. Introduction

On 22 November 2016, the European Commission (EC) published a proposal for a directive "on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures" (the Directive Proposal).[1]

This paper focuses on certain aspects of the provisions in the Directive Proposal dealing with preventive restructuring frameworks,[2] more particularly the stay of enforcement proceedings by secured creditors against assets of the debtor[3] and the protection that secured creditors may be entitled to in respect of such a stay. In this regard, this paper will look at the provisions in chapter 11 of the US Bankruptcy Code dealing with "adequate protection" for secured creditors, as well as recent amendments to the Singapore Companies Act and will assess whether the European legislator should consider introducing the concept of "adequate protection" in the Directive Proposal.

II. The Draft Directive Proposal

Article 5 of the Directive Proposal deals with the (mandatory) introduction of Debtor in Possession (DIP) procedures in the Member States. The Directive Proposal provides that debtors accessing preventive restructuring procedures remain totally, or at least partially, in control of their assets and the day-to-day operation of the business.[4]

Article 6 of the Directive Proposal deals with a "stay of individual enforcement actions" while a restructuring plan is negotiated. A "stay of individual enforcement actions" is defined as a temporary suspension of the right to enforce a claim against a debtor, ordered by a judicial or administrative authority.[5] Paragraphs 1, 2 and 9 of article 6 of the Directive Proposal read as follows:

> 1. Member States shall ensure that debtors who are negotiating a restructuring plan with their creditors may benefit from a stay of individual enforcement actions if and to the extent such a stay is necessary to support the negotiations of a restructuring plan.
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> 2. Member States shall ensure that a stay of individual enforcement actions may be ordered in respect of all types of

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* This paper is based on a short paper submitted by the same author on the INSOL International Global Insolvency Practice Course (GIPC).

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1 *EC proposal for a directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures*, COM (2016) 723 final, 2016/0359 (COD). – hereinafter "Directive Proposal".

2 *Ibid*., Ch. 2, arts. 2 to 18 (inclusive).

3 *Ibid*., art. 6, para. 2.

4 *Ibid*., art. 5, para. 1.

5 *Ibid*, art. 2 (under (4)).

> creditors, including secured and preferential creditors. The stay may be general, covering all creditors, or limited, covering one or more individual creditors, in accordance with national law.
>
> (…)
>
> 9. Member States shall ensure that, where an individual creditor or a single class of creditors is or would be unfairly prejudiced by a stay of individual enforcement actions, the judicial or administrative authority may decide not to grant the stay of individual enforcement actions or may lift a stay of individual enforcement actions already granted in respect of that creditor or class of creditors, at the request of the creditors concerned.

The first sentence of paragraph 2 provides that a stay of individual enforcement actions may also apply to secured creditors. This is not currently a common provision in the insolvency laws of all Member States.[6] In fact, even in the context of a UK scheme of arrangement, an (explicit) stay of individual enforcement proceedings is not available (although UK courts are willing to grant relief by way of a provisional measure).[7]

Below, the concept of "adequate protection" under US federal bankruptcy law, in respect of the "unfair prejudice" referred to in paragraph 9 of article 6 of the Directive Proposal, will be examined.

However, before this is done an analysis is undertaken of the interrelationship between the stay referred to in article 6 of the Directive Proposal and article 8 of the recast European Insolvency Regulation (EIR).[8]

III. The Directive Proposal and Article 8 of the EIR

In the recast process, the text of the old article 5 has not been amended, but only renumbered to article 8 EIR. Article 8 EIR provides in paragraph 1 that:

> The opening of insolvency proceedings shall not affect the rights *in rem* of creditors or third parties in respect of tangible or intangible, moveable or immoveable assets, both specific assets and collections of indefinite assets as a whole which change from time to time, belonging to the debtor which are situated within the territory of another Member State at the time of the opening of proceedings.

It is generally understood that the consequence of article 8 EIR is that a secured creditor with a security right on an asset that is located outside of the country in which the insolvency proceedings have been opened, is not affected by the insolvency proceedings at all. Such foreign assets may even be said to be "immune" to the bankruptcy (unless secondary proceedings can be opened in the jurisdiction in which the assets are located, but this would require the debtor having an

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[6] For example, in the Netherlands neither of the two insolvency proceedings that are available (bankruptcy and suspension of payments) provide for a stay of enforcement actions by secured creditors for the purpose of a restructuring plan. On the contrary, Art. 57, para. 1, of the Dutch Bankruptcy Act (DBA) provides: "Pledgees and mortgagees may exercise their rights as if there were no bankruptcy."

[7] *Re Bluecrest Mercantile BV v Vietnam Shipbuilding Industry Group* [2013] EWHC 1146 (Comm); see also N.W.A. Tollenaar, *Het pre-insolventieakkoord, Grondslagen en raamwerk*, Wolters-Kluwer, 2016, p. 216.

[8] Council regulation (EC) No 2015/848, *PbEU* L 141/19.

establishment in that jurisdiction in terms of article 2(10) EIR).[9] This "immunity" also applies, of course, to a stay of individual enforcement actions under the laws applicable to the insolvency proceedings.

So how should a stay of individual enforcement actions, which will be laid down in national law on the basis of the Directive Proposal in respect of a preventive restructuring framework, be weighed against article 8 EIR? Could a security right on an asset located outside of the Member State in which the stay was ordered be enforced notwithstanding the stay?

A preliminary question is whether the EIR applies to the preventive restructuring frameworks as contemplated in the Directive Proposal. The decisive factor is whether these proceedings will be listed in Annex A to the EIR. It is envisaged that they will. Recital 10 of the EIR reads as follows:

> The scope of this Regulation should extend to proceedings which promote the rescue of economically viable but distressed businesses and which give a second chance to entrepreneurs. It should, in particular, extend to proceedings which provide for restructuring of a debtor at a stage where there is only a likelihood of insolvency, and to proceedings which leave the debtor fully or partially in control of its assets and affairs. It should also extend to proceedings providing for a debt discharge or a debt adjustment in relation to consumers and self-employed persons, for example by reducing the amount to be paid by the debtor or by extending the payment period granted to the debtor. Since such proceedings do not necessarily entail the appointment of an insolvency practitioner, they should be covered by this Regulation if they take place under the control or supervision of a court. In this context, the term 'control' should include situations where the court only intervenes on appeal by a creditor or other interested parties.

This is laid down in article 1(c) EIR, which provides that the regulation shall, amongst others, apply to collective proceedings in which a temporary stay of individual enforcement proceedings is granted by a court in order to allow for negotiations between the debtor and its creditors.

The Directive Proposal and the Explanatory Memorandum thereto, do not address the issue of conflicting provisions between the EIR and the Directive Proposal. It is stated that the Directive Proposal is "complementary" to the EIR but that, of course, assumes that there is not a conflict.[10] The observation is made that goods (and therefore collateral) circulate freely throughout the single market,[11] but that has not led to a provision dealing with article 8 EIR. The EIR itself is also referred to in the recitals to the Directive Proposal, but there it is only observed that the EIR does not "tackle" the discrepancies between insolvency procedures in national law, which is put forward as a reason to establish substantive minimum standards.[12]

Given the stated purpose of the Directive Proposal of allowing the debtor to continue operating its business,[13] one would certainly assume that the Directive Proposal intends to "override" article 8 EIR and allow the stay to have effect in all Member

[9] See eg, R. van Galen, *De herziene Europese Insolventieverordening*, Ondernemingsrecht 2017/3, p. 15.
[10] Explanatory Memorandum, p. 9.
[11] Directive Proposal, Recital 9.
[12] *Ibid*., Recital 10.
[13] *Ibid*., Recital 1; Explanatory Memorandum p. 21.

States in which collateral is located. However, because a European regulation - most likely[14] - "trumps" national law, even if that national law is an implementation of a European directive, this point is insufficiently (or inadequately) addressed.[15]

IV. Circumstances in Which Adequate Protection Should be Provided

A general stay on individual enforcement actions, as envisaged in the Directive Proposal, is a well-known concept (with automatic effect) in US chapter 11 proceedings. In fact, a general stay is deemed essential as "allowing a secured creditor to foreclose immediately on the debtor's property or demand payment in full from the debtor would crater the debtor's reorganization efforts at the outset; such a provision would essentially turn chapter 11 into a liquidation statute."[16]

The concept of adequate protection in the US is deemed a balancing act:

> Adequate protection is intended in part to balance the prepetition rights of secured creditors with the postpetition rehabilitative purposes of the Bankruptcy Code. (. . .). To illustrate, debtors in possession need to use their property — at least such property that is necessary to their reorganization efforts — and they need liquidity typically through postpetition financing and the use of cash collateral. Meanwhile, secured creditors need assurance that the debtor's reorganization efforts will not adversely affect the value of their interests in the debtor's property.[17]

To effectuate such a balance, "[i]f a debtor seeks to use cash collateral or prime a prepetition secured creditors' interests as part of, or pursuant to, a postpetition financing arrangement, (. . .) section 361 of the US Bankruptcy Code requires the debtor to provide the secured creditor with adequate protection of its interest in property."[18] Furthermore, a secured creditor may request relief from the automatic stay, which a bankruptcy court must grant if the debtor has not provided adequate protection of such creditor's property interest.[19]

The basis for providing adequate protection to secured creditors has been summarized by US Congress as follows:

> Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, [par.] 361

[14] Both directives and regulations are of course secondary sources of community law, whereas the Treaty is the primary source. There is no hierarchy between regulations and directives. Nonetheless, my analysis would be that the specific provision for collateral located outside the country in which the insolvency proceedings are opened - art. 8 EIR - cannot be set aside by national law on the basis of the Directive Proposal that provides for a general stay and that does not specifically take into account collateral located outside of that Member State.

[15] It was nonetheless a conscious decision of the European Commission not to propose amendments to article 8 EIR in the recast process, see prof. mr. P.M. Veder and prof. mr. J.J. van Hees, *Internationale aspecten van het dwangakkoord ter voorkoming van faillissement*, in prof. mr. A.C.P. Bobeldijk and others, *Het dwangakkoord buiten faillissement*, Uitgeverij Paris, 2017, p. 192.

[16] *ABI Commission to Study the Reform of Chapter 11, Final Report and Recommendations* (hereinafter "ABI Commission"), 2012-2014, p. 69.

[17] *Ibid*., p. 69-70.

[18] *Ibid*., p. 69.

[19] US Bankruptcy Code, s. 362(d)(1).

> recognizes the availability of alternate means of protecting a secured creditor's interest. Though the creditor might not receive his bargain in kind, the purpose of the section is to ensure that the secured creditor receives in value essentially what he bargained for.[20]

The US Bankruptcy Code requires a debtor to provide adequate protection to a secured creditor in at least three circumstances:[21]

1. When the automatic stay is in effect (that is, to defeat "cause" for granting a secured creditor relief from the stay);[22]

2. When the debtor uses, sells or leases collateral secured in whole or in part by a creditor, and only to the extent of such creditor's interest;[23] and

3. When the debtor proposes to prime a secured creditor's lien with an additional lien.[24]

The circumstance described under 1. above – the automatic stay – is clearly also foreseen in the Directive Proposal. It is, in fact, the explicit purpose of articles 6 and 7 of the Directive Proposal.

It is not clear whether the Directive Proposal also foresees the use, sale or lease of collateral by the debtor (the circumstances described under 2 above) while a stay is in place. Of course, if it is envisaged that the debtor is entitled to sell such collateral, it should be able to do so free and clear of security rights, liens etc. (hereinafter referred to as "encumbrances") - which any purchaser would require.

Under the US Bankruptcy Code, the debtor is authorized to use, sell or lease property without notice or court approval, provided such use, sale or lease takes place in the ordinary course of the business of the debtor (and until such time as the relevant secured lender demands adequate security – see the discussion of this point below).[25]

> To determine whether a transaction is in the ordinary course of business, bankruptcy judges usually apply one of two tests. The first is an objective standard (. . .) which looks at the debtor's industry to determine if the sale is the type of transaction conducted by other businesses in the ordinary course. The other is a subjective test (. . .) which looks at the expectations of creditors (i.e., whether the transaction subjects creditors to different economic risks from those which the creditor accepted and could reasonably anticipate) when extending credit.[26]

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[20] H.R.Rep. No. 95-595, at 339 (1978).
[21] T.M. Lupinacci and B.D. Bensinger, *Evidence necessary to prove adequate protection*, ABI Newsletter September 2007, p. 2 - available at https://apps.americanbar.org/buslaw/committees/CL160000pub/newsletter/200709/lupinacci.pdf.
[22] US Bankruptcy Code, s. 362(d)(1). Technically, this is not so much a requirement for the debtor to provide adequate protection as it is a consideration by the court whether a lack of adequate protection supports lifting the stay so the secured creditor may enforce its interest.
[23] *Ibid*, s. 363(e).
[24] *Ibid*., s. 364(d)(1)(B).
[25] A.N. Karlen, "Adequate Protection under the Bankruptcy Code, Its Role in Business Reorganization", 2 *Pace L. Rev*. 1 (1982), p. 26.
[26] M.J. Venditto and S.K. Kam, "United States: What Happens to Your Collateral During a Bankruptcy?", ReedSmith Lending Law Report, 2016, p.1. Available at:

The debtor may also use cash collateral with the secured party's consent or court approval.[27]

Given the stated purpose of the Directive Proposal of allowing the debtor to continue operating its business,[28] one would assume that in the event a stay is granted, the debtor would also be allowed to sell collateral - free of encumbrances - or consume secured assets in the ordinary course of its business. The same applies to the provision that the debtor remains in control of the day-to-day operation of the business.[29] Therefore, although it is not stated in the Directive Proposal *expressis verbis*, one must assume that the debtor is entitled to sell secured assets that are subject to a stay if this is necessary for the operation of its day-to-day business. In that case, some form of protection must be provided to the (relevant) secured creditor, although that subject is not touched upon in the Directive Proposal. Such protection is discussed further below.

"Priming", the third circumstance in which chapter 11 requires adequate protection, does not seem to be a circumstance that was considered in the Directive Proposal. A priming lien is defined in the US Bankruptcy Code as follows:[30]

> The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien (. . .)

What a priming lien does, therefore, is to allow for a first (or equal) ranking security on assets that were already provided as collateral to a (pre-petition) secured creditor. Priming is not addressed by the Directive Proposal and, to my knowledge, court ordered priming liens in the context of DIP or estate financing are not available in any of the (important) EU jurisdictions.[31] Priming liens will therefore not be discussed any further in this report.[32]

With the exception of priming, therefore, many of the circumstances in which the US Bankruptcy Code provides that adequate protection must be provided to secured creditors, are also the subject of the Directive Proposal. Lessons learned in the US may therefore be very relevant in the context of the Directive Proposal.

V. Forms of Adequate Protection

For all three categories of circumstances in which adequate protection should be provided to secured creditors, the US Bankruptcy Code provides three non-exclusive examples of what may constitute adequate protection:[33]

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http://www.mondaq.com/unitedstates/x/319942/Insolvency+Bankruptcy/What+Happens+to+Your+Collateral+During+a+Bankruptcy.

[27] A.N. Karlen, *supra* note 25, p. 26.

[28] Directive Proposal, Recital 1; Explanatory Memorandum p. 21.

[29] Directive Proposal, art. 5, para. 1.

[30] In s. 364(d)(1).

[31] Although new and interim ("DIP") financing is discussed, but this does not involve priming liens – arts. 16 and 17 of the Directive Proposal.

[32] As an aside, whether or not the Directive Proposal should address priming liens is a different matter altogether. It could well be argued that the Directive Proposal should, as does the Singapore Companies Act following the 2017 amendments. If priming is not allowed, as is the case in many jurisdictions including the Netherlands, "a prepetition secured creditor having a lien on key assets could become the sole source of a debtor's liquidity during the case, and this would greatly shift bargaining power to the prepetition secured creditor." E. Wise and M.K. Kelsey, "Obtaining Adequate Protection: An Analysis Pertaining to Real Estate Projects", *Norton Journal of Bankruptcy Law and Practice*, Vol. 22, No. 2 (2013), p. 248.

[33] US Bankruptcy Code, s. 361.

- A cash payment or periodic cash payments to the secured creditor;
- Providing an additional or replacement lien; or
- Granting such other relief as will result in the "indubitable equivalent" of the secured creditor's interest in the asset.

Noticeable first and foremost, is that an "administrative priority" (that is, a priority estate claim) is not only not listed as an example of adequate protection, but is expressly excluded as such.[34] An administrative priority was rejected by the US Bankruptcy Code's drafters as adequate protection "because such protection is too uncertain to be meaningful."[35] That said, in practice many lenders do demand that any court order authorizing a debtor to use cash collateral grant them administrative priority status as well.

On the other hand, a form of adequate protection that is not listed as an example, but that is one of the most common forms of "indubitable equivalent", is a so-called "equity cushion": the value of the collateral in excess of the claim of the secured creditor.[36] It is not possible to pinpoint a percentage that would be considered a sufficient equity cushion. Nonetheless, in the US it is stated that "courts generally find equity cushions of greater than 20% to be sufficient, almost universally consider an equity cushion of less than 11% to be insufficient, and may find equity cushions of 11 to 20% sufficient or insufficient depending on the circumstances of the case".[37] Erosion of the equity cushion by (unpaid) current interest and / or depreciation should be taken into account.[38]

Valuation issues will arise when a court is approached to assess whether an equity cushion exists and to which percentage, with methods to value including going concern, liquidation and fair market values.[39] It is held that "the proposed disposition or use of the collateral is of paramount importance to the valuation question . . . The appropriate standard for valuing collateral must depend upon what is to be done with the property - whether it is to be liquidated, surrendered or retained by the debtor".[40] The appropriate determination of what constitutes adequate protection requires the analysis of all relevant facts.[41] Of course, it is critically important that such valuations are available at the outset of the process.[42]

The ABI Commission proposes a valuation on the basis of "foreclosure value", instead of more commonly used valuation standards such as liquidation value and going concern value:[43]

[34] *Ibid*., s. 361(3).
[35] A.N. Karlen, *supra* note 25, p. 5 (quoting Senate Report - S. Rep. No. 989, 95th Cong., 2d Sess. 49, 54 (1978), reprinted in 1978 U.S. Code Cong. & Ad. News 5787 - p.54). Administrative "superpriority" status is, however, granted to make up for any deficiency in adequate protection previously provided – US Bankruptcy Code, s. 507(b).
[36] S.C. Krause and A. Zatz, "Recent developments in adequate protection under Section 361", *Norton Annual survey of Bankruptcy Law & Practice* (2012 Ed.), p. 568.
[37] S.C. Krause and A. Zatz, *supra* note 36, p. 568-569.
[38] A.N. Karlen, *supra* note 25, p. 23-25, 28.
[39] J.L. Vris and R. London, *An Introduction to DIP Financing*, 2007, p. 13.
[40] E. Wise and M.K. Kelsey, supra note 32, p. 251.
[41] E. Wise and M.K. Kelsey, *supra* note 32, p. 251.
[42] ABI Commission, *supra* note 16, p. 46.
[43] *Ibid*., p. 67.

> [T]he term "foreclosure value" means the net value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral under applicable nonbankruptcy law. In evaluating foreclosure value, a court should be able to consider a secured creditor's ability to structure one or more sales, or otherwise exercise its rights, under applicable nonbankruptcy law, in a manner that maximizes the value of the collateral.

Further, in respect of a sale of a secured creditor's collateral under section 363 of the US Bankruptcy Code, the ABI Commission proposes that the secured creditor's allowed secured claim (for which adequate protection is to be provided) "should be determined by the value actually realized from the sale".[44]

Back to the three non-exclusive examples of what may constitute adequate protection provided by the US Bankruptcy Code, periodic cash payments are among "the most common ways that a debtor provides adequate protection to its secured creditors".[45] In particular, "[t]he drafters [of the US Bankruptcy Code] noted that periodic cash payments (…) would be appropriate if the collateral is depreciating at a relatively fixed rate".[46] A single cash payment is also allowed, but not very likely to be used.[47]

The second example is a replacement lien. It is stated that a replacement lien is generally provided if the collateral consists of accounts, inventory or other collateral that the debtor uses or consumes in the operation of the debtor's business (this is referred to as "soft collateral").[48] The pre-petition security interest of a secured lender does not (in most jurisdictions, including the US) extend to goods or funds that are acquired or received in insolvency (that is, post-petition). Therefore, courts do allow the debtor to provide adequate protection to a secured creditor by granting a security right on property acquired in insolvency (to compensate for the collateral used or consumed in the insolvency of the debtor). This device is consistent with the view that adequate protection is designed to protect the value of a secured creditor's collateral, not his rights in a specific collateral.[49]

As the indubitable equivalent of the secured creditor's interest in the asset may well be anything that the debtor and its advisors may come up with, there is no typical situation in which the indubitable equivalent is provided. The "indubitable equivalence" method makes adequate protection a flexible concept adaptable to the various circumstances in which it is applied.[50] Courts have consistently interpreted the indubitable equivalence method as a "catch all, allowing courts discretion in fashioning the protection provided to a secured party".[51] The ABI Commission is,

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[44] *Ibid*., p. 67. Although not relevant to the valuation in respect of adequate protection *per se*, it is noteworthy that in the case of a chapter 11 plan contemplating a reorganization of the debtor, or a sale of substantially all of the debtor's assets under s. 363 of the US Bankruptcy Code, the ABI is of the opinion that "secured creditors should be entitled to receive in respect of their secured claims distributions under the chapter 11 plan or order approving a section 363x sale having a value equal to the reorganization value (…) attributable to the collateral securing their claims" - which value is likely higher than the foreclosure value in the event the debtor uses or consumes the collateral - ABI Commission, p. 207.

[45] T.M. Lupinacci and B.D. Bensinger, *supra* note 21, p. 5. Other common ways include an equity cushion and a superpriority lien.

[46] A.N. Karlen, *supra* note 25, p. 11.

[47] J.L. Vris and R. London, *supra* note 39, p. 11.

[48] T.M. Lupinacci and B.D. Bensinger, *supra* note 21, p. 5.

[49] A.N. Karlen, *supra* note 25, p. 11.

[50] *Ibid*, p. 12.

[51] S.C. Krause and A. Zatz, *supra* note 36, p. 632.

however, of the opinion that the debtor in possession should not be permitted to use avoidance actions or recoveries to provide adequate protection to secured creditors.[52]

It is further argued that "the form of adequate protection afforded in a given case may also depend upon the nature of the "entity" to be protected. For example, an institutional lender may be adequately protected by a debt service moratorium together with measures designed to protect the collateral's value. If the debt secured by collateral, however, is a retired person's personal asset, periodic payments may be the only way to adequately protect his interest."[53]

Future rents and the future value of collateral may be considered a form of adequate protection in the event the debtor's expenditures preserve the secured creditor's interest in the collateral. However, the receipt of the rents and / or the increase of the value in the collateral should not be speculative, in which case they will not qualify as adequate protection.[54] Whether increased value is sufficient for adequate protection should be considered on a case-by-case basis, with focus on the extent of the risk involved.[55] In many such cases, whether adequate protection is provided depends to a large extent on the feasibility of the debtor's plan.[56]

The burden of proof in respect of adequate protection - both in the context of the automatic stay and the use, sale or lease of a secured creditor's collateral – ultimately lies with the debtor.[57] The creditor seeking relief from the automatic stay, or who objects to the use, sale or lease of its collateral, "has the burden of proof on the issue of the validity, priority, or extent of" the debtor's equity and its own interest in the property, respectively.[58] However, such creditor need only make a *prima facie* case showing that its interest is not adequately protected (and if it does, the burden of proof shifts to the debtor).[59] This does not apply if the collateral involved is cash, the debtor's use of which is dependent on either the consent of the secured creditor or authorization by the court.

In short, the conclusion from the above is that adequate protection under the US Bankruptcy Code is a well-developed, albeit rather fact-dependent, notion.[60]

VI. 2017 Amendments to the Singapore Companies Act

On 23 May 2017, the Companies (Amendment) Act 2017 came into force, providing for important amendments to Singapore's insolvency laws. Of interest here is that the amendments introduce an automatic 30-day moratorium in respect of the Singapore scheme of arrangement. Prior to the introduction of the amendments to the Singapore Companies Act, a moratorium did already exist, but it was not automatic and was considered relatively weak compared to the moratoriums in the liquidation and judicial management regimes. The moratorium for schemes, for example, did not

[52] ABI Commission, *supra* note 16, p. 73.
[53] A.N. Karlen, *supra* note 25, p. 13.
[54] S.C. Krause and A. Zatz, *supra* note 36, p. 649.
[55] E. Wise and M.K. Kelsey, *supra* note 32, p. 259.
[56] P.D. Russin and R.S. Lubliner, "Selected Chapter 11 Adequate Protection Issues", ABI 13th Annual Southeast Bankruptcy Workshop 2008, p. 22.
[57] US Bankruptcy Code, ss. 363(g)(2), 363(p)(1) and 364(d)(2).
[58] *Ibid*., ss. 362(g)(1) and 363(p)(2).
[59] S.C. Krause and A. Zatz, *supra* note 36, p. 629-630.
[60] See also S.C. Krause and A. Zatz, *supra* note 36, p. 631.

extend to the enforcement of security or in regard to the judicial management regime.[61]

A discussion in respect of the amendments to the moratorium can be found in two key reports that were instrumental to the passing of the amendments to the Companies Act. The first is the 2013 Report of the Insolvency Law Review Committee (the "2013 ILRC Report"), and the second is the 2016 Report of the Committee to Strengthen Singapore as an International Centre for Debt Restructuring (the "2016 Committee Report").

In the 2013 ILRC Report, the Committee considered and declined to recommend that the moratorium in the scheme of arrangement procedure should be triggered automatically, on the basis that such an extension would be unfair to creditors and could potentially lead to abuse.[62] The Committee also identified that there were no statutory restrictions or controls against continued trading by the company, the disposition of assets and / or the further incurring of debts and liabilities by the company.[63] In that respect, the Committee considered that creditors should be given the power to apply to the court to prevent any improper asset disposals or business activities, pending the approval and sanction of the scheme.[64]

The 2016 Committee Report, under several references to Chapter 11 proceedings,[65] set out a different view. In the 2016 Committee Report the grant of an automatic moratorium is recommended, together with safeguards against abuse. Such safeguards include publication of the notice of an application for a moratorium and the requirement for information to be provided with the application.[66]

The recommendations in the 2016 Committee Report were adopted.[67] If the court grants a moratorium order, the debtor must provide certain financial information to creditors. The information provided will then allow secured creditors (including their receivers) to determine if they should apply for a termination of the automatic moratorium on the basis of section 211B(10)(b) of the Companies Act.[68]

The above is also confirmed in the Parliamentary Debate on the Companies Amendment Bill.[69] It is worth noting that Parliament did reference the discretion of the Courts, stating that in considering the information provided by the company, the Court can then design the scope of the moratorium and its terms to fit the specific circumstances of each case and need not order a moratorium over security enforcement.

Section 211D of the Companies Act enhances creditor protection by providing that the Court may, on application by a creditor, make an order restraining the debtor from disposing of the property of the relevant company other than in good faith and in the ordinary course of its business.

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[61] *Report of the Insolvency Law Review Committee, Final Report*, 2013 (hereinafter "2013 ILRC Report"), p. 136, par. 7.
[62] *Ibid.*, p. 141, par. 18.
[63] *Ibid.*, p. 137, par. 8.
[64] *Ibid.*, p. 148, par. 32.
[65] See eg, *Committee to Strengthen Singapore as an International Centre for Debt Restructuring, Report of the Committee*, 2016, par. 3.7, 3.17 and 3.18.
[66] *Ibid.,* paras. 3.8 to 3.10.
[67] The safeguards are reflected in ss. 211B(3) and 211B(4) of the Companies Act.
[68] Companies (Amendment) Bill 2017, p. 121.
[69] Companies Amendment Bill (Second Reading), at p. 6.

Remarkably, the concept of adequate protection does not seem to have been addressed in the Singapore Companies Act in respect of (i) the (automatic) moratorium or (ii) the use, sale or lease of collateral. These are the first two (of the three) circumstances in which adequate protection is required under the US Bankruptcy Code (see the discussion above). Section 211B(10)(b) provides an avenue for the affected secured creditors to attack the moratorium, but it is not set out in the Act what the criteria is for the courts to decide on a "discharge or variation" of the moratorium.

Adequate protection is (only) addressed in the context of "rescue financing" (that is, a priming lien).[70] This is the third circumstance in which adequate protection is required under the US Bankruptcy Code. In respect of rescue financing, there is adequate protection for the holder of an existing security interest if:[71]

(a) the Court orders the company to make one or more cash payments to the holder (. . .);

(b) the Court orders the company to provide the holder additional or replacement security (. . .);

(c) the Court grants any relief (other than compensation) that will result in the realisation by the holder of the indubitable equivalent of the holder's existing security interest.

These examples of adequate protection are very similar (if not identical) to those cited in section 361 of the US Bankruptcy Code (see the discussion above).

VII. Should the Directive Proposal Address Adequate Protection?

As discussed above, in respect of the automatic stay the US Bankruptcy Code provides (i) in what circumstances protection to secured creditors must be provided and (ii) provides examples of protection that is deemed adequate. This framework is further detailed in US case law.

The Directive Proposal, on the other hand, provides that Member States must make available a stay of enforcement actions within the context of a preventive restructuring framework (article 6, paragraphs 1 and 2, both state "Member States shall ensure that…"). The Directive Proposal provides for a stay (and probably allows the sale of collateral free of encumbrances as well as the use of collateral - see the discussion above), but it only addresses protection for secured creditors to a very limited extent. It is noticeable that a recent draft report of the Committee on Legal Affairs of the European Parliament also does not mention, let alone propose, the introduction of adequate protection mechanisms into the Directive.[72]

The Directive Proposal provides that the duration of the stay will be limited to a maximum period of four months.[73] The stay may be extended several times, although

[70] Companies Act, s. 211E(1)(d)(ii).
[71] *Ibid*., s. 211E(6).
[72] Draft report of 22 September 2017 of the Committee on Legal Affairs of the European Parliament on the proposal for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU (PE 610.684v01-00).
[73] Directive Proposal, art. 6, par. 4.

the total duration of the stay must not exceed twelve months.[74] An extension of the stay may only be granted if (a) relevant progress has been made in the negotiations on the restructuring plan and (b) the continuation of the stay of individual enforcement actions does not unfairly prejudice the rights or interests of any affected parties.[75] These time limits of course provide some protection to secured creditors, but four months (let alone twelve) is a very long time in a distressed situation indeed.[76] In that period, the secured creditor may see a significant decrease in the value of its collateral.

Further, article 6, par. 9 of the Directive Proposal provides as follows:

> Member States shall ensure that, where an individual creditor or a single class of creditors is or would be unfairly prejudiced by a stay of individual enforcement actions, the judicial or administrative authority may decide not [to] grant the stay of individual enforcement actions or may lift a stay of individual enforcement actions already granted in respect of that creditor or class of creditors, at the request of the creditors concerned.

This paragraph provides for a binary choice: either the (secured) creditor obtains relief because of "unfair prejudice", or it does not. This provides the Courts with much less room to manoeuvre and much less guidance than the US Bankruptcy Code and the relevant case law provide.

The procedure envisaged by the Directive Proposal is therefore truly a very blunt instrument, taking into account the well-developed notion of adequate protection under US Bankruptcy law. As stated above, allowing a secured creditor to foreclose immediately on the debtor's property, or demand payment in full from the debtor, would doom the debtor's reorganization efforts from the outset. For that reason, Courts will likely be reluctant to provide relief to a secured creditor by lifting the stay, as the secured creditor will then likely foreclose and the Courts may effectively just as well declare the debtor bankrupt.

The concept of "unfair prejudice" is not defined in Directive Proposal. As a result, it is unclear in which circumstances creditors are in fact unfairly prejudiced and, therefore, also the circumstances in which the courts should lift the stay.[77] There are some indications of what may constitute "unfair prejudice" in the recitals to the Directive Proposal:

> In establishing whether there is unfair prejudice to creditors, judicial or administrative authorities may take into account whether the stay would preserve the overall value of the estate, whether the debtor acts in bad faith or with the intention of causing prejudice or generally acts

[74] *Ibid.*, art. 6, par. 7.
[75] *Ibid.*, art 6, par. 5.
[76] Of course, under the US Bankruptcy Code the stay may also be as long or may even go on for much longer. Under the US Bankruptcy Code the stay continues until relief therefrom is granted or the case is closed. However, as set out above, the US Bankruptcy Code deals with this issue by way of the adequate protection provisions. That is not the case under the provisions of the Directive Proposal.
[77] It is not unlikely that in some jurisdictions secured creditors will not receive any compensation in respect of the stay itself. In the Netherlands, for example, in the context of an insolvency specific freezing order – which serves a different purpose than a preventive restructuring framework – the secured creditor may be barred from enforcing its collateral for a period of up to 4 months (art. 63a of the Dutch Bankruptcy Act). Compensation for this delay was not even contemplated in the drafting of this provision. The same may well apply to a stay in respect of a preventive restructuring framework.

> against the legitimate expectations of the general body of creditors. A single creditor or a class of creditors would be unfairly prejudiced by the stay if for example their claims would be made substantially worse-off as a result of the stay than if the stay was not granted, or if the creditor is put more at a disadvantage than other creditors in a similar position. [78]

This recommendation is not very helpful, amongst other reasons because it is not binding ("may take into account") and because it does not provide a framework for a judge that can actually help him or her decide on how to address the legitimate concerns of secured creditors that are subject to the stay in a particular case.

As set out above, the amendments to the Singapore Companies Act do not (explicitly) provide for adequate protection in respect of the (automatic) moratorium or the sale, use or lease of collateral either. This is, however, much less an issue in a single jurisdiction than it is in a European directive that is intended to be implemented in the legislation of 27 Member States. The result of not addressing adequate protection in the Directive Proposal (and only providing for lifting the moratorium in the event of "unfair prejudice"), is that the national law applicable to the preventive restructuring framework will decide on further protection that is provided to secured creditors (if any), with very little guidance from a European legislative instrument. This may lead to widely diverging results between the Member States in many aspects: for example, whether or not the debtor is allowed to sell or consume collateral, whether or not protection should be provided to secured creditors, what forms of protection are acceptable and how the collateral is to be valued. Most likely, in respect of the use, sale (free of encumbrances) or lease of collateral - if such must be allowed on the basis of the Directive Proposal - secured creditors will have some form of protection in most of the Member States. One could hardly imagine a debtor selling secured assets without any (or all) of the proceeds being paid to the secured creditor, or the secured creditor being provided with some other form of adequate protection. This adequate protection may well include cash payments, replacement liens or other relief that will result in the "indubitable equivalent" of the secured creditor's interest in the asset. However, under the current draft that would be wholly up to the national law in which the preventive restructuring framework is introduced. As such, therefore, the Directive Proposal does not fulfil its purpose to "tackle" the discrepancies in national law[79] as well as it could on an issue that is considered critical in the US.

In my view, these issues should not be underestimated. Adequate protection "is a critical determination made early in a chapter 11 case that can affect the ultimate outcome of the debtor's reorganization and creditor recoveries".[80] As Karlen concludes:[81]

> The concept of adequate protection goes to the very essence of business reorganizations under Chapter 11 of the Code.

[78] Directive Proposal, Recital 20.
[79] *Ibid*., Recital 10.
[80] ABI Commission, *supra* note 16, p. 70.
[81] A.N. Karlen, *supra* note 25, p. 33.

VIII. Conclusion

The Directive Proposal provides that Member States must introduce the possibility of a stay of enforcement proceedings by secured creditors in the context of a preventive restructuring framework. In respect of the stay, however, several issues are not addressed. In particular, (i) the relationship between article 8 EIR and the stay envisaged in the Directive Proposal is not clear and, (ii) it is not sufficiently clear under the Directive Proposal whether the debtor is allowed to sell collateral free of encumbrances, or consume collateral, during a stay. It is noticeable that the stay envisaged in the Directive Proposal has many elements in common with circumstances in which adequate protection for secured lenders is required under the US Bankruptcy Code. The notion of adequate protection under the US Bankruptcy Code is well developed, albeit rather fact-dependent. Under the Directive Proposal, on the other hand, Member States are only required to provide for the possibility that a judicial or administrative authority lifts the stay because of unfair prejudice. The national law applicable to the preventive restructuring framework will decide on any further protection that is provided to secured creditors (if any), with little guidance from a European legislative instrument. This may lead to widely diverging results and it may therefore well be worthwhile addressing adequate protection in the Directive Proposal in more detail. The notion of adequate protection under the US Bankruptcy Code should be considered a rich source of inspiration for that purpose.

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