

BEST PRACTICES IN EUROPEAN RESTRUCTURING

Contractualised Distress Resolution in the Shadow of the Law

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CHAPTER I

TIMELY IDENTIFYING AND ADDRESSING THE CRISIS*

SUMMARY: 1. On the ‘crisis’ and on triggers for insolvency proceedings and restructurings. – 2. On the importance of early and effective triggers. – 3. Recognition of the crisis. – 3.1. What the law can do. – 3.2. What the debtor/debtor’s management and hired professionals can do – 3.3. What the creditors and shareholders can do; the role of financial creditors in particular. – 4. Incentives to pursue restructuring. – 5. Reduction of disincentives. – Annex 1: A restructuring-friendly environment. – Annex 2: Promoting a co-operative approach between debtor and banks.

1. On the ‘crisis’ and on triggers for insolvency proceedings and restructurings

Over literally millennia, insolvency laws have developed more or less reliable and exact indicators for the beginning of the common pool problem such as ‘acts of bankruptcy’ (flight of the debtor, non-payment of an adjudicated claim, etc.) or general definitions (over-indebtedness, illiquidity, etc.). In more recent years, the reach of insolvency (and hybrid) proceedings has, in many countries, widened and their boundaries have blurred. Insolvency proceedings can be triggered even during earlier, often less clearly defined stages of the debtor’s crisis (e.g. imminent insolvency, likelihood of insolvency, unsurmountable difficulties and similar).¹ In some important

* *Although discussed in depth and shared by all the members of the Co.Di.Re. research team, this Chapter is authored by Christoph G. Paulus and Wolfgang Zenker.*

¹ For instance, the Spanish Insolvency Act allows debtors (unlike creditors or third parties) to file a petition for insolvency not only when they are insolvent (actual insolvency), but also when they are on the verge of

instances, proceedings that are considered to address insolvency may even be started by the debtor without having to prove or even just assert their insolvency or crisis.²

The ‘CoDiRe’ research project is focusing primarily, though not exclusively, on restructurings provided for in the law and/or involving authorities, as opposed to purely private and contractual restructurings. They are plan-based restructurings, which take place outside formal insolvency proceedings, often allowing a majority of stakeholders (usually acting in concert with the debtor’s management) to effectively overrule a minority. On one hand, these proceedings are commonly considered – e.g. in the European Insolvency Regulation and the draft Restructuring Directive – as such to avoid insolvency (and other more formal and cumbersome) proceedings, so they have the potential to be commenced and conducted also during earlier stages of the debtor’s crisis than these proceedings. On the other hand, they frequently subject creditors and other stakeholders who have not contractually agreed (e.g. in bond terms or a company’s articles of

insolvency (imminent insolvency). The concept of ‘imminent insolvency’ is broadly defined in the law as a situation whereby ‘the debtor foresees that s/he will not be able to satisfy regularly and punctually his obligations’ (art. 2.3 IA). The debtor’s prognosis must be made having regard to the prospective inability to meet obligations (lack of liquidity or impossibility to obtain it), not the insufficiency of assets to meet liabilities. The inability to pay on time and according to regular means will occur in the future, as debts fall due. It involves an objective valuation of probabilities. It cannot be just a possibility; it has to be more likely than not. The law has intentionally left open the time range. There is no clear case law on the matter, although there is judicial and academic consensus, based both on literal and teleological interpretation, that ‘imminence’ refers to a short-term period (e.g. one or two months falls undoubtedly within the scope of the rule).

² An example is the ‘negotiation period’ or ‘article 5-bis moratorium’ under the Spanish insolvency framework. If the debtor is insolvent, and with a view to suspend the time to mandatorily file for insolvency, the debtor may inform the Court about the commencing of negotiations to reach any of the three types of collective out-of-court proceedings described in this section, or even to negotiate an in-court anticipated insolvency plan. This communication is a formal requirement, while there is only a superficial control that the legal requirements are met: there is no analysis of the merits of the petition, and the judge does not need to see evidence of the debtor’s insolvency. The judge must, however, check that the COMI is in its jurisdiction, because the negotiation period of art. 5-bis is included in Annex A of the recast EU insolvency proceedings as one of the types of insolvency proceedings existing in Spain.

incorporation) to such treatment to a stay and/or a majority vote with regard to their claim or other stake in the debtor.

The possibility of overriding stakeholder's rights may make a proceeding attractive to debtors not only for its intended purpose but also for abuse. In other words, a mere renegotiation process requiring unanimity and not enforcing any restrictions (e.g. a moratorium), or a process agreed upon in advance by all participants, may be initiated at any point in time, as early as the parties wish, and without the necessity of judicial control. To the contrary, other proceedings will require some form of a gatekeeper. The precise requirements, and even the general approach,³ will depend on the respective country's legal and judicial culture, constitutional and further legal framework, and the specifics of the proceeding in question, its effects and its initiator(s) (solely debtor driven vs. options of creditor initiative). It is therefore impossible to make 'one-size-fits-all' recommendations.

However, in general and relying on practical experiences in particular in the USA and the UK, a restructuring as such – unlike certain measures interfering with, e.g., creditor rights – should not necessarily require any specific degree of crisis or likelihood of insolvency. It is recommended, therefore, to make available semi-formal restructuring proceedings to debtors without them having to cross any threshold of crisis or financial difficulties and show this to any judicial or administrative authority. This approach allows for non- (or minimally) invasive proceedings without court involvement and promises a reduced stigma connected to the process. The risk, indeed quite moderate, that debtors commence such proceedings while not in any financial difficulty or need of restructuring, possibly wasting resources of other stakeholders involved, can be tackled with a mechanism to terminate the proceeding by authoritative order in the case of abuse on the application of a quorum of stakeholders.

The more likely scenario that debtors with clearly non-viable businesses apply for restructuring proceedings instead of an out-of-court or insolvent liquidation, only further

³ The general approach will state what are the abstract criteria of eligibility (the crisis threshold), will provide for some good faith requirement to prevent abuse, will set forth what is the level of judicial involvement and oversight with respect to commencement, review of individual measures, and whether oversight is ex ante or ex post.

diminishing the estate, can also be tackled by a similar mechanism (in addition to involuntary insolvency petitions and/or a duty to file for insolvency, possibly after having a stay lifted).

So, when this chapter deals with ‘timely identifying the crisis’, this does not so much refer to the eligibility criteria of any one national pre-insolvency or insolvency proceeding or of a future proceeding according to the draft Restructuring Directive. Nor does it refer to an exactly and universally defined condition of ‘crisis’. Here, crisis simply refers to any situation in which there is a need for action to safeguard or restore a debtor’s viability, value or any stakes in the business, ideally by means of financial and/or operational restructuring. This called-for action frequently will at first be no more than a thorough assessment of the debtor’s situation or a negotiation with individual creditors, clients or potential investors, but can (in the worst case) culminate in filing a petition to commence insolvency proceedings.

Policy Recommendation #1.1 (*Requirements to begin restructuring proceedings*). Restructuring proceedings started by the debtor should be accessible without any threshold, such as crisis or likelihood of insolvency. Such requirements should be introduced only for specific tools or measures directly affecting stakeholders’ rights and (if provided for) for proceedings initiated by creditors. On an application by a creditor quorum, an authority should ascertain whether a proceeding has been started abusively and, if so, terminate it.

2. On the importance of early and effective triggers

A particularly important cause⁴ of the legislative ‘trend’ (*supra*, par. 1) to earlier triggers for proceedings of any kind is the insight that there are more means to react to crisis, to

⁴ Another reason, that is somewhat connected to the one mentioned above, is to be found in the usually minimal returns to the stakeholders from conventional liquidation proceedings. Returns tend to further diminish the later insolvency proceedings are triggered.

insolvency and to a common pool problem than to liquidate and distribute the debtor's assets amongst their creditors. Efforts to sell its business as a going concern or to restructure and 'turn around' the debtor as a business entity, however, are (a) less invasive and final and (b) best undertaken as soon as possible before all the debtor's credibility on the market and all the (tangible and intangible) assets ensuring the debtor's viability have been wagered and lost. The research in all four jurisdictions considered shows that restructuring and insolvency professionals unanimously consider late reaction to a crisis to be the single most important reason for businesses becoming unsustainable and heading towards liquidation.

This seems to particularly affect MSMEs, and, among these, especially owner-managed and family businesses, because of inferior monitoring and resources, lack of management competence and experience, absence of professional advisors and the special financial (as owners) and emotional investment of the management in the business's future that may result in irrational evaluations and decisions and a general lack of professional distance.⁵ One particular challenge for all legislative and other efforts in the field of restructuring is and will thus be to make MSMEs timely notice and acknowledge a crisis and the need to react.

For the avoidance of doubt, this chapter does not only concern restructuring or insolvency proceedings and their triggers but also – and to some extent even especially – out-of-court and merely contractual/negotiation-based restructuring efforts. These are usually the first tool to be taken into consideration by debtors, even before considering to start any

⁵ Empirical research shows that the governance structure of the firm is relevant in determining timeliness in addressing distress. E.g., according to Italian national findings (mainly resulting out of interviews of professionals), businesses in which managers are fully aligned with shareholders tend to procrastinate addressing situations of distress. The qualitative evidence gathered shows that family businesses address business distress when there is no more space for restructuring. A possible reason is that in family businesses, directors are often shareholders, therefore tending to postpone restructuring, because of the risk of incurring personal liabilities.

In Italy, a similar pattern occurs also for professionally managed, private-equity businesses, probably due to incentives of equity fund partners to avoid disclosing failure to investors. See the results of the qualitative part of the Italian empirical research published on the website www.codire.eu.

These results are consistent with those obtained in Spain. See the results of the Spanish empirical research published on the website www.codire.eu.

legal proceeding that, depending on its design in the respective law, may create additional costs, unwanted publicity, insecurity, loss of control, or other adverse effects. Thus, for the purpose of this chapter, it is assumed that there is a more or less extensive array of different restructuring (and liquidation) tools available, and look at ways to:

- facilitate the timely recognition, identification and acknowledgment of the crisis (par. 3),
- incentivise the debtor and/or other stakeholders to act upon this information and (assuming viability) pursue a restructuring (par. 4), and
- remove disincentives (par. 5).

There will be some very brief remarks regarding the perceived lack and the desirability of a restructuring friendly legal environment (Annex 1) and the need to establish a co-operative approach between debtor and banks (Annex 2).

3. Recognition of the crisis

3.1. What the law can do

The law can mainly provide for monitoring and early warning systems that are supposed to ensure that a company's directors are – without too much delay – made aware of any adverse development of business and the company's financials, in particular key accounting figures (turnover, profits/losses, etc.), depletion of (statutory or optional) capital reserves, potential issues with key clients, and especially any concerns regarding the company's liquidity/solvency. Many countries' ('hard' or 'soft') laws on corporate governance already demand that at least certain companies (e.g. by size or form of incorporation [public companies]) install such systems (e.g. in Italy the board of statutory auditors, so-called *collegio sindacale*); in other companies, it will still usually be a general duty for directors to keep abreast of the business and to watch out for any developments that require an intervention for the benefit of the company.

The draft Restructuring Directive also contains a provision to this effect: Article 3 calls – at least for MSMEs – for access to (unspecified) early warning tools that can detect a deteriorating business and signal the need to act as a matter of

urgency as well as for access to information about the availability of early warning and restructuring tools. Recital 13 shows that the installation and use of these early warning tools should be inexpensive, and recital 16 names, as examples, accounting and monitoring duties for the debtor or their management, reporting duties under loan agreements as well as incentives or obligations for third parties to flag negative developments. While it may be considered very creative and, in fact, euphemistic to qualify personal or management duties as ‘tools’ that debtors should be given access to and receive concise information about, this approach seems sensible in theory.⁶

Its problems lie on the practical side. In some jurisdictions, insolvency and restructuring professionals report that, in many cases in particular with MSMEs, the debtor’s accounting is not in order (frequently likened to a shoebox of receipts), there are no adequate performance audits and directors are not all too rarely unaware of the status of their company’s daily affairs as well as incompetent regarding business and finances.⁷ Furthermore, even debtors and directors who are fully aware of the facts often refuse to draw the obvious conclusions but clutch at any straw to justify why the situation is not as dire as suggested by the company’s accounts.⁸ Both aspects threaten

⁶ The notorious German duty to file when there is an opening reason pursuant sec. 15a InsO, with regard to overindebtedness, is meant to be an early warning system since a debtor is thereby meant to continuously control its financial status. In practice, though, this is rarely done.

⁷ This is the case for Italy, for example, where smaller businesses often have an inadequate reporting system that does not allow early detection of distress.

Similarly in Spain, where according to the general opinion regarding the causes for the delay in seeking specialised legal advice for MSMEs are generically considered to be linked to the context and motivation of debtors more than lying in the legal framework (which actually tries to incentivise the adoption of early solutions to the crisis). Small debtors insolvency culture is weak, in the sense that the different mechanisms offered by the legal system remain mostly unfamiliar to them, especially contractualised solutions. These may often derive from inadequate advice from the internal or external legal advisors, who lack specific insolvency training. See the Spanish National Findings, available on the website www.codire.eu.

⁸ Indeed, the empirical research conducted in Spain shows that two different attitudes are particularly common in small debtors and tend to delay any insolvency-related decisions. The first one consists basically in the denial of the critical situation that may be affecting the business (the ‘ostrich syndrome’). The second attitude that endangers the use of preventive

the effectiveness of early warning systems – especially with the very debtors that need them the most and that the draft Restructuring Directive has in mind.

Strengthening, broadening or simply better enforcing the already existing duties and corresponding civil or criminal liabilities or, e.g., requiring entrepreneurs or directors to show certain basic qualifications in accounting and finance before starting or managing a business would furthermore increase the transaction costs of doing business and could possibly interfere with entrepreneurship and economic growth. To strike the right balance has proven a delicate task for legislators.

In any case, however, general⁹ early warning systems should be inexpensive and easy to apply. Management should be under a general duty to constantly monitor the business and its development, in particular with regard to transactions above a certain threshold in relation to the business's size, key customer and supplier accounts and terms, as well as cash flow and liquidity and to compile regular reports or accounts for the shareholders and/or the authorities (in particular, tax authorities). Regular audits of the accounts will likely be too expensive to be made a universal requirement. External accountants, tax consultants, auditors, and similar professionals commissioned by the debtor as well as (in particular) the employees – who are in closer touch with day-to-day business than directors and, especially in larger businesses, will almost invariably learn of certain types of problems sooner – should be under an obligation to alert (at least) management of any developments they notice that can endanger the business's viability.¹⁰ The management should have to inform the employees of this obligation and issue guidelines – where the law does not already provide for them – naming certain events

solutions is the belief that sooner or later the crisis will pass. See the Spanish National Findings, available on the website www.codire.eu.

⁹ As opposed, possibly, to special, more sophisticated early warning systems that the law may require for bigger and/or public companies, in particular where the shareholders' or partners' liability is legally (as in limited liability companies) or factually limited (as in companies where the legally unlimited liability lies, in turn, with a limited liability company, as it is the case, for instance, for the German GmbH & Co. KG).

¹⁰ An unwritten obligation to actively search for such developments, however, would probably go too far at least with MSMEs as it would hugely affect the costs of the services provided by external auditors and consultants or the cost of labour.

that always constitute such a detrimental development, specific to the debtor's business. In particular with MSMEs, these guidelines – unlike 'living wills' for banks – should not require a high level of sophistication, regular updates, professional accounting, compliance departments, etc., so they do not put much of a financial or organisational burden on the debtor.

These events triggering an instant warning might be called 'crisis events'. Notable examples could be losses beyond a certain threshold (also in relation to the company's capital reserves), loss or insolvency of a main customer or supplier, loss of key employees, change in the price of supplies, or in general loss of favourable terms of business with main customers or suppliers, drop in orders made by main customers, termination of loan agreements, overdue receivables of a certain sum, liquidity issues resulting in overdue commitments, in general any form of default on the business's obligations, foreclosures, other forced sales or acts of debt enforcement, negative development of credit scores or ratings, etc.¹¹ Any such warning should have to result in management thoroughly assessing the business's situation, viability and need of restructuring.

An intriguing and important question legislators have to address when providing for such early warning tools or notification systems is whether the warning should only be addressed to the debtor or the management respectively or whether shareholders, employees, creditors or, for example, a public or semi-public entity like a court or a professional body should at this point have to become involved (cf. the French *procédure d'alerte* or the Italian draft legislation) either directly or by way of the management. The involvement of third parties might act as an incentive for management to not ignore the warning (see also *ultra*, par. 4), thus increasing the systems' effectiveness. On the other hand, any resulting publicity could endanger the debtor further (reputational effects as well as more immediate commercial and financial effects of a potential crisis becoming public knowledge), invite abuse by, for instance,

¹¹ In Italy, the key triggers for restructuring often are (i) liquidity constraints and (ii) capital maintenance rules. In some cases, the breach of capital maintenance rules for stock companies and limited liability companies under Articles 2446/2447 and 2482-bis/2482-ter of the Italian Civil Code (i.e. the 'recapitalise or liquidate' rule, which forces liquidation if the minimum capital is not restored within a short timeframe) is the real trigger.

competitors or disgruntled employees, involve expenses either for the debtor or the taxpayer and impair any collective proceedings to resolve a crisis. Obligations for employees to inform on their employer would also give rise to a series of conflicts, and thus seem at least problematic.

Overall, we believe that management should be – in addition to current obligations of traded companies to ‘*ad hoc*’ publish inside information – under an obligation to inform shareholders of the developments at regular shareholders’ meetings and, in case of massive losses or other developments making insolvency highly likely or inevitable, at an extraordinary shareholders’ meeting or by written communication. In all other cases, the information of shareholders should be left to the management’s discretion (like it is always the case for the information to creditors¹²). The compulsory involvement of courts or other authorities might be very useful, especially to help the management of MSMEs to better assess the situation. But with the additional costs and the questionable enforceability, one should hesitate to define it as a policy recommendation. However, initiatives should be encouraged to offer management of MSMEs free or affordable (voluntary) counselling regarding the debtor’s state of affairs and assessing the crisis and viable reactions,¹³ with the sole *caveat* that public funding must not create a moral hazard or unduly externalise costs to the taxpayers. An alternative would be a voluntary or compulsory insurance for restructuring (and in particular counselling) costs.

Although there are solid arguments in favour of such a duty, one should doubt whether it is the case to advocate legal obligations (other than incentives and encouragements) for institutional creditors – public or private – to flag negative developments as mentioned in recital 16 of the draft Restructuring Directive. Creditors are the ones suffering most from the crisis and they should not also be subjected to

¹² The management enjoys discretion unless a duty to inform the creditor derives from the contract between the parties or the law, as it may be the case with employees (cf. sec. 106 German Works Constitution Act [BetrVG]). Obviously, the management must give accurate information to financial creditors that are taking credit decisions regarding the debtor company.

¹³ In Germany, for example, the local Chambers of Commerce and Industry and the KfW (state-owned development bank) offer programmes for subsidised crisis assessment (round tables) and turn-around counselling.

obligations (and possibly liability or other detriments in case of a breach) in the efforts to resolve the crisis.

Policy Recommendation #1.2 (*Early warning systems*). The law should provide for universal early warning systems and obligations of management to constantly monitor and have monitored the business's affairs for indications of a crisis. This should apply – with possibly additional requirements for big and/or public companies – to all businesses, regardless of legal status or size.

Policy Recommendation #1.3 (*Duty to define crisis events*). The law should define general 'crisis events' and provide for a duty of the management to define specific 'crisis events' that trigger warnings by employees and professionals, e.g. auditors, accountants and consultants. A particularly important general 'crisis event' shall be any default of the debtor.

Policy Recommendation #1.4 (*Role of management with regard to early warning*). All warnings are to be addressed to the management that shall generally have to consider how to best safeguard the interests of creditors as a whole and decide, at its discretion, whether to involve third parties (shareholders, creditors, courts, other authorities). Such discretion may be limited by laws to protect, e.g. the market or the employees, by contractual obligations or by the management's general duty towards the shareholders.

Policy Recommendation #1.5 (*Affordable counselling for MSMEs to prevent and address crisis*). Public or professional bodies, such as the chambers of commerce and trade, should look into offering free or affordable advice to MSMEs in setting up early warning systems and in assessing a crisis and the appropriate reaction.

3.2. What the debtor/debtor's management and hired professionals can do

Obviously, the debtor and its management can and must adhere to the law ('compliance'), observe soft law (e.g. codes on corporate governance), install a prescribed early warning system and direct their employees accordingly. Furthermore, even in the absence of the legislation suggested above (*supra*, par. 1), entrepreneurs and directors can and should voluntarily adopt the outlined early warning systems – in particular encourage or direct employees to promptly alert them of potentially detrimental and dangerous events and developments in the course of day-to-day business – and keep themselves informed on the current state of their business's finances and in particular cash flow/liquidity forecasts. One could also argue that the voluntary adoption of early warning systems, absent specific rules, be compulsory on the basis of the general standards conduct that the entrepreneurs and directors are required to observe (who would bear the risk of potential liability for general negligence in case of non-adoption).

Even to the extent it is not a requirement by law, entrepreneurs and directors should equip themselves with a general working knowledge of basic accounting and finance, should keep their books current and in order and ensure that reporting and auditing obligations (including the timely filing of tax returns) are met. It is recommended to support such efforts by providing public funding for offering entrepreneurs and directors of MSMEs affordable training regarding their obligations and general business knowledge and acumen, e.g. through professional bodies (namely chambers of commerce and trade etc.).

Entrepreneurs and directors are supposed to be constantly aware of their own limitations and avail themselves (while being mindful of the costs and their impact on the business's finances) of counselling and support, by employees or hired advisors and professionals like lawyers, business or tax consultants, auditors. Hired professionals should be supplied with current and accurate information, given full access to the relevant data and employees and tasked also with assessing the status of the business and its current and prospective viability. Even where such a duty cannot already be derived from the law,

professional standards or individual contracts,¹⁴ the hired advisors or auditors should assess the information made available to them (as well as the absence of certain information) for evident indications of a crisis and the need for restructuring, alert management of their findings or any reasonable doubts, and advise management on options to further assess and to address the situation. Any such communication has to be candid and unambiguous, and should be documented. After all, management may not want to face or accept the threat of insolvency and therefore may seek alternative interpretations. In this case, advisors have to stand their ground and should not ‘explain away’ the crisis. The research shows that with MSMEs restructuring efforts have been initiated in several cases by auditors (where present) and tax consultants (in Germany) alerting management to a (potential) crisis.

Guideline #1.1 (*Voluntary early warning systems*). Even in the absence of legal duties or recognised standards, debtors should install adequate early warning systems monitoring the business for indicators of a crisis / ‘crisis events’. They should instruct and direct employees to recognise such indicators and promptly alert management.

Policy Recommendation #1.6 (*Basic training on accounting, business and finance*). Entrepreneurs and directors should have access to training on accounting, finance and business basics and their legal obligations.

Guideline #1.2 (*Access to current and accurate information for advisors*). Professional advisors hired by the debtor should be given access to current and accurate information and tasked to assess it also for signs of a crisis and advise management accordingly.

¹⁴ For Germany, cf. Federal Court of Justice (Bundesgerichtshof), 26 January 2017, case IX ZR 285/14, ECLI:DE:BGH:2017:260117UIXZR285.14.0, outlining the duties of a tax consultant hired to draft the annual financial statements to (a) assess the viability of the business and (b) alert management of material insolvency and the corresponding directors’ duties when the information made available to them clearly supports such finding.

3.3. What the creditors and shareholders can do; the role of financial creditors in particular

As stated above (*supra*, par. 1), creditors should not normally be under an obligation to keep themselves informed on the financial status, business success, or viability of their debtors, let alone actively alert their debtors or public entities to perceived issues within the debtors' businesses.

The most pronounced exception to this general rule concerns banks and other financial institutions. They are under legal obligations to assess and mitigate their exposure to risks. In this context, at least with loans or other forms of credit above a certain threshold, they have to request from the debtor the disclosure of very detailed information about their financial and economic situation and assess the debtor's viability. This is not just an initial control obligation but an ongoing duty for the entire course of the exposure to the debtor's credit risk. Moreover, a number of additional monitoring requirements have been introduced by European regulators in response to the financial crisis and the massive increase in non-performing loans it has contributed to generate. Many of these new requirements seem to be capable of playing an important role in promoting a timely identification and management of crisis situations.

An organisational measure that is particularly recommended by supervisors is the establishment of dedicated NPE workout units,¹⁵ separated from the loan-granting functions, so as to eliminate potential conflicts of interest and ensure the presence of staff with specific expertise and experience.

Supervisory guidelines prescribe that dedicated units of lenders should engage with the borrower throughout the full NPE lifecycle. They also indicate what the focus of their activities should be during each phase of that cycle. This should result in an active role of lenders in making the debtor aware of difficulties in a timely manner and triggering of early actions. Supervisory guidelines, in particular, require banks to internally implement a number of credit monitoring tools and early

¹⁵ See *infra* Chapter 5, footnotes 14 and 16.

warning procedures and indicators (at both the portfolio and borrower level) so as to promptly identify signals of client deterioration. Banks are also advised to develop specific automated alerts at the borrower level to be activated in case of breach of specific early warning indicators. When such breaches occur, banks should involve dedicated units to assess the financial situation of the client and discuss potential solutions with the counterparty.

The system of early warning mechanisms to be established at the lenders' level, coupled with wider financial assessments to be conducted on a portfolio- and loan-segment basis should enable banks to develop customised recovery solutions at a very early stage.

The findings of the research show that currently banks, like tax consultants and auditors (*supra*, par. 2), are already very frequently the main initiators of restructuring efforts and negotiations.

However, it is worth remembering that both prudential requirements and supervisory expectations on NPL management are aimed at promoting efficient and prudent conduct by intermediaries in the management of credit risks. Banks' action or their lack of appropriate initiatives in this respect will be assessed by supervisors and might trigger supervisory actions. They should not – very much in line with *supra*, par. 1 – be interpreted as imposing on banks specific duties to inform debtors or to take any initiative in substitution of inactive debtors. Banks may offer their assistance or require borrowers to engage in finding solutions and are recommended to do so for prudential reasons, but only borrowers are responsible for managing distress as part of their entrepreneurial activity, and may consequently be held liable towards stakeholders for the lack of prompt action. For their part, as a general rule banks should refrain from interfering with the business management of their clients, both in good times and bad.

Thus, and even regardless of special obligations of the debtor to disclose information, financial creditors – in particular, when this is the case, the bank with which the debtor mainly transacts¹⁶ – are (together with certain institutional

¹⁶ In some jurisdictions, namely Germany of the four examined, debtors tend – traditionally and still prevalently to some extent – to conduct most of

public creditors like tax authorities and social security creditors) often in a privileged situation because of the extent of the information on and insight into the debtor's situation and finances readily available to them. In addition to that, loan and other financing agreements of a certain size almost invariably contain various 'financial covenants', among them control mechanisms and reporting duties, both regular and in case of certain events (loss of capital, endangered liquidity, growing debts, etc.). Provided that the debtor fulfils its obligations under these covenants, the respective creditor receives crisis warnings and can – even where the debtor does not take them seriously or plainly disregards them – engage in a dialogue with the debtor and (if necessary) put pressure on the debtor to act upon the crisis and pursue a restructuring by threatening to accelerate loans or terminate the financing. Our qualitative research through expert interviews, in particular but not exclusively in Germany, shows that financial covenants providing for contractual reporting duties of (probably in particular medium sized)¹⁷ businesses play an important and beneficial role in this context.¹⁸

Even though it is normally not a creditor's obligation to monitor the debtors' financial situation or look for signs of a crisis, it usually is still in its best self-interest to recognise the crisis as it gives them options to adjust their current and future business with the debtor accordingly (e.g. by not extending trade credit but requiring cash transactions) and to actively encourage and support the debtor's restructuring efforts or other ways to address the crisis, without unduly influencing the debtor and interfering with its business. Probably the only –

their business (current and checking accounts, loans, guarantees, etc.) with one single bank ('Hausbank'); in other jurisdictions, to the contrary, entrepreneurs tend to resort to many banks (multiple lending), even when the business is small (this is the case in Italy). In contrast, the empirical research conducted in Spain shows that the existence of a main (and often only) bank is a general feature of MSMEs.

¹⁷ With big enterprises, it rarely seems to require this external catalyst, whereas micro and (very) small enterprises do not often take out loans of a size warranting sophisticated financial covenants.

¹⁸ This is also the case in Italy, where qualitative research has shown that covenants in financial agreements to which the firm is a party *before* restructuring can play a crucial role in pointing out the financial crisis. Italian National Findings indicate that distressed businesses that have previously entered in financial agreements that contain covenants have almost always already breached such covenants.

however very important – potential downside of this knowledge can result from an increased exposure to (mostly civil) liability and in particular later avoidance or claw-back of payments received from the debtor (cfr. *infra*, par. 5).

However, non-financial creditors' means to monitor a debtor's financial conditions are very limited. For the most part, the simplest, yet best available tools are to observe the debtor's payments (are they made timely and in full?), to pursue outstanding receivables, at some point to start asking for plausible explanations of delays and to not accept vague, evasive or non-answers. From our experience, inquiries with credit agencies providing credit scores and other commercial information on debtors are of limited value as they are relying on publicly available information and on reports by other creditors so that they will usually work on a certain (often considerable) delay – if such an inquiry returns a red flag, it should be taken seriously, while a decent or good credit score should not be considered a conclusive all-clear.

Just like the creditors, or initially even more so, shareholders should be very interested in carrying out an early restructuring should the company head towards crisis because their shares in the equity are affected and devalued even before the creditors' claims.¹⁹ In an insolvent liquidation, whether piecemeal or by going concern sale, they will almost always walk away empty-handed. Despite this, the qualitative research shows that, in particular, shareholders of family businesses as well as private equity investors tend to delay restructuring efforts. Depending on the company's form of incorporation, its statutes and bylaws, the equity distribution, and the shareholders' involvement in managing the company, the degree of insight shareholders have into the debtor's financials and the viability of its business hugely varies. Thus, there are no universal guidelines for shareholders' best practices at this stage – other than to take an interest in the business, make use

¹⁹ This, in turn, means that the situation for shareholders changes completely once they are 'out of the money' and have little or nothing to lose. From this point on, they are likely to be indifferent or even interested in keeping the business going, holding out and/or gambling for resurrection, given that they would likely be divested in a restructuring. One way to address this concern is to allow shareholders to retain some of their interest in the business even after restructuring. The 'relative priority rule' recommended in this Report (cfr. Chapter 2) serves this purpose.

of the shareholders' rights and encourage management to address a recognised crisis promptly.

Guideline #1.3 (*Banks' assessment of debtor's financial condition*). Financial institutions and other institutional creditors with privileged access to financial information regarding the debtor should assess it for clear indications of a potential crisis. In appropriate cases, loan and financing agreements should contain financial covenants providing for regular as well as – in case of certain events – ad-hoc reporting by the debtor.

Guideline #1.4 (*Discussion of financial condition of the debtor on the initiative of a creditor or other party*). If a creditor (or shareholder) gains knowledge of sufficiently strong indicators of a debtor's crisis, they should contact the debtor with the prospect of openly discussing the situation and the options to address it.

4. Incentives to pursue restructuring

Experience shows that debtors and directors are often reluctant to admit to the crisis and to address it openly, in particular by filing for insolvency proceedings or any proceedings with similar effects (particularly on their reputation, their control over the company or, especially with family businesses, their investment).²⁰ External impulses by advisors (*supra*, par. 3.2) or creditors (*supra*, par. 3.3) may help but are by no means a guarantee that management will accept that the situation is serious and should be acted upon.

²⁰ In Italy, the stigma associated with judicial insolvency procedures is still regarded as very high, thus inducing businesses in distress to pursue alternative solutions even when these appear hardly viable. The same happens in Spain, where one of the main reasons explaining the scarce use of formal insolvency proceedings is the traditional personal stigma generally associated with insolvency proceedings. Indeed, this stigma has undoubtedly been a relevant factor to explain the low use of the system in Spain, especially in the initial years. An element that is often present in most societies – and that constitutes a hurdle for most systems across Europe and beyond – had special intensity in Spain, a country where a punitive insolvency framework from the 19th century had been in place until 2004.

Incentives can come in the form of the proverbial carrot or the stick – the currently predominant approach of the law in various jurisdictions when it comes to the debtor’s directors is a stick called ‘liability’. This liability can come in various shapes and forms: general or restricted to certain types of companies; criminal or civil; the latter towards the company or the creditors directly, based on ‘wrongful trading’, failure to restructure, failure to timely file for insolvency or manifold other failures; an obligation to advance the costs of an insolvency proceeding, etc. According to our research, the most common denominator of these liabilities appears to be that they do not *reliably* work as effective incentives, in particular considering MSMEs.²¹ They do, however, work in some cases, especially (but not only) for bigger companies with professional directors that are not considerable shareholders, and they commonly add an extra layer of protection for creditors by either giving them direct claims or allowing the estate to (more easily) raise claims against reckless or at least negligent directors.

Thus, liability does have its place in the law. So it makes perfect sense if Article 18 of the draft Restructuring Directive requires the Member States to institute directors’ duties where there is a likelihood of insolvency to, *inter alia*, take reasonable steps to assess the crisis as well as the company’s viability and – if reasonable – to avoid such insolvency and to not endanger the business’s viability in the interests of creditors and other stakeholders. Such a duty will usually come with – at least – a civil liability attached. Informed by our research as well as general considerations, though, we do recommend changes to Article 18 to focus the liability and clarify the directors’ duties.

However, the carrot in the form of positive incentives may overall be the superior – or at least, accompanying liability, an equally valuable – approach. The most valuable positive incentive probably is one the law cannot offer, i.e. the positive recognition of management’s crucial role in turning the business around and averting the crisis, countering the negative reputational impact of being in charge when a crisis started.

²¹ Another possible negative incentive is the disqualification of directors neglecting their duties from leading another business venture for a certain period of time. It does not, however, appear to be any more effective than liability with regard to the current business – its effect mostly is preventive, keeping incompetent and/or reckless persons away from future (official) management roles.

Another positive incentive that the law can dispense more easily is granting access to certain proceedings (such as moderation, conciliation, restructuring or similar) only if management applies for them during an early stage of crisis as long as these proceedings are considered preferable by management, e.g. because they are more predictable or less invasive (with regard to supervision or replacement of management, interference with day-to-day business, etc.), when compared to the alternatives (and in the last instance formal insolvency proceedings). In particular with single entrepreneurs or partner-led partnerships, privileged discharge of debts could function as a carrot incentivising management to enter restructuring or insolvency proceedings sooner.

A very important issue is whether to allow creditors or other stakeholders²² to bypass a reluctant debtor (i.e., for corporate debtors, their management) and effectively initiate restructurings regardless of the debtor's (at least initial) approval. Given that there are strong arguments both in favour and against creditors' initiative,²³ the research group has

²² Shareholders can potentially use their ownership (provided they garner the necessary majority or can exercise relevant minority rights) to replace or order management to act according to their requests.

²³ The Dutch legislature will soon introduce new provisions to the effect of empowering creditors to initiate a pre-insolvency restructuring and, possibly, divesting the debtor of the business. In brief, if a debtor will soon be unable to pay its debts as they fall due and, upon the creditor's request, does not undertake a restructuring, the court may appoint an expert entrusted with the task of proposing a restructuring plan, to the exclusion of the debtor. See Article 371 (unofficial translation, courtesy of Resor.nl):

'Article 371 (*Proposal of a restructuring plan by the creditor*) 1. If it can reasonably be assumed that a debtor will be unable to continue paying his debts as they fall due, a creditor may request the debtor in writing to propose a restructuring plan within the meaning of Article 370. If, within one week, the debtor does not undertake to do so, or if, after having given this undertaking, one month has elapsed and no restructuring plan has yet been proposed which has a reasonable prospect of being confirmed by the Court pursuant to Article 381, the Court may, at the creditor's request, appoint an expert who will then have the right, to the exclusion of the debtor, to propose a restructuring plan.

2. The Court may also, on the application of a creditor, appoint an expert as referred to in the first paragraph where the debtor has proposed a restructuring plan which, upon a vote as referred to in Article 378, has not been accepted by a single class or in respect of which the Court has denied confirmation on the basis of Article 381.

3. Upon request or of his own motion, the debtor must provide, in accordance with any directions thereby given, the expert referred to in the first and second paragraphs with all information and cooperation which the expert

decided not to recommend a change in the draft Directive to this effect or make a corresponding policy recommendation. The situation is different, however, when the debtor has already initiated a restructuring: in such case the creditors should be allowed to propose a competing plan. Overall, an effective restructuring will not work with (or against) a reluctant debtor and, while the threat of a competing plan may well counterbalance the debtor's leading role in the process, the creditors' right to initiate a proceeding would not have this effect. As long as the debtor is not insolvent – at which point the creditors can file an involuntary petition – the initiative should generally rest with the debtor.

In any case, for certain proceedings that mostly provide for moderated negotiations and are not cumbersome or prejudicial on one hand, and for certain situations of qualified default/non-performance or otherwise close to insolvency on the other hand, a case could be made for allowing creditor initiative. This decision should be made by the national legislators. Short of that, creditors are basically limited to communicating with and advising or convincing the debtor to pursue a restructuring attempt, also by exercising their bargaining power and threatening to enforce their claims.

Guideline #1.5 (*Debtor should address crisis in a timely manner*). Debtors should address a crisis in a timely fashion by properly assessing it and, given the business's viability, taking action to avert it with a view of minimising the risks to creditors as a whole by, for example and as appropriate, making operational changes and/or initiating negotiations with key creditors, customers, suppliers or potential investors.

Policy Recommendation #1.7 (*Incentives to prevent and address crisis*). The law should create both positive and negative incentives for directors to safeguard their creditors' and other stakeholders' interests by monitoring the business, assessing its viability in a crisis, and take appropriate steps (e.g. restructuring or liquidation).

states he needs for the exercise of his duties or in respect of which the debtor knows, or ought to know, that these are relevant. (...)'.

5. Reduction of disincentives

In particular with regard to creditors, it appears crucial that the law does not create adverse incentives (disincentives) to collect and communicate information regarding a crisis (see *supra*, 3.3) and, for instance, to enter into restructuring negotiations with the debtor, to reschedule debt and/or to supply fresh money to finance what appears to be a promising restructuring attempt. By far the most relevant disincentive in this regard appears to lie in the avoidance powers in case of a subsequent insolvency proceeding.

The draft Restructuring Directive recognises this and in Articles 16 and 17 provides for protection of new and interim financing and of other restructuring-related transactions. However, in addition to other shortcomings, this only covers transactions in the context of a formalised restructuring proceeding (modelled after the draft Restructuring Directive) and does not affect the avoidability of any payment received outside of such proceedings but after, for instance, the creditor gained knowledge of the debtor's crisis.

Creditors should not be encouraged to collude or bargain with the debtor to the detriment of other creditors, or to use their superior knowledge of a crisis to put undue pressure on the debtor resulting in preferential treatment compared to other creditors. However, up until at least the point of material insolvency, it should be regarded as legitimate to pursue (with the mechanisms provided for by the general law) one's claims even when suspecting or having positive knowledge of a crisis. Taking sensible precautions, paying attention or being alert should not work against a creditor. On the other hand, the law should not favour enforcement of claims impairing restructuring prospects over sensible cooperative behaviour.

Avoidance and lenders' liability regimes have been considered a big obstacle for restructurings in our research, especially in the expert interviews with advisors to both debtors and creditors. In Germany, for example, the very strict avoidance regime (in particular in its interpretation by insolvency practitioners and some courts) creates certain incentives for creditors to distance themselves from the debtor, not communicate with the directors, not negotiate or accept partial payment on overdue claims but to enforce them

judicially and have assets seized. In Italy, the reforms of 2005-2006 and subsequent fine-tuning measures significantly reduced the reach and scope of avoidance actions and introduced specific exemptions to avoidance actions and to criminal liability: formerly, purely informal out-of-court restructurings were considered too risky to pursue and would only take place for very significant debtors. Still now, lender liability is a serious issue in crisis management in Italy.²⁴

Illustration. Simplified, according to sec. 133 German InsO, payments made by the debtor during the last four years before a petition to commence insolvency proceedings can be avoided if the debtor acted with the intention to disadvantage his creditors and the recipient was aware of this intention. The latter is presumed if the recipient was, at the time of the payment, aware of the debtor's (in some cases: imminent) insolvency. While these requirements (which have already been tightened in 2017 because of excessive avoidance claims) for avoidance read very restrictive, courts (with hindsight bias) tend to construe them extensively. For example, if a director is aware of facts constituting insolvency, it is more or less presumed that all subsequent payments were made with the intention to disadvantage the creditors as a whole, and, similarly, the debtor's non-performance over a considerable time, erratic payment of instalments and/or similar evidence often leads insolvency practitioners and judges to presume the recipient's knowledge of said intention – all the more so if the recipient had even the faintest knowledge of the debtor's strained financial situation. On the other hand, if creditors successfully enforce their claims with the help of the authorities, the enforcement actions are (usually) not considered payments made by the debtor so that they are unavoidable unless made in close proximity (three months) to filing. Thus, it may appear prudent for creditors to not negotiate with debtors in crisis, to not consider participating in restructuring efforts but

²⁴ Spain has somehow tackled the problem of the lender's liability by providing that lenders are not to be automatically considered as de facto directors by virtue of the obligations that the borrower has assumed under the refinancing agreement (see art. 93.2-2nd IA). However, this provision does not completely prevent lenders from being considered de facto directors, since this condition might derive from the specific provisions contained in the agreement. In other words, the lender's liability has to be determined on a case-by-case basis.

to directly enforce their claims and hope the debtor – while then almost inevitably headed for insolvency – will not file within three months.

Other German rules and their excessive interpretation create a certain risk that far-reaching financial covenants can result in the creditor being treated as a (subordinated) shareholder-lender. While the courts accept an (all-too-narrowly construed) privilege for payments in the context of restructuring attempts, overall, the avoidance rules – especially but not only in Germany – pose both a huge obstacle to actual restructurings and a disincentive for creditors to engage in negotiation with the debtor and keep their eyes open for crisis signals.

Policy Recommendation #1.8 (*Disincentives to creditors' cooperation and overly harsh avoidance regimes*). Creditors and other stakeholders must not be discouraged by the law and its application from monitoring the debtor's financial situation and engaging in communication and negotiations with the debtor regarding a crisis and its resolution. Avoidance regimes and lenders' liability, in particular, should be appropriately curtailed and – outside of the debtor's material insolvency – restricted to cases of abuse and collusion.²⁵

Annex 1: A restructuring-friendly environment

Closely connected to the last point, national laws contain several obstacles for restructuring attempts and do not always provide for sufficient tools and reliefs to allow for the restructuring of viable businesses.

To carry on with the example of Germany: in addition to the obstacles mentioned before (avoidance and lenders' liability), qualitative research identified further obstacles, for example the tax regime (with the main concern being the

²⁵ Cf. the French example of shielding lenders (in particular banks) – albeit only in the context of institutional restructuring proceedings – from liability found in C. com., art. L 650-1, allowing only for three avenues to liability: (1) fraud, (2) interference with management, (3) excessive securities.

‘taxation of restructuring profits’) and the subordination of shareholder loans even if they were extended with the sole purpose of financing a worthwhile restructuring attempt (see also Chapter 3, par. 3.2.8, 5.1.11 and 5.1.13 on these issues).²⁶ Currently, German law does not provide for any statutory priority of fresh money provided by non-shareholders to finance a restructuring attempt, and lacks tools facilitating going-concern sales (whether in insolvency or beforehand). For example, if a business heavily relies on certain contracts or licenses, a going-concern sale is not possible without the approval of the other party or the licensor.

Policy Recommendation #1.9 (*Restructuring-friendly legal environment*). Legislators should take steps to create a generally restructuring-friendly legal environment by creating sensible privileges for worthwhile restructuring attempts (whether merely contractual and out-of-court or in the form of a restructuring proceeding), e.g. priorities for interim and new financing, by facilitating going-concern sales and by abolishing or curtailing existing obstacles.

Annex 2: Promoting a co-operative approach between debtor and banks

Banks must implement structured monitoring systems for prudential/supervisory purposes. Such systems are aimed, *inter alia*, at capturing the occurrence of specific events (e.g. initial arrears) that may signal the deterioration of the loan. Nothing, however, prevents a debtor from taking initiatives prior to the occurrence of those specific events, which cause lenders to send alerts and take preliminary contacts. Indeed, a debtor might always be aware of other sensitive events unknown to creditors that may affect the business’s financial soundness, and they should start to plan remedies on their own, possibly with the assistance of financial advisors.

²⁶ The rule in sec. 39 para. 4 sent. 2 InsO only exempts situations in which creditors for the first time acquire (sufficient) shares during restructuring but not situations where existing (qualified) shareholders extend loans.

Under these circumstances, however, a debtor might be exposed to the risk of wasting time and resources in devising a plan that might envisage concessions that a financial creditor would not accept due to regulatory and operational constraints, or as a consequence of its own NPL strategy or internal assessments on the prospects of the specific exposure or the segment of exposures to which the latter belongs (on this specific point see also Chapter 5). To prevent this, debtors should approach their financial creditors in a timely manner – i.e. at very initial signs of distress – to verify with them the existing (regulatory or operational) boundaries within which any negotiation would have to take place in case the situation gets worse. In turn, banks should be encouraged to share the result of internally conducted financial assessments with interested debtors, including sectorial analyses, that may anticipate the evolution of the crisis and may help the debtor identify the most effective and feasible remedies. This type of assistance may be particularly beneficial to small and medium enterprises, which might not have in place adequate risk monitoring mechanisms or may not avail themselves of the assistance of qualified financial advisory services.

In order to promote a cooperative approach by banks in this respect, debtors should in turn be ready to provide – subject to proper confidentiality arrangements – any information that may impact their creditworthiness and that might be useful for a prompt assessment by lenders of the financial situation of the debtor and the possible activation of early warning mechanisms (this topic has obvious implications on the negotiation phase, for which see Chapter 5).

CHAPTER II

FAIRNESS*

SUMMARY: 1. Introduction. – 1.1. Substantive and procedural goals. – 1.2. Imperfect information and how not to respond to it. – 1.3. Fairness of process and of outcome. – 2. Treatment of equity claims. – 2.1. The ‘debt/equity bargain’. – 2.2. The treatment of equity holders in the absence of the God’s eye view. – 2.2.1. The ‘still solvent’ scenario. – 2.2.2. The ‘micro, small and medium enterprises’ scenario. – 2.2.3. The ‘irrational creditors’ scenario. – 3. Notification and information provision. – 4. Comparator. – 5. Competing plans. – 6. Class constitution. – 7. Conduct of meeting. – 8. Court’s review and confirmation. – 9. Dissenting stakeholder classes.

1. Introduction

1.1. Substantive and procedural goals

In order to understand how plans might be fair, it is useful to distinguish between the substantive and the procedural goals of insolvency law.¹ *Substantive goals* are the ends or objectives of this law, pursuit of which shows why it is desirable to have this law at all. At a prosaic level, insolvency law’s substantive goals include identifying those distressed businesses that remain viable and facilitating their preservation as going concerns, recycling the assets of non-viable distressed businesses to fresh uses, and, in each case, returning the maximal feasible value from the process to those entitled to it. *Procedural goals* relate to the methods the law adopts in

* *Although discussed in depth and shared by all the members of the Co.Di.Re. research team, this Chapter is authored by Riz Mokal.*

¹ R. MOKAL, ‘Corporate Insolvency Law. Theory and Application’, Oxford, OUP, 2005, 20-26.

seeking to pursue substantive goals. Efficiency is an important procedural goal, and requires minimising the waste of social resources and mitigating perverse incentives.

1.2. Imperfect information and how not to respond to it

In relation to distressed businesses, it is often a critical and disputed question whether the business remains viable and ought to be preserved as a going concern, or whether instead it is non-viable and ought to be liquidated. In the former case, there are also questions, equally critical and disputed, as to *how* the business should be restructured in order to rescue it from distress, who should manage it through and beyond the restructuring, and how the value thereby preserved or created should be distributed.

From the ‘God’s eye view’, from which truth is discerned perfectly with no limitations inherent to the observer, these questions would be readily answerable.² The God’s eye view is not, needless to say, accessible to mere mortals engaged in insolvency proceedings. No court or expert has privileged insight into the competence and integrity of present and potential future management; the loyalty and goodwill of key employees, suppliers, and customers; the prospects for the economy as a whole and the particular sector in which the business in question and its competitors operate; or the relative contribution to a successful rescue of the various parties and of factors beyond the parties’ control. In the absence of any such God’s eye view, the substantive goals of the law cannot be pursued directly. They must instead be sought by proxy, through the very process of formulating, proposing, voting on, confirming, and implementing a plan. The process should involve parties with the best knowledge of the debtor, its business, management, and prospects; who hold a legal stake in the outcome; and who have personal incentives to get the restructure-or-liquidate decision right. Such parties must be armed with appropriate information, be accorded cost-effective access to expert evaluation of the proposed plan, and then be

² While the notion of a God’s Eye view dates back to Xenophanes of Colophon c. 500 BC, its modern formulation is owed to H. PUTNAM, ‘Reason, Truth and History’, Cambridge, Cambridge University Press, 1981, 50.

asked to vote on it. (For the reasons explored below, the parties paradigmatically fitting this description are creditors as a group.)

A restructuring plan proposes how the assets, operations, and affairs of the business would be arranged so as to effect a rescue, who would helm this process, and how the resulting value would be distributed. This may either entail the direct continuation of the business or its sale as a going concern. The approval and confirmation of a restructuring plan represents the decision that the business remains viable, may appropriately be entrusted to the management proposed in the plan, and that the proper distribution of the resulting value has been identified. The rejection of all proposed plans indicates that, for some combination of reasons bearing on the foregoing issues, the business is fit only for liquidation as a gone concern.

1.3. Fairness of process and of outcome

Fairness is a key attribute of the processes for formulating, proposing, voting on, confirming, and implementing plans. It requires vesting decision-making at each of these stages in the parties – primarily creditors but also equity holders and possibly others – in a way that is commensurate with their stake in the outcome; by facilitating the availability to them of information and expertise bearing upon their decisions, by ensuring that there is due accountability as to the exercise of decision-making power, and by doing so in a cost-effective (which is to say, least wasteful) manner. Understood thus as concerned with due respect for legal rights, availability of information and expertise, due accountability, and cost-effectiveness, fairness is a key procedural goal of insolvency law, best enabling pursuit of the law’s substantive goals (identified above).³ A plan inherits the fairness of the process from which it results.

This chapter considers the requirements of fairness at each significant step in the plan proposal, consideration, confirmation, and implementation process. It begins by clearing

³ This draws on R. DWORKIN, ‘Law’s Empire’, Cambridge MA, Harvard University Press, 1986, 164-5; R. MOKAL, ‘On Fairness and Efficiency’, (2003) 66(3) *Modern Law Rev*, 452, 457-462.

the ground of certain endemic confusions regarding the treatment of equity claims.

2. Treatment of equity claims

2.1. The 'debt/equity bargain'

It is important to bear in mind the fundamental nature of what may be called the debt/equity bargain.⁴ Creditors are restricted to principal plus interest at the stipulated time, may in principle only claim against the debtor's assets where it is a limited liability entity and have no recourse to its equity holders, do not stand to gain additional benefit even if the debtor is spectacularly successful in its use of the sums it has borrowed, stand to suffer losses in the debtor's insolvency, but are entitled to be paid *before* equity receives anything. By contrast, equity holders' claims have no upper limit and they stand to capture any upside from the debtor business once fixed (i.e. debt) claims have been paid in full. Correspondingly, however, equity holders are residual claimants not entitled to *any* particular return at all, any such return being contingent, precisely, on the prior satisfaction of debt claims.

This debt/equity bargain defines the essential context of any restructuring plan. Definitionally, creditors' legal rights are violated if and to the extent that they are not paid at the time and in the manner and quantum of their entitlement. Fully solvent restructurings apart, this is true of all scenarios in which a plan is proposed or contemplated. Even 'preventive' procedures that become available where there is merely a likelihood of insolvency characteristically involve overriding creditor entitlements to provide interest payment holidays, extended principal repayment periods, and more. That is to say, creditors' legal rights are forcibly rewritten in a way that is detrimental to them at least *prima facie*.

In all such scenarios, then, the debt/equity bargain is in play. Since creditors are not to receive their entitlements, their interests supersede and trump the interests of equity holders,

⁴ See R. MOKAL, 'An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain', (2000) 59(2) Cambridge Law Journal 335, 345-346.

who are not entitled to any particular return and not entitled to be paid at all unless creditors receive their entitlement, or else agree otherwise by consenting to a restructuring plan by requisite majorities.

2.2. The treatment of equity holders in the absence of the God's eye view

This implication of the debt/equity bargain troubles some commentators in three scenarios in particular.

2.2.1. The 'still solvent' scenario

The first concerns the aforementioned 'preventive' or 'pre-insolvency' scenario where a restructuring process is invoked before the debtor has missed any debt repayment. Here, insolvency is not established and the question is whether creditor interests should nevertheless trump equity ones. In the absence of universal creditor agreement that the debtor remains solvent, the response must be in the affirmative. There is *ex hypothesi* a conflict between equity, which asserts the debtor's solvency, and debt, which denies it. Which side had the truth would be easy to ascertain from the God's eye view. Lacking omniscience, legal actors including judges and legal processes are exactly in the position described above: a plan is being proposed non-consensually to rewrite creditors' legal entitlements. Since creditors are not to receive that to which they are legally entitled, equity holders are not entitled to any value in the debtor's estate. The only way in which they ought to be permitted to receive some such value is by persuading at least the requisite majorities of creditors to a plan that provides as much. Not only do creditors have legal rights at stake and personal incentives to get the restructure/liquidate decision right, they have dealt with the debtor, its management, and the part of the market in which the debtor and its competitors operate. They rather than a judge or anyone else are best placed to take the leading role in the restructure/liquidate decision, and thus in voting on the plan. There is no reason to believe that a plan that has failed to obtain requisite creditor majorities would permit the business to continue, nor that it would allocate the value in the estate fairly, i.e. respectfully of legal rights, duly

informed by debtor-specific knowledge, and in a cost-effective manner.

2.2.2. The 'micro, small and medium enterprises' scenario

The second scenario in which some may challenge the implications of the debt/equity bargain concerns micro, small and medium enterprises ('MSMEs'). The viability of some MSMEs may depend on the same person(s) combining the role of manager and residual risk-bearer (i.e. equity holder). Given the size, nature, and/or location of the business and its turnover, the business may not be viable unless the same persons were both managers and equity owners, thereby effectively cross-subsidising the two roles. Further, the viability of some MSMEs may turn on the continuing goodwill of certain of its suppliers, customers, and/or key employees, which in turn may be contingent on pre-distress managers retaining ongoing control.⁵ In relation to a business characterised by one or more of these factors, it might be thought that the retention of the pre-distress equity holding management should have independent weight even against the wishes of creditors.⁶ Again, however, this assumes access to the God's eye view from which it is just evident *both* that the business is viable and ought therefore to be continued *and* that it may only continue with the old equity-holding management in place. In the absence of omniscience, the question is how to decide whether and how best to continue the business. Who should have decisive say? Not the old equity holders, who have clear incentives to favour their own retention. Nor a court, which has no direct knowledge of or expertise bearing on the business, its affairs, managers, competitors, or prospects. Creditors as a group are better placed than any other to make these decisions.

⁵ Both these situations receive detailed consideration in R. MOKAL, *Corporate Insolvency Law*, Oxford, OUP, 2005, Chapter 7.

⁶ A further issue is whether the equity-holding management would have adequate incentive to early address the situation of distress, lacking a reasonable perspective of retaining an equity interest in the company as a result of the restructuring. This is particularly important because a delay in accessing restructuring could result in a worse outcome for the creditors as a group or, even, in making unviable a business that, if the restructuring were timely started, would have been viable. In this regard, see also Chapter 1.

2.2.3. The 'irrational creditors' scenario

Third, some may worry that creditors should only be entrusted with the primary role in the plan approval process if and insofar as they are rational, but that creditors may often act irrationally. This concern with irrationality should, however, be in principle symmetrical between creditors on the one hand, and equity holders, courts, and others on the other. In the absence of reasons for thinking that creditors are particularly prone to irrationality in a manner that does not hold for these other actors, there is no basis for stigmatising creditor decision making and favouring decision making by others. Creditors may sometimes be rational and at other times irrational, but so may these others. Creditor irrationality provides no reason for departing from the analysis in the previous portion of this section.

Policy Recommendation #2.1 (*Creditors' support as a requirement for the confirmation of a plan*). A plan should only be confirmed if it receives requisite support from creditors whose rights are to be affected.

3. Notification and information provision

Notification of steps in the plan formulation and approval process may be provided electronically and/or online where this is the usual mode of communication with the relevant stakeholder group.

All those affected, including creditors and equity holders, must be given individual notice of the meeting at which the plan is to be voted on and provided with ready access to the plan and appropriate information about it. Where individual notice cannot be provided, the debtor should be required to take all reasonable steps to provide notification, and should be required to satisfy the court both that individual notification was not practicable and that it has done everything reasonably practicable to provide notification. A reasonable notice should range from two to four weeks, although the court should be entitled to permit or require an abridged or extended period.

Policy Recommendation #2.2 (*Notice to creditors*).

Intended parties to a restructuring should be provided with adequate notice of steps in the plan formulation, approval and confirmation process. Two to four weeks of notice should be provided unless the court authorises an abbreviated or extended period.

Policy Recommendation #2.3 (*Electronic or online notice*).

The notification may be provided electronically and/or online where this is the usual mode of communication with the relevant stakeholder group.

Policy Recommendation #2.4 (*Individual notification*).

Each affected stakeholder must be provided with individual notification unless the court is persuaded that such notification is not reasonably practicable and that all reasonably practicable steps have been taken to notify the stakeholders in question.

Those whose vote is sought should be provided with sufficient information about the effect of the plan and the benefits and burdens provided under and collateral to the plan to stakeholders, including the debtor, its affiliates, and decision-makers.

The information should enable the parties to reasonably consider the pros and cons of the plan and whether voting for or against it would better advance their interests.

The information should be up to date. If material changes have occurred between the provision to parties of the plan and the date of the meeting, this should be disclosed to the parties with reasonable promptness.

In cases of a complex plan, a list of questions and answers should be included, as well as a list of advisory organisations.

The legal framework should be designed so as to create incentives for the debtor to err on the side of excessive rather than insufficient disclosure of information.

Policy Recommendation #2.5 (*Adequate information to be provided to stakeholders*). Stakeholders whose vote is sought should be provided with sufficient

information about the effect of the plan, the allocation amongst stakeholder groups of benefits and burdens under it, any collateral benefits offered or provided to some but not all stakeholders, the intended treatment of management. The information should be up to date, and, if necessary, should be updated.

4. Comparator

Stakeholders should be provided with analysis of the comparator for the plan, that is, the scenario most likely to materialise in the absence of the implementation of the proposed plan (e.g. continuation in business with no modification of its obligations, insolvent liquidation). Stakeholders should be informed of what they are likely to receive in both the plan and the comparator scenarios.⁷

Stakeholders' liquidation returns set the absolute floor for the plan being admissible. That is to say, a plan under which any stakeholder receives less value than under a liquidation is highly unlikely to be justifiable except with that stakeholder's individual consent. To the contrary, alternative plans – either merely hypothetical or indeed put forward by creditors or third parties but that for any reason have not been approved yet and do not look likely to be approved (see next paragraph) – do not set any absolute floor relevant to the admissibility of other plans.

Even if the debtor were to be placed in insolvent liquidation proceedings, it remains possible in principle either for its business to be broken up and disposed of piecemeal ('piecemeal sale') or else for it to be sold off wholly or in significant part as a going concern ('going concern sale'). The plan should explain why piecemeal or going concern sale is the correct comparator.

⁷ In Spain, a thorough analysis of the comparator scenario was performed in the *Abengoa Case*, Commercial Court no. 2 of Seville, Judgement 442/2017, 25 September 2017.

Policy Recommendation #2.6 (*Information on the no-plan scenario*). The plan should provide information about the debtor's prospects and the stakeholders' likely returns in the event that the plan is not approved. As appropriate in the circumstances of the particular case, this may require information in the event of the debtor's entry into insolvent liquidation or other proceedings or else the debtor's continuation in business with no modification of its obligations. If the correct comparator is insolvent liquidation, the plan should explain whether the debtor's business would be subject to a going concern sale or a piecemeal sale. In each of these scenarios, the plan should explain why it is in the affected stakeholders' interests to approve it.

5. Competing plans

There is a question whether stakeholders may be presented with more than one plan on which to vote. In general there are three alternatives.

First, only the debtor may be permitted to place a plan before stakeholders. This important element of control over the restructuring process would tend to incentivise the debtor to commence that process, and capitalises on the debtor's private information about the enterprise, its assets, affairs, and prospects. However, it also opens up the potential for expropriation of stakeholders shut out of the indubitably advantageous plan formulation process at the behest of the debtor and favoured stakeholders.

The second option is for any creditor to be permitted to draw up its own plan, to present it to stakeholders, and to invite the debtor to propose the plan for a vote of the stakeholders. However, the debtor retains the right to choose whether to do so. To the extent that stakeholders are persuaded of the superiority of the creditor plan, they would be less likely to support the one presented by the debtor. How realistic it proves for creditors to exercise this information- and resource-intensive option to formulate a plan that might never be put to a vote is very much open to question.

The third alternative is for one or more creditors to be permitted to formulate and put forward their own plan for a vote of the stakeholders. If that plan attracts the requisite support and proves more popular with stakeholders than the plan formulated by the debtor, then it rather than the debtor's plan should be presented to the court for confirmation. The option for creditors to formulate a competing plan is likely to remain theoretical in most cases given the costs and debtor-specific information required to formulate a credible plan. Besides possibly disincentivising the debtor to commence the restructuring process, there is also a perceived risk that the availability of this option would open up possibilities for abuse by creditor coalitions that would illegitimately expropriate the rights of equity holders. This abusive scenario is highly implausible, given that the debtor could pay creditors from its own resources or by obtaining new funding, or else it could persuade the court to exercise its independent judgment to reject the offending plan. In general, it is difficult to think of any jurisdiction in which courts have a reputation for being overly ready to disentitle equity holders at creditors' behest, and easy to think of several whose courts are regarded as overly reluctant to do so. The significant advantage of this option is to incentivise creditors to consent to the continuation of the business because they have confidence in the plan presented by one or more of their own number rather than by the debtor. In marginal cases, this option may preserve wealth and employment through the continuation of the business.

A variant on the third alternative described above, familiar from US restructuring practice, is for the debtor to be afforded an initial exclusivity period within which only it may propose a plan. If no plan has been proposed when the period expires and is not extended by the court, creditors and the bankruptcy trustee may also propose plans that end up competing with the one put forward by the debtor. The exclusivity period is intended to incentivise the debtor to formulate and table a plan with due promptness. However, its efficacy turns on knowledgeable specialist bankruptcy judges able to assess whether to extend the period on the basis that the debtor is making due progress in formulating its plan or else to refuse any extension on the ground that there is no sufficient prospect of the debtor putting forward a credible plan if allowed additional time. In the absence of such judicial expertise, as in

the large majority of EU jurisdictions, the existence of an exclusivity period risks adding to the length of proceedings as debtors are given but do not make due use of it, and, what is worse, are then able to persuade judges to extend the period.

Policy Recommendation #2.7 (*Competing plans*). Any creditor or a group of creditors should be permitted to formulate their own plan and to place it before relevant stakeholders for their consideration and vote.

6. Class constitution

Stakeholders must be placed in classes to enable a collective, mutually informed consideration of the plan based on shared interests. Classification involves a balancing exercise. To place stakeholders in the same class who do not have sufficiently common interests is to negate the reason for classification. At the same time, since each class is entitled to distinct consideration when assessing the appropriateness of a plan, to place some stakeholders in a separate class is to provide them with some degree of veto power in relation to it.

It is for the party proposing a plan (characteristically, the debtor) to identify the stakeholder groups(s) to whom it seeks to propose the plan. The plan proposer must also propose how to categorise the stakeholders into classes.

Each class should be constituted of stakeholders with legal rights that are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

The dissimilarity of rights is a function jointly of pre- and post-plan rights. Stakeholders X and Y may belong in separate classes if either or both of the rights they currently hold and those they would hold if the plan were to be put into force are so dissimilar as to make it impossible for them to consult together with a view to their common interest.

What matters *for the purposes of classification* are the legal *rights* of the stakeholders, and not their private *interests*, i.e. interests not derived from their rights against the debtor. However, the private interests of some stakeholders may diverge so significantly from those of other members of the

class that the court should discount or disregard those stakeholders' votes as unrepresentative of the class.

The mere fact that stakeholders' rights are different does not require that they be placed in separate classes. What matters is dissimilarity so significant that those stakeholders cannot consult together with a view to their common interest, as mentioned above. For example, it may be appropriate to place in the same class stakeholders whose respective rights are subject to different contingencies as at the date of the proposed confirmation of the plan, so long as they are valued in a transparent, consistent, and defensible – even if rough and ready – manner.

Stakeholders whose rights are not affected by the plan need not be asked to vote on it.

Policy Recommendation #2.8 (*Classification of stakeholders for voting purposes*). The party proposing the plan should also propose how stakeholders are to be classified for voting purposes.

Policy Recommendation #2.9 (*Class formation: commonality of interest*). Stakeholders should be placed in the same class if their legal rights both prior to and as amended if the proposed plan were to be implemented are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

Policy Recommendation #2.10 (*Class formation: relevance of legal rights, not private interests*). What matters for classification purposes are the parties' legal rights against the debtor. Their private interests, and any rights they might hold against third parties (such as guarantors) should generally be irrelevant to classification, though they may be taken into account by the court in considering whether their vote should be discounted.

7. Conduct of meeting

There should be an appropriate link between the stake each voter has in the outcome and the value accorded to their vote. Creditors should be entitled to vote the face value of their claim even if they had acquired such claim at a discount.⁸

Policy Recommendation #2.11 (*Value of claim for voting purposes*). Creditors should be entitled to vote the face value of their claim.

In general, where no one present at the meeting objects to the manner in which it is conducted, the court should not entertain subsequent objections on the issue.

The purpose of the meeting is to enable consideration and debate of the merits of the plan. However, the law should not require a physical meeting but instead should permit voting by proxy or virtual meetings. When the meeting is virtual, the communication tools used to allow creditors to cast their vote should ensure adequate certainty about the identity of the creditor, while not requiring them to incur any additional costs.

Where stakeholders are represented by proxy or are content with a brief or even no discussion, that in itself should not be a basis for challenge.

Policy Recommendation #2.12 (*Voting procedures not requiring a physical meeting*). The law should permit voting by proxy and virtual meetings for voting on a plan. The means of communication, preferably digital, used to allow the creditors to vote on the plan should ensure certainty on the capacity of creditors to take part in the virtual meeting.

⁸ Certain ‘loan-to-own’ scenarios, in which specialist funds acquire distressed debt claims with a view to converting them to a controlling share of the debtor’s equity, can be problematic. In relation to the fairness of restructuring plans, this issue is addressed through the design of the ‘relative priority rule’, discussed below. Broader concerns, such as the abuse of loan covenants so as to facilitate acquisition of control over the borrower, fall beyond this project’s scope.

Policy Recommendation #2.13 (*Presumption of validity of stakeholders' meeting*). There should be a rebuttable presumption that the meeting at which stakeholders voted was conducted properly and that the parties voted in a valid manner. The paucity of a debate at the meeting should not be a basis for rebutting this presumption.

8. Court's review and confirmation

In general, parties given sufficient information about the plan and sufficient time to consider its implications for them are in a better position than the court to consider whether the plan is in their interests. Their votes should be sufficient to deem that the class has approved the plan, unless there is reason to doubt that they were representative of their class.

The court must not simply rubber-stamp a plan approved by the requisite majorities, but must exercise its own judgement to satisfy itself that the plan meets the requirements of the law. It should consider the following:

(a) Was the information provided to the stakeholders, and the time given for considering it, adequate? In answering these questions, the court should consider the level of sophistication of those asked to vote.

(b) Were the majorities in each class acting in a bona fide manner in the interest of the class? There should be a rebuttable presumption that they were. This test would not be met if those in the majority were promoting private interests not deriving from the legal rights against the debtor held by each class member. The court should discount or disregard votes of those with personal interests adverse to those of the class, or personal interests not shared with other members of the class such that they would not have voted for the plan in the absence of those collateral interests. The votes of stakeholders connected with the debtor, its affiliates or decision makers would often be worthy of such treatment. So would the vote of a party with the benefit of a credit default swap or similar that entitled it to a greater return in the debtor's liquidation than if the proposed plan were to be implemented.

(c) Are there any circumstances in the context in which the plan was formulated, proposed, voted upon, or proposed to be implemented that might impair its appropriateness? Examples include where the plan is unnecessary, involves a serious breach of contract with a third party, is ultra vires of the debtor, is subject to significant conditions that remain unmet, or is likely to be ineffective (for example, where part of the plan is to be implemented in another jurisdiction and it is more likely than not that the courts of that jurisdiction would refuse it recognition and effect). See also Chapter 4, par. 5.4.2, on conditions to the plan.

(d) Is the plan manifestly non-feasible? In general, and as explained above, it is the affected stakeholders rather than the court that are in the best position to assess whether the distressed debtor remains viable, and if so, how best to afford it a chance to trade out of its difficulties. The court should be restricted to satisfying itself that it is more likely than not that the debtor would not enter liquidation or require further restructuring if the plan were to be confirmed (unless the plan itself envisages such liquidation or further restructuring). Further discussion of this issue is in Chapter 6, par. 4.4.

(e) Is the plan in the best interests of dissenting creditors ('the best-interest test')? This requires dissenting creditors to receive at least as much under the plan as they would in the comparator scenario, that is, one most likely to materialise if the plan were not confirmed (see *supra* par. 4). In all cases, this would require the plan to provide at least as much to dissentients as they would receive in the debtor's piecemeal sale. A *piecemeal* sale would not be the comparator where, for example, the court is satisfied on the basis of credible evidence that a *going concern* sale would likely result if the plan were not confirmed.⁹ The law may also qualify as a comparator a different plan that was put to a vote, has received adequate support, and is likely to be approved if this plan were not (to the contrary, no merely hypothetical plan should be used for this purpose, see *supra* par. 4). In any such case, the best-interest test would require the plan to match or exceed dissentients' return with that alternative; matching or exceeding returns in the event of a piecemeal sale would not be always sufficient

⁹ The going concern sale of the business may refer to a whole group, see for instance the Spanish case of *Abengoa* (cfr. footnote 7 in this Chapter).

(e.g. when the comparator is a going concern sale in the context of an insolvency proceeding).

The court may adjourn the hearing to enable stipulated steps to be taken, require the plan to be subject to another vote, impose preconditions for its confirmation, or reject the plan outright.

Policy Recommendation #2.14 (*Conditions for confirmation of a plan that has been approved by each affected class of stakeholders*). The court should confirm a plan that has been approved by each affected class of stakeholders if satisfied that:

- 1) adequate information was provided to affected stakeholders, taking into account their level of sophistication;**
- 2) majorities in each approving class were acting in a bona fide manner in the class's interest, there being a rebuttable presumption that they were;**
- 3) there are no issues impairing the appropriateness of the plan in the circumstances in which the plan was formulated, proposed, voted on, or proposed to be implemented;**
- 4) the plan is not manifestly non-viable; and,**
- 5) the plan is in the best interests of dissenting creditors or equity holders, in that it provides them with at least as much as they would receive if the plan were not approved.**

Policy Recommendation #2.15 (*Conditions imposed by the court*). The court should be allowed to impose conditions on its approval of the plan.

9. Dissenting stakeholder classes

Where a plan that affects the rights of a stakeholder class has failed to attract the requisite support amongst class members, it might nevertheless be approved so long as it treats the class fairly. In addition to the requirements described above, the plan must be appropriate and must show due respect for the

legal rights of class members. This would at a minimum entail fulfilment of each of the following three conditions:

(a) The best-interests test is satisfied.

(b) At least one class of creditors whose rights are to be impaired under the plan has approved it by the requisite majority.

(c) The ‘relative priority rule’ is observed.¹⁰ This requires that (i) each dissenting class is to receive treatment at least as favourable as other classes with the same rank; (ii) no class of a lower rank is to be given equivalent or better treatment than it; and (iii) higher ranking classes must receive no more than the full present economic value of their claims.

The relative priority rule is a preferred alternative to the ‘absolute priority rule’ familiar in US restructuring practice. The absolute priority rule makes it a precondition for confirmation of a plan rejected by one or more classes of affected stakeholders that members of each dissenting class would receive the full face value of their claims before the members of a lower class receive, or retain, anything. This approach is defective. It incentivises dissent from the plan so long as the dissentients expect the plan to receive sufficient support from claimants in other classes. Such dissentients would expect to free-ride on others’ sacrifice by being paid in full while those others accepted a haircut. This makes confirmation of the plan less likely, however, since each class might in this way have some such incentive to dissent.

The relative priority rule provides a more realistic alternative, ensuring fairness for dissentients by protecting their relative position against all other affected stakeholders but without creating hold-out incentives. The relative priority rule also makes it more feasible for plans to be confirmed that permit equity holders to retain a stake in the debtor or its business, which in turn is likely to incentivise – particularly in the case of MSMEs – greater and more timely use of restructuring proceedings and the option of drawing on equity’s debtor-specific knowledge, expertise, and goodwill. The rule also provides a measure of protection against improper ‘loan-to-

¹⁰ A good discussion of the underlying principles is found in S. MADAUS, *Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law*, *Eur. Bus. Org. Law Rev.* (2018), particularly Section 5.2.

own' strategies by which acquirers of distressed debt seek to acquire a share of debtor's equity greater than the present economic value of their debt claims.

Policy Recommendation #2.16 (*Conditions for confirmation of a plan that has not been approved by each affected class of stakeholders*). The court should confirm a plan that has not received adequate support of the members of one or more affected classes of creditors or equity holders ('cross-class cram down') if, in addition to the conditions in Policy Recommendation #2.14, it is satisfied that:

- 1) at least one class of creditors whose rights are to be impaired under the plan has approved it by the requisite majority; and,**
- 2) the relative priority rule is observed, in that**
 - (i) each dissenting class is to receive treatment at least as favourable as other classes with the same rank;**
 - (ii) no class of a lower rank is to be given equivalent or better treatment than it; and**
 - (iii) higher ranking classes must receive no more than the full present economic value of their claims.**

CHAPTER III

THE GOALS, CONTENTS, AND STRUCTURE OF THE PLAN*

SUMMARY: 1. Introduction. – 2. The restructuring plan. – 3. Possible measures of the restructuring plan. – 3.1. Measures on the asset side. – 3.1.1 Sale of the business. – 3.1.2. Sale of non-strategic assets. – 3.1.3. Changes in workforce. – 3.2. Measures on the liabilities side. – 3.2.1. Change in the financial terms of credit exposures. – 3.2.2. Change in interest rates. – 3.2.3. Postponement of debt. – 3.2.4. Debt write-downs ('haircuts'). – 3.2.5. Treatment of loan covenants. – 3.2.6. New contributions by shareholders or third parties. – 3.2.7. Exchange of debt for equity. – 3.2.8 New financing. – 4. Valuation issues. – 4.1. Objectives and uncertainties. – 4.2. Techniques. – 4.2.1 Discounted Cash Flow (DCF) method. – 4.2.2. Market Valuation Methods. – 5. The explanatory (or disclosure) statement. – 5.1. Context. – 5.2. Consequences of failure to implement the restructuring. – 5.3. Overview of existing indebtedness. – 5.4. Timeline. – 5.5. Financial projections and feasibility. – 5.6. Valuation and allocation of the value amongst claimants. – 5.7. Legal pre-conditions for restructuring. – 5.8. Actions to be taken by affected stakeholders. – 5.9. Objections to proposed plan. – 5.10. Fund(s) to address contingencies. – 5.11. Intercompany claims. – 5.12. Position of directors, senior management and corporate governance. – 5.13. Tax issues. – 5.14. Professional costs associated with plan formulation and approval. – 5.15. Jurisdiction.

* *Although discussed in depth and shared by all the members of the Co.Di.Re. research team, this Chapter is authored by Riz Mokal, with help from Charles G. Case III and Lorenzo Stanghellini.*

1. Introduction

The restructuring plan is the key element in the proposal, approval, and implementation of the restructuring of a distressed company or group of companies.¹ It aims to inform the stakeholders and the court about the need for and rationale of the restructuring and about how the restructuring would affect parties' rights and obligations. A well-drafted plan would provide an overview of the affected (and non-affected) parties of the restructuring (and classes, if necessary).

Restructuring usually requires claimants to make significant concessions of some kind. Therefore, the restructuring plan includes important distributive consequences for the parties involved and the value of their individual claim. A restructuring plan formulated in a sophisticated restructuring environment can bind all types of capital providers, including secured and preferential creditors and shareholders, and may also be limited to a subset of creditors, e.g. financial creditors. The applicable law – in conjunction with the respective restructuring plan – should clearly define who is bound by the terms of the plan. In principle, parties who are not included or involved in the adoption of the restructuring plan – or had at least the opportunity to participate – should not be bound by its terms,² although they may be indirectly affected by its legal effects (for a more in-depth discussion, see Chapter 6).

¹ A group of companies may undergo simultaneous restructuring. In this case, the restructuring may occur through a single plan, or else through a plan in relation to each participating entity, depending on applicable law and practice and on what is envisaged by stakeholders in a particular case. Our discussion is intended to address both possibilities. For instance, out of the several informal or semiformal solutions provided by the Spanish Insolvency Act to face business insolvency, exclusively one is expressly admitted for groups of companies (collective ordinary financing agreements, type I agreements or 'acuerdos de refinanciación colectivos', art. 71-*bis* IA). However, despite not being expressly admitted, more than half (54%) of the homologated refinancing agreements examined (type II agreements or 'acuerdos de refinanciación homologados', A.D. 4th IA) are group agreements (meaning those through which a plurality of companies within the same group is refinanced). See the Spanish National Findings, available at www.codire.eu.

² An exception of sorts to this principle can be found e.g. in the German insolvency law: If the plan (*Insolvenzplan*) does not include provisions concerning the subordinated creditors, they do not participate in the adoption of the plan and their claims are deemed waived (with the exception of those subordinated pursuant to sec. 39 par. 1 no. 3 InsO), cf. sec. 225 par. 1 InsO,

In order to provide transparency for all parties, the restructuring plan should include a description of the business and its competitive context; the valuation of the debtor or the debtor's business in its present state, in order to make useful comparisons and establish a minimum starting value; a reasoned statement on the causes and the extent of the financial difficulties of the debtor, as well as a description of the current status. The key principles of the plan should also include the proposed duration, the measures that ought to be implemented with the plan and its effects. The plan also needs to include an opinion or reasoned statement by the management or party responsible for proposing it about the viability of the business, the purpose of the restructuring plan in supporting the going concern by avoiding insolvency and necessary pre-conditions for its successful implementation.

A word on terminology. In this document, the term 'plan' is used expansively to refer to both the contractual or quasi-contractual provisions that amend the rights and obligations of the parties, and to statements (referred to, for example, as the 'disclosure statement' in US practice and the 'explanatory statement' in the UK scheme of arrangement context) – whether separate or an integral part of a single plan document³ – that provide the parties and the court with all requisite information as part of the restructuring process.

This chapter describes the goals, contents, and structure of a well-drafted restructuring plan. It also considers valuation issues, which are amongst the most difficult and contentious in many restructurings.

Policy Recommendation #3.1 (*Scope of plan*). A plan should be capable of binding the full range of capital providers, including secured and preferential creditors, tax authorities, and equity claimants.

sec. 222 par. 1 sentence 2 no. 3 InsO. These creditors can, however, still object to the confirmation of the plan according to sec. 251 InsO.

³ An example of the latter is the German *Insolvenzplan* which consists of a constructive or operative part and a declaratory part (and certain annexes), sec. 219 InsO.

Policy Recommendation #3.2 (*Applicability to claimant subset*). The law should permit the plan to bind only a subset of any given category of claimants. For example, it may only affect financial lenders, leaving all other claimants out of its scope, not bound by it and therefore with the benefit of their existing rights.

2. The restructuring plan

A restructuring plan characteristically proposes to restore the viability of the debtor, which is to say, it suggests a way to enable the debtor to pay its way in the medium to long term.⁴ The plan does so by proposing one or both of the following strategies:

1. a restructuring of the assets and operations of the debtor ('operational restructuring'); and/or,
2. a restructuring of the debtor's capital structure and liabilities ('financial restructuring').

Experience from multiple jurisdictions indicates that most debtors would require an appropriate combination of both operational and financial restructuring to render the business viable once again. However, operational restructuring requires real-world changes such as the closure of facilities, disposal of assets, and redundancy of employees, thus tending to be more painful to implement. For this reason, there is often a tendency – particularly on the part of the debtor's managers and owners – to downplay the need for it. By contrast, financial restructuring tends to place the burden of restoring the debtor's viability on the creditors, thus being likely to be favoured by debtors.

The restructuring plan should provide the stakeholders and the court with all the information that is reasonably required to enable them to assess the plan. This would include, without limitation:

- (1) explaining why the restructuring is required, in particular by showing how, in its absence, the debtor would be unable to meet its obligations as they fell due;

⁴ Some plans presented in restructuring proceedings are aimed at liquidating the business in a way expected to be more value-preserving than would be practicable under the applicable liquidation regime. Subject to observing the safeguards set out in this report, there would appear to be no real objection to such use of the restructuring process.

(2) explaining the assumptions and projections on which the restructuring is based, showing how these are reasonable;

(3) describing how the restructuring plan would operate on the debtor and its liabilities, identifying the assets to be disposed of, the operations to be discontinued, the changes proposed to the management, the liabilities to be modified, and any new right created;

(4) disclosing the steps taken by the debtor and any other party in the restructuring process to date, including in particular whether some stakeholders have been offered inducements to agree to the restructuring; and,

(5) indicating the outcome for the debtor and its business if the plan were to be approved, and also if it were not.

Guideline #3.1 (*Operational and financial restructuring*) The party proposing the plan should consider whether the assets side of the debtor's balance sheet, and not merely the liabilities side, requires restructuring in order to provide the debtor with the best chance of restoring its viability.

3. Possible measures of the restructuring plan

The practice shows that there is a wide range of measures that can be proposed in the restructuring plan, either affecting the assets or the liabilities side of the debtor's balance sheet. Here we focus on the most important and common among such measures.

3.1. Measures on the asset side

3.1.1 Sale of the business

The restructuring plan may propose the sale of the entire business. The intended buyer may be owned by an entirely new set of investors, in which case the outcome is substantively identical to liquidation, though undertaken in a manner that stakeholders evidently consider to be superior to that likely

from placing the debtor in the formal liquidation process.⁵ Alternatively, the intended buyer's owners may include some of the debtor's present investors (creditors, shareholders, or both). This would be the case when stakeholders take the view that it would be better for tax, regulatory, or other similar reasons to continue the business through a new entity.

3.1.2. Sale of non-strategic assets

Through the sale of non-strategic assets, the company may be able to secure liquidity, which may be key to the survival of its core business as a going concern. The law should not deem the sale of non-strategic assets, including business units running operations that are to be discontinued according to the plan, as amounting to a formal liquidation under the law.⁶

3.1.3. Changes in workforce

Reducing the cost of the workforce may be critical to restore the debtor's viability.⁷ The current employment levels

⁵ In Italy, a significant part of in-court restructuring (*concordato preventivo*) and a non-negligible part of out-of-court (*accordo di ristrutturazione*) restructuring attempts aiming at rescuing the business do so via a sale of the business: (a) among businesses that achieve in-court restructuring (*concordato preventivo*) aiming at rescuing the business, around 20-23% of them do so via a sale of the business; while, 6-12% of in-court restructurings aiming at rescuing the business do so by carrying on the business as a going concern; (b) approximately 12% of out-of-court restructurings (*accordo di ristrutturazione*) aiming at rescuing the business do so via a sale of the business. See the quantitative part of the Italian empirical research, published on the website www.codire.eu.

⁶ The agreement may contemplate not only the affected assets (normally, non-operating assets and/or assets that are not essential for the proper operation of the business), but also the procedure to carry the sale out, the period in which it must be done, and the destiny of the product of the sale. In Spain, the disinvestment or asset sale mandates are not very frequent (12 cases out of 70). See the Spanish National Findings available on www.codire.eu.

⁷ It should be noted, however, that staff readjustments do not always imply reductions or cuts. In Spain, in 4 cases out of 70, readjustments implied an increase in the workforce, by hiring new personnel (also top experienced managers able to open new markets) and/or creating specific job positions for

may be excessive in view of the reduced demand for the debtor's product, the liabilities associated with continued employment may no longer be affordable, or salaries and workers' benefits that were adequate and sustainable in a different business environment may simply no longer be so.

This kind of operational change is often very difficult to negotiate (see Chapter 5, par. 4.2). For large businesses there may be political pressure to avoid layoffs; in addition, in micro and small businesses there may be personal ties that make measures affecting the workforce difficult to carry out for incumbent managers (see also Chapter 7 on the implementation of the plan). The law often provides for specific procedures that make reduction of the workforce easier or less expensive during a restructuring, or facilitate the transfer of the business by a distressed debtor by partly disallowing workers' rights, with a view to ensuring the survival of the business and thereby the safeguarding of (at least some) employment.⁸

Given the importance of measures impacting on the workforce, the plan should consider the applicable laws and regulations or collective agreements and take into specific account whether the chosen restructuring tool is in the best interests of creditors, given the situation.

Policy Recommendation #3.3 (*Sale of business as going concern*). The law should permit the sale of the debtor's business in whole or in part as part of the restructuring process.

Policy Recommendation #3.4 (*Changes in workforce*). The law should provide for specific measures by which the debtor's workforce may be reduced as part of a restructuring process.

tasks arising from the new business plan. See the Spanish National Findings, available at www.codire.eu.

⁸ See, e.g., Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of enterprises, businesses or parts of enterprises or businesses. The directive allows for Member States to provide for a reduction of employees' rights in connection with the transfer of a business if the debtor 'is in a situation of serious economic crisis...declared by a competent public authority and open to judicial supervision' (Art. 5 par. 3).

Guideline #3.2 (*Assets-side measures*). The party proposing a plan should consider whether operational changes such as sale of assets or of the business or reduction in the labour costs are necessary in order to afford the debtor the best chance of restoring its viability.

3.2. Measures on the liabilities side

There are certain measures on the liabilities side that are easier (and quicker) to implement than others. Depending on the financial situation of the company or group of companies, some of these measures may already be executed prior to the negotiations of a restructuring plan to have sufficient breathing space to actually begin negotiations.

3.2.1. Change in the financial terms of credit exposures

In general, the first aspect to consider is to renegotiate with creditors – especially financial creditors – renewed and less onerous terms for current exposures.

3.2.2. Change in interest rates

One of the simplest ways to provide the company in distress with breathing space would be adjusting the interest rate (fixed or variable) since debts with a high interest rate (as fixed costs) are a burden to a company in distress. The alteration of interest rates may be (re)negotiated in the restructuring plan.⁹

⁹ The empirical research conducted in Spain, for instance, has shown that the revision of interest rates downwards in order to reduce financing costs is a common practice. In some cases, the interest rates are reduced, but their progressive annual increase is simultaneously agreed (e.g. Euribor +1% the first year, Euribor +1.25% the second year, Euribor +1.5% the third year, etc.). In other cases, the reduction of interest rates is subject to the condition that if certain financial parameters suffer a favorable progression for the debtor, the interest rate will not be reduced. Similarly, some agreements also envisage that certain tranches of debt accrue interest only if certain economic boom conditions are met. See the Spanish National Findings, available at www.codire.eu.

3.2.3. Postponement of debt

An important restructuring technique would entail that creditors agree for the debtor to make some or all payments later than currently required. Such postponement of payments may apply to the principal in whole or in part, and/or to interest payments.

3.2.4. Debt write-downs ('haircuts')

Another important measure is the reduction of outstanding debt, often referred to as a 'haircut'.

Empirical evidence shows that in out-of-court restructurings the prevailing measure with regard to indebtedness is mere postponement, seldom coupled with write-downs, whereas in formal insolvency procedures the norm is write-down, with the exception of some long-term secured debts.¹⁰ However, it is not uncommon for a business to undergo multiple rounds of restructuring: this may indicate that the first measures applied were insufficient (see Chapter 4, par. 5.3) or that the debtor is no longer viable. Care should therefore be taken to ensure that the business is capable of servicing its restructured debt. This raises important issues concerning the feasibility of the plan, which are considered in Chapters 2 and 6.

3.2.5. Treatment of loan covenants

The plan would provide for whether the debtor is required to cure any existing covenant violations or whether the creditors' remedies in right of such violation are to be waived. It would also indicate which of the existing covenants would be

¹⁰ This is particularly true for Spain, where the most frequent content of the refinancing agreements is the postponement of the due date. Indeed, approximately 90% of the agreements contemplate some type of payment deferment, which usually takes the form of a modification of the repayment schedule. In other cases, loans are cancelled and replaced by new ones, with a new repayment schedule. In contrast, clauses contemplating write-offs are rare. In most cases, they refer to quantitatively insignificant amounts. See the Spanish National Findings, available at www.codire.eu.

maintained post-restructuring, which would be eliminated, and whether any new ones would be imposed.

3.2.6. New contributions by shareholders or third parties

A form of new contribution by shareholders and third parties are capital injections to the company in distress to either increase the company's capital or decrease the company's debt. The plan should address whether any pre-emption or other rights of the current shareholders would be respected or, where the law permits – as we believe it should in the context of a restructuring – overridden.

Contributions (including new financing; see below) are usually made conditional upon confirmation of the plan and may or may not confer the right to obtain shares or other equity instruments in the business. Depending on the jurisdiction, new contributions may be freely allocated amongst creditors, without respecting absolute or even relative priority, because the monies involved do not come from the business estate.¹¹ This is to be contrasted with the *restructuring surplus* – the positive difference between the value of the restructured business and the liquidation value – which should only be allocated in accordance with restructuring law priorities. New contributions are therefore one of the instruments used in practice – within the confines of the applicable law – to give flexibility to the plan's distribution waterfall.

3.2.7. Exchange of debt for equity

The plan may provide for certain debt claims to be extinguished in whole or in part in return for equity in the debtor or a successor entity. This reduces the debtor company's

¹¹ This is true e.g. for Italy (see Court of Cassation, 8 June 2012, No. 9373 allowing for the free distribution among stakeholders of 'new money' that does not enter the debtor's estate), but not for Germany, where – in an insolvency proceeding – not only fresh money/capital injections become part of the estate and have to be distributed according to the usual priorities, but also direct payments by third parties granting certain stakeholders a preferential treatment may be void (sec. 226 par. 3 InsO) and may lead to the plan not being confirmed (sec. 250 no. 2 InsO).

debt load without exposing its business to the hazards of a market sale, which may not realise full value for the benefit of stakeholders.

A useful method for preserving some interest in the existing equity holders is to vest preferred equity in the erstwhile creditors while allowing the existing equity holders to retain their now more junior interests. The benefit of this method is to resolve disputes about the value of the debtor's business between creditors and existing equity holders. Time can tell whether subordinated common shares still have a value, and speculative evaluations are mostly dispensed with.¹²

Another technique aiming at the same goal is for the plan to provide certain creditors, often junior claimants, with warrants or options to acquire equity later. Again, the plan should address the extent to and the way existing shareholders would be diluted, subordinated, or wiped out, etc.¹³ A crucial point is, of course, setting the exercise price of the option or the circumstances in which warrants can be used.

If the creditors (characteristically, senior claimants) are not willing to exchange their debt for equity when the restructuring agreement is negotiated, the plan may provide for the conversion of their debt into convertible debt, leaving them with an option to give up their debt later for equity. The option may either become available at a specific time or else be available throughout the life of the debt. The creditors will then carry the risk on the development of their claims. It should be noted, however, that convertible debt is still debt and the financial plan will have to take this into account, in the event that creditors decide not to convert.¹⁴

¹² See also Chapter 2, par. 2.1, on the 'debt/equity bargain' and its implications: in particular, for equity holders to retain an interest in a business that is unable to pay its debt there must be good reason, either on the grounds of setting appropriate incentives (shareholders will not restructure if they get to keep nothing), or on the grounds of uncertainty (although cash-flow insolvent, equity interests still may retain some value).

¹³ Drafting these plans may be costly and complex, especially for SMEs. Although one might risk losing some nuances, it may be the case to provide for templates for such cases. The American Bankruptcy Institute has suggested some standard measures for equity retention in SMEs undergoing restructuring under Chapter 11.

¹⁴ In Italy, qualitative analysis shows that debt-for-equity swaps and conversion of debt into 'hybrid' financial instruments are rare (and virtually absent for small businesses) because banks are not keen to exert control on

In relation to each of these techniques, the valuation of the business, discussed below, would be critical.

3.2.8. New financing

A successful restructuring may require fresh financing for the debtor in two phases.¹⁵

The first, interim financing, enables the debtor to operate while a restructuring plan is developed, negotiated, put to a vote, and placed before the court for approval. Given its instrumental role in the negotiation of a plan, interim financing is dealt with in Chapter 5. The second type of new money, usually labelled as ‘new financing’, enables the debtor to

restructured businesses, and rather opt for hybrid instruments that give them a share in the future profits of the firm, ranking above the shareholders’ claim.

In Spain, the capitalisation of debt appears in approximately 25% of the approved refinancing agreements. It should be noted, however, that mandatory capitalisation of debt is very rare, and when it occurs it is limited to one tranche of the debt. Indeed, in most of the agreements providing credit capitalisation, it is conceived as a mere option, depending on the occurrence of certain circumstances. The option to capitalise the debt in case of default is often envisaged, although the conditions usually vary among debt tranches (for example, capitalisation may be possible in the event of default of two or more repayment instalments of tranche A of debt, but in case of default of a single repayment instalment of tranche B on its maturity date). Sometimes, the capitalisation is available in case of non-fulfilment of certain covenants (for example, in the event of a negative deviation of 40% of the EBITDA established in the business plan), in case of early termination, or when certain circumstances are met (for example, when this is necessary in order to restore an eventual and potential asset imbalance). It may also happen that debt-to-equity swaps are limited to certain claims (for example, for the equity loans between the funded company and its shareholders). See the Spanish National Findings, available at www.codire.eu.

¹⁵ Italian quantitative and qualitative (interviews with judges, lawyers and advisors) analysis underlines the importance of new finance to rescue business in distress. However, according to the analysed sample: (a) only few plans consider new financing: i.e. 25-30% of the out-of-court restructurings (*accordo di ristrutturazione*); (b) when new finance is provided it is mostly debt capital, while only a low percentage of new finance consists of fresh equity. In Spain, only one-third of the analysed cases envisage the provision of new financing. Commonly, new financing is granted by some of the debtor’s shareholders (especially in the form of equity loans, and sometimes with the commitment to capitalise the debt within a certain period). See the Spanish National Findings, available at www.codire.eu.

operate as it seeks to implement the duly approved plan.¹⁶ For this reason it is dealt with here.

This second tranche of funding, which the plan itself would usually provide for, only becomes available if an existing or a new lender is induced into providing it. This would occur if the debtor's assets (if permitted to continue to operate as a going concern) have sufficient surplus value after meeting the liabilities that the debtor is envisaged as carrying in the restructuring plan upon the plan's approval. The applicable law determines the rank of the new funding, if and which collateral (e.g. the surplus as such) can be pledged for it and the extent to which providers of new financing are shielded against avoidance or liability in case the restructuring ultimately fails. The law may also permit the extension of 'super-priority', that is, subordinating existing unsecured creditors, or the 'priming' of existing secured creditors if such creditors consent, or else if the court can be satisfied that the interests of such creditors are adequately protected. In any scenario, provided adequate safeguards for the existing creditors are in place, the lender of fresh money required to implement an ex-ante promising restructuring plan must be protected against the risk of avoidance actions and personal liability in case the plan fails and the debtor is later subject to insolvency proceedings. Many jurisdictions consider voidable those transactions in which the third party has knowledge of the debtor's financial difficulty, and in case of new financing this is the case almost by definition. Hence, this risk must be deactivated lest impeding new financing at all.

Many jurisdictions provide some form of subordination for financing provided by shareholders (e.g. loans when the company was overindebted).¹⁷ If such is the case, then an exception should be provided at least for shareholders who have become such by way of a debt/equity swap in the restructuring. Absent such exception, creditors may be unwilling to accept swaps and then extend credit for fear of subordination. Another exception could be made for existing shareholders, although

¹⁶ Both kinds of financing are envisaged in the draft Restructuring Directive (Art. 16; see also Art. 10(1)(b)).

¹⁷ In Spain, for instance, the new financing provided by existent shareholders is subordinated according to the general rules, and the preference that is established for fresh money does not apply when said financing is provided by a closely related person (art. 84.2-11.º IA).

this should be weighed against the opportunity to encourage them to contribute equity rather than debt.

The second point to be noted is that current bank prudential regulations may possibly hinder new financing by banks that are already creditors. If a bank has categorised an exposure towards a debtor as non-performing, and the debtor undergoes a restructuring in which the debt remains with the same entity or its group (and hence cannot be derecognised under applicable accounting standards), then, since categorisation is debtor-based for non-retail clients (EBA ITS 226, referring to Art. 178 CRR), it follows that any exposure, including new exposure, should be placed in the same categorisation. Exiting non-performing status when the exposure had forbearance measures, as is the case with restructured debt, requires a cure period of 1 year (EBA ITS 231), plus 2 years to exit the forbore status (EBA ITS 256). It can therefore be very costly in terms of prudential capital to extend new financing to a restructured debtor that was already a client (see also Chapter 5, par. 3.2 and the associated Policy Recommendations).

Policy Recommendation #3.5 (*Allocation of new funding*).

The law should permit any new funding obtained by or promised to the debtor to be allocated outside the application of ranking of existing claims.

Policy Recommendation #3.6 (*Debt-for-equity swaps*). The

law should permit the restructuring plan to effect an exchange of debt for equity claims.

Policy Recommendation #3.7 (*Preferred equity and convertible debt*). The law should permit the

restructuring plan to provide for (i) different classes of equity claims, and (ii) creditors to exchange debt claims for equity claims at a future date upon the materialisation of a contingency stipulated in the plan.

Policy Recommendation #3.8 (*Non-subordination of loans of claimants who swap debt claims for equity*). Claimants

who give up debt claims in return for equity should not be subject to any rule requiring the subordination of loans provided by equity holders.

Policy Recommendation #3.9 (*New financing*). The law should exempt new financing from avoidance and provide for priority over unsecured creditors under court control when new financing is necessary for the success of the plan. In some circumstances, applicable law may permit priority over existing secured creditors, if such creditors consent or if the court can be satisfied that the interests of such creditors are adequately protected. The lender should be exempted from liability when new financing has been extended in good faith.

4. Valuation issues

This section discusses the valuation of the debtor's business or of its relevant constituents.

4.1. Objectives and uncertainties

Valuation of a business is a challenging process at the best of times, and these challenges become acute when the debtor is distressed. In principle, the valuation exercise should arrive at a value approximating the 'fundamental value' of the business, which in most businesses is the discounted present value of the business's future cashflows.¹⁸ In practice, this may not happen for a combination of *structural* and *strategic* reasons.¹⁹

Structural uncertainty arises because the restructuring may not require the business to be exposed to market valuation —

¹⁸ Valuation methods can be of equity, income, financial or mixed nature; they can be based on comparables (market valuation) or be specific. In the Anglo-American context financial methods as well as methods based on comparables are the most frequent. On the evaluation of companies in crisis see S. GILSON, E. HOTCHKISS AND R. RUBACK, 'Valuation of Bankrupt firms', (2000) 13(1) *Review of Financial studies*, 43-74; S. GILSON, 'Valuing companies in Corporate Restructuring', Harvard Business School, 2000. Specifically for Italy see M. LACCHINI, 'Le valutazioni del capitale nelle procedure concorsuali', Cedam, Padua, 1998; A. DANONI, 'Crisi d'impresa e risanamento finanziario nel sistema italiano', Giuffrè, Milan, 2003.

¹⁹ This discussion draws on C. MICHAEL, R. MOKAL, 'The Valuation of Distressed Companies', (2005) *Int. Corp. Rescue*, 63-68 and 123-131, which also provides full referencing of sources.

the most common valuation methodology — and because market valuation may in any case be unsatisfactory. A ‘forced sale’, which is one in which the seller needs to sell in order to meet its own obligations,²⁰ virtually always involves an imbalance of bargaining power in the buyer’s favour. Since the sale of a distressed business is almost definitionally a forced sale, it is likely not to yield the business’s fundamental value. The problem is compounded if the sale is a ‘fire sale’, that is, a forced sale in a depressed market.²¹ Here, sectoral distress would be causing similar businesses to be offered for sale while at the same time stressing potential buyers. Again, a market valuation would undershoot fundamental value, perhaps significantly. Stakeholders’ appreciation of reasons like these may indeed have persuaded them that a market sale would not be in their interests.

Strategic uncertainty arises because stakeholders would still have only partially overlapping interests. Senior claimants have incentives to undervalue the business, since that enables them to claim a greater proportion of its post-restructuring value, whereas junior claimants have corresponding incentives to overvalue it.²² Along similar lines, the debtor’s senior management has incentives to undervalue the business if it stands to obtain equity in the plan. Suppose €0.5 million of management reimbursement is to take the form of equity. Then the lower the valuation of the business, the higher the proportion of post-restructuring equity that would need to be allocated to the management.

Against this background and given that there is no access — by the parties, experts, or the court — to God’s eye view to which these uncertainties are no matter and from which

²⁰ R. MOKAL, ‘Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts’, (2015) 10 *Brooklyn Journal of Corporate, Financial & Commercial Law*, 15, 27, citing A. SHLEIFER AND R. VISHNY, ‘Fire Sales in Finance and Macroeconomics’, (2001) 25 *Journal of Economic Perspectives* 29, 30.

²¹ R. MOKAL, *ivi*, at 30, citing A. SHLEIFER AND R. VISHNY, *ivi*, at 30.

²² For example, suppose total senior and junior debt each amount to €1 million. If the business is valued at €1 million, then 100% of it belongs to senior creditors; junior debtors and equity are wholly underwater and entitled to nothing. However, if the business is valued at €2 million, senior and junior debtors are each entitled to 50% of its post-restructuring value. And if the plan places a value in excess of €2 million on the business, it *ipso facto* entitles the pre-distress equity to a post-restructuring share.

fundamental value may unerringly be discerned (see Chapter 2, par. 1.2 and 2.2), a key role of the restructuring plan is to identify something approximating the fundamental value of the business and to provide for this value to be fairly and efficiently allocated amongst stakeholders.

4.2. Techniques

Great care should be taken in accepting book values for the debtor's assets, since they may bear little relation to the going concern value of the assets kept together, and further, may also be unrealistic in the context of the debtor's distress. Instead, use should be made of one or more of the valuation techniques that have become well established in sophisticated restructuring practice.

4.2.1. Discounted Cash Flow (DCF) method

The method seeks most directly to identify the business's fundamental value. It seeks to estimate the discounted present value of all future cash flows. The two sources of cash used in the methodology come from the future cash expected to be generated by the debtor's assets and operations, and the future tax shields generated by interest payments on debt, calculated to present value using a discount rate. The identification of the best discount rate to use is itself a highly contested issue, and good practice would be to arrive at it in a transparent manner in consultation with stakeholders, which is not always feasible.

4.2.2. Market Valuation Methods

The Market Value Multiples (MVM) valuation is used to compare values of publicly traded companies through a multitude of different financial ratios and determine whether the value in question is overvalued, undervalued or appropriately valued with its publicly traded peers.

This valuation is predicated on the efficiency of the capital markets to value the profit earned by the company the same as

it values the profits of other companies in the same peer group.²³

Another market valuation method is the Precedent Transaction valuation. Among market valuation methods, precedent transaction valuations are the easiest to perform because this method looks at the values attributed to the equity, assets or debt in previous transactions within the company's peer group as an indicator of how the company's equity, assets or debt should be valued in this transaction. It should be noted that every transaction is unique and that sometimes a premium is paid to acquire control of a company in order to obtain a strategic business advantage. Conversely, sometimes companies are sold at a discount due to publicly-known distress or, on a broader scale, the uncertainty in the industry or financial markets moving forward.

Guideline #3.3 (*Valuation methods*). When a valuation of the business is required, use should be made of one or more well-established valuation techniques. Relevant parameters should be chosen in a transparent manner, if possible in consultation with stakeholders. It should also be assessed which individual should perform the valuation and, in particular, if an expert is required in case of valuation on the debtor's side.

5. The explanatory (or disclosure) statement

A well-drafted plan proposed in the context of a mature restructuring regime would tend to include an explanatory statement together with the quasi-contractual documents that would amend the parties' rights and obligations as to (start to) give effect to the restructuring.

The explanatory statement seeks to explain to the creditors and other stakeholders, and eventually the court, all aspects of the proposed restructuring. To enable all stakeholders with a claim in the company to exercise a reasonable judgement as to

²³ Ordinarily, a peer group is a group of publicly traded companies that are competitors in the same industry and are of comparable financial size in terms of market capitalisation or top line revenue. Choosing a proper peer group when conducting a MVM valuation is vital to the accuracy and effectiveness of the overall computation.

whether the restructuring is in their interests, the explanatory statement provides them with detailed information, including as to the substance of what is proposed, the process by which the proposals came to be formulated, the manner in which they would be put to formal stakeholder vote, and the process and timeline for the proposed implementation of the restructuring, should it be approved.

The primary elements of an explanatory statement meeting this standard are described below. The plan would usually be accompanied by copies of any other legal instrument that would need to be executed according to applicable law²⁴ for the plan to take effect.

5.1. Context

This includes the reasons for the debtor's distress, consideration of the viability of the business, and its medium- to long-term prospects. The section may describe:

- the debtor's business and business model;
- group structure and ownership:
 - effect on parent, subsidiaries;
- reasons for current situation:
 - market conditions and current environment;
 - impact on the group and effect on financial situation (e.g. compliance with covenants, ability to repay or successfully refinance existing indebtedness at maturity);
- consequence: necessary steps through restructuring to manage liquidity and to stabilise the business;
- managing the debtor through the restructuring process:
 - existing management;
 - appointment of restructuring (financial) consultant;
 - specialist independent managers or monitors;
- overview of debt with detail (outstanding debt, interest, collateral);
- restructuring discussions with stakeholders to date;

²⁴ Applicable law may also provide for a respective immediate effect of the plan replacing all or some of the otherwise necessary legal instruments (cf. in Germany sec. 254a InsO).

- identification of the jurisdiction(s) governing the proposed restructuring.

5.2. Consequences of failure to implement the restructuring

This part describes the consequences of failure to implement the restructuring plan. It explains the obligations that, absent restructuring, the debtor would be unable to meet, and the consequences – characteristically, insolvent liquidation – that would then ensue. The emphasis here tends to be on destruction of value to the detriment of creditors as a group, for the following reasons, amongst others:

- potential repercussions on customer relationships and contracts;
- loss of synergies from being a member of a corporate group;
- difficulty and cost of replicating the existing services and expertise provided to other entities of the group;
- potential value leakage from any claims the remaining members of the group (or their insolvency office-holders) may assert against each other.

A critical element is ‘comparator analysis’, which shows the estimated value that would be obtained from the debtor’s business or assets in case the plan is not implemented. This comparator would characteristically be the debtor’s liquidation on a forced or indeed fire sale basis. The comparator analysis would explain (by way of example):

- the likelihood of secured creditor actions and their likely consequences;
- the effect on creditors if the debtor ends up in the comparator scenario: this would usually be significantly lower returns, possibly over a more protracted timeframe, than if the restructuring were successfully implemented;
- any market testing undertaken and the market value and expected recovery rates thereby revealed;
- why restructuring is therefore preferable to the comparator.

5.3. Overview of existing indebtedness

This considers all information about the financial situation of the debtor and in particular:

- (1) existing debt (overview of debt borrowed and issued);
- (2) effect of the restructuring on the existing debt;
- (3) effect of the restructuring on existing share capital and ownership;
- (4) overview of restructuring measures affecting financial debt.

5.4. Timeline

The timeline lays out the different milestones prior to and during the implementation of the restructuring plan, including:

- (1) conditions upon approval and consequence for failure of approval;
- (2) approval, voting and confirmation of the restructuring plan;
- (3) filing date;
- (4) restructuring effective date and conditions;
- (5) longstop date, i.e. the latest date by which the restructuring plan must become effective or else be withdrawn from consideration;
- (6) actions to be taken by restructuring plan creditors.

5.5. Financial projections and feasibility

The purpose of the financial projections is to evaluate the ability to satisfy the debtor's financial obligations post-restructuring while maintaining sufficient liquidity and capital resources over an extended (or prolonged) period. If not already required by the applicable law, a formal confirmation from the debtor, its management, and/or independent experts, that the implementation of the restructuring plan would allow the company or group of companies to avoid liquidation, to continue the going concern, and to be in condition to meet future obligations as they fall due may contribute to securing the plan's approval and confirmation.

The financial projections are prepared on the assumptions of an effective restructuring date, the viability of the post-restructuring company or group of companies, and operations substantially similar to the current business by representing selected cash flow projections and credit metrics for the post-restructuring company or group of companies on a consolidated basis, usually for no longer than ten years. This is about the limit for credible projections. The projections should be developed on an appropriately detailed basis and should incorporate multiple sources of information. Projections should also incorporate assumptions related to general economic conditions as well as industry and competitive trends for a sufficiently long forecast period. These assumptions are based on historic industry experience as well as market perspectives derived from experts regarding projected industry supply/demand/capacity indicators and the estimated directions of specific markets.²⁵

The plan should substantiate the ways in which the assumptions and projections underlying it are credible. One way of doing so would be to explain that it has been subjected to scrutiny by independent experts instructed by the debtor itself or a group of creditors. Such experts would review the plan's assumptions and projections for reasonableness and to ensure that they are in line with the expected market conditions. A review would include steps such as the following:

- (1) review and analysis of the financial projections in order to consider and confirm whether the assumptions used were reasonable;
- (2) the organisation of meetings with the debtor's management and its advisers to discuss key assumptions used;
- (3) review and analysis of the assumptions made, in particular the sector specific costs and the industry market conditions and outlook.

The assessment of a proposed plan would characteristically conclude that the plan:

- (1) was realistic and could feasibly achieve the goals of the restructuring plan;

²⁵ The financial projections should consider different assumptions, depending on the company's business model. Among others: assumptions about revenues, costs, special items and carryover costs, general and administrative (G&A) costs, restructuring and transaction as well as existing cash and debt assumptions.

- (2) was in the best interests of the debtor/s;
- (3) if implemented would enable the creditors to recover more than they would in the comparator scenario (usually a liquidation and/or enforcement by secured lenders);
- (4) was fair in that an intelligent and honest stakeholder, being a member of the class concerned and acting in respect of its interest, might reasonably vote in favour of it.

5.6. Valuation and allocation of the value amongst claimants

The plan should explain the valuation methodologies, chosen from amongst those described above, justify their choice over alternatives, and demonstrate why their implementation would be in the best interests of creditors and, if appropriate, other stakeholders.

The valuation should be carried out by an expert (generally a financial consultant or accounting firm), delivering a comparison between recovery rates for creditors of the restructuring plan under the different scenarios in consideration (e.g. new shares, debt-equity-swap) as the going concern value and recoveries in liquidation (piecemeal asset sale or business sale) or other comparator.

As a rule, the valuation should demonstrate that the value available to the creditors pursuant to the plan implementation would be greater than under the comparator scenario, which would often be an insolvent liquidation.

The value of the creditors' claims (present or future, contingent or certain, disputed or undisputed) should be assessed in accordance with their quantum and rank. This helps the parties, and eventually the court, to determine whether the creditors receive value under the plan equal to the amount they would expect to receive in the absence of the plan's implementation.

5.7. Legal pre-conditions for restructuring

The plan would characteristically be subject to the satisfaction of certain legal pre-conditions, which may include:

- the approval of the plan by the requisite majority or majorities of stakeholders;

- the approval or confirmation (sanction) order of the restructuring plan by the competent court or authority;
- the restructuring documents having been executed, either becoming effective in accordance with their terms or being held in escrow pursuant to the terms of the restructuring plan;
- the debtor's decision-makers having executed any such document that the plan requires them to;
- the organisational documents of any connected entity having been amended as required by the restructuring plan.

5.8. Actions to be taken by affected stakeholders

Characteristically, if duly approved the plan would itself bring about changes to the rights and obligations of the affected claimants, often without requiring any step on their part other than to participate in the voting if they so choose. In some cases, however, the plan may positively require some claimants to take certain steps, such as the execution of contractual documents or the delivery of titular ones. In the latter case, the plan should set out the manner and timing for the performance of such steps.

5.9. Objections to proposed plan

A well-drafted plan would proactively address objections to its viability, approval, and implementation that have been brought to the plan proposer's attention. It would explain why the objections do not meet their mark, so that the affected stakeholders should still vote for the plan and the court should approve it.

5.10. Fund(s) to address contingencies

Where certain relevant claims are likely to be contingent at the time that the plan is expected to be approved,²⁶ the plan may propose the creation of a ring-fenced fund to meet them if and when they arise. The plan would address the basis for considering that the fund was adequate to meet such claims. It would also set out the destination for whatever value remains in the fund after any relevant claims have been met.

5.11. Intercompany claims

The plan would need to address any relevant claims between the debtor and any connected entity. It may do so, for example, by providing, conditional upon plan approval, for such claims to be subordinated to the claims of unconnected creditors, by their extinguishment in part or whole, or by assignment or novation.

5.12. Position of directors, senior management and corporate governance

The positions of directors and senior management will also have an effect on the restructuring so it is important to provide transparency about their positions.

The overview should include a description of the current senior management and directors, their backgrounds, their terms and possible termination, and their existing and/or proposed compensation. It should also include an overview of the different committees that the company or group of companies (if any) have implemented, e.g. an audit committee, a compensation committee and/or a nominating and corporate governance committee, and whether these are comprised of independent directors.

The plan should state if there are any service contracts between the group or any of the group's subsidiaries and any of

²⁶ This may, depending on the applicable law, include the scenario that a competent court finds that the plan does not fully meet the 'best interest of creditors' test (see Chapter 6 and, for Germany, sec. 251 par. 3 InsO).

the group's directors providing for benefits upon termination of their employment or service. The plan should also disclose and discuss related-party transactions and possible interests of directors and relevant shareholders with regard to the plan and its effects.

Where the plan envisages the debtor waiving potential claims against a director whether departing or remaining, it should provide adequate disclosure of the actual or likely existence of such claims and the rationale for the proposed waiver. Importantly, however, the court should in principle not withhold its approval of the plan on the basis that it objects to the waiver, unless there is real concern about the adequacy of such disclosure or other impropriety in the manner of seeking creditor consent. Such waivers may be an important part of the overall bundle of rights and obligations that the requisite majorities of stakeholders are willing to accept, and it would be commercially inappropriate and unfair for the court to upset this distribution of costs and benefits by seeking removal of one element of it. Further, it is the stakeholders themselves who would generally be better placed than the court to assess the value to be attached to the waiver as a way of inducing the relevant director to depart or stay, as the case may be.

5.13. Tax issues

Tax issues are often crucial to the feasibility and acceptability of a plan.²⁷ As a matter of restructuring policy, haircuts and other debt relief should not be considered a taxable

²⁷ Italian businesses, especially when small, face significant hurdles in dealing with tax authorities, which are often one of the main creditors of businesses in distress.

However, in relation to negotiations with tax authorities, qualitative research has revealed: (a) difficulties in ascertaining the amount of fiscal debt and the complexity of the issues relating to tax claims; (b) difficulties in identifying the counterparty for negotiation, since the competence for tax claims is often fragmented among several public bodies; (c) too weak incentives in pursuing effective solutions for employees of tax authority, who sometimes appear afraid of facing personal responsibility (tax authorities too often aim at maximising the short-term value, neglecting the fact that they are repeated players); (d) that tax authorities seem to be more cooperative in negotiations with bigger businesses than with small ones. The data emerge from several interviews of professionals assisting debtors, both lawyers and accountants.

benefit to the debtor²⁸ since doing so causes the tax authorities (rather than the debtor) to be the primary beneficiaries of the sacrifice of the creditors who have provided debt relief, and in turn disincentivises them from making that sacrifice in the first place. Similarly, creditors should be incentivised to agree to debt relief by being permitted to use such relief as a deductible loss.

Against such a legislative background, the plan should ideally explain how what it proposes would affect the debtor's tax position. It may also draw attention to the tax consequences for affected stakeholders and encourage them to obtain independent advice.

In order to ease the creditors' comprehension of the plan, it may be the case to illustrate also the possible tax consequence for the creditors, clarifying that such illustration may not apply to all creditors and may depend on certain applicable rules.

5.14. Professional costs associated with plan formulation and approval

The plan may inform the affected parties about the costs that the company or group of companies have incurred in relation to the restructuring over the course of time since the commencement of negotiations. It may also provide an estimate of the total costs and expenses payable in relation to the restructuring until the restructuring effective date and which costs are included in that estimate. This should again provide transparency to all constituencies about the costs associated with the plan proceeding.

5.15. Jurisdiction

The plan should identify the court with jurisdiction over the restructuring and may also identify any other courts with jurisdiction over collateral issues, such as in relation to real property located abroad.

²⁸ See, for example and also regarding the (permitted) offset against previous losses, the respective new rules in, i. a., sec. 3a EStG (German Income Tax Act) [pending approval by the European Commission].

Guideline #3.4 (*Content of the plan*). The plan and the explanatory documents should include all necessary information, accompanied by relevant documents, for stakeholders to assess and decide whether or not to support the plan. At a minimum, the plan should address (1) the context of the restructuring, (2) the consequences of the failure to implement the restructuring; (3) an overview of existing indebtedness; (4) the timeline of the plan; (5) financial projections and a feasibility analysis; (6) the valuation and allocation of the value amongst claimants; (7) legal pre-conditions for restructuring; (8) actions to be taken by affected stakeholders; (9) objections to the proposed plan arisen in negotiations; (10) provisions to address contingencies; (11) the treatment of intercompany claims; (12) a discussion on the position of directors and senior management and of the corporate governance of the debtor entity; (13) tax issues; (14) professional costs associated with plan formulation and approval; (15) jurisdiction.

Policy Recommendation #3.10 (*Director liability and its effect on the plan*). The law or the courts should not bar plans that provide for a waiver of directors' liability on these sole grounds, as long as there is appropriate disclosure and there is no impropriety in seeking the stakeholders' consent.

Policy Recommendation #3.11 (*Taxation in restructuring*). Write-downs and other debt relief should not be considered a taxable benefit to the debtor. Creditors should be permitted to use such relief as a deductible loss.

CHAPTER IV

DRAFTING HIGH-QUALITY PLANS AND THE ROLE OF PROFESSIONALS*

SUMMARY: 1. Introduction. – 2. The critical role of advisors. – 2.1. Professional qualification and experience. – 2.2. Position and independence of advisors. – 2.3. The advisors' approach. – 2.4. The issue of costs. – 3. The peculiarities of restructuring plans. – 3.1. The peculiarities of restructuring plans *vis-à-vis* ordinary business plans. – 3.2. Drafting restructuring plans in the shadow of judicial reviewability. – 4. The restructuring plan. – 4.1. The restructuring plan: the past, the present and the future of the business. – 4.2. The past: explaining the causes of distress and why they can be overcome. – 4.3. The present: valuing assets and liabilities. – 4.4. The future: the business plan and the satisfaction of claims. – 4.5. The focus on cash flow forecasts. – 5. Dealing with uncertainty. – 5.1. Uncertainty as an unavoidable component. – 5.2. The time frame of the restructuring plan. – 5.3. Time frame of the restructuring vs. time frame for paying creditors. – 5.4. Setting out clear assumptions, forecasts and projections. – 5.4.1. The case for clarity. – 5.4.2. Conditions of the plan. – 5.5. Governing uncertainty. – 5.5.1. Describing the actions to be carried out pursuant to the plan. – 5.5.2. Testing for the variation of assumptions. – 5.6. Deviations from the plan and adjustment mechanisms. – 5.7. Provisions for adverse contingencies.

* *Although discussed in depth and shared by all the members of the Co.Di.Re. research team, paragraphs 1, 2 and 3 are authored by Andrea Zorzi, paragraphs 4 and 5 are authored by Iacopo Donati.*

DRAFTING HIGH-QUALITY PLANS AND THE ROLE OF PROFESSIONALS

1. Introduction

Restructuring a distressed enterprise is a complex endeavour, which usually requires the agreement of many parties (the debtor and, according to the specific tool that has been chosen, all or some creditors). In some cases, it also requires the assessment of an external expert or examiner and the confirmation of the court.¹ The debtor and the creditor will have to reach a common understanding of two critical points:

(a) what the assets and liabilities of the debtor are and what the economic and financial situation is;

(b) how to address the situation of distress in the best interest of the affected parties.

Debtor and consenting creditors usually need to agree on a certain set of actions, to be implemented in the course of a pre-established time frame. For instance, they will have to agree on the sale of certain assets or of the business (in whole or in part), on the reduction and rescheduling of certain debts, and/or on the extension of new financing. All these actions have to be coordinated and aimed at achieving the sustainability of the business afterwards.

To this purpose, a high-quality restructuring plan is a key element. A well-drafted plan should be:

- based on the correct assessment of the present situation (hence based on an accurate review)

- realistic as regards the future (hence based on correct assumptions and appropriate forecasts and, where applicable, projections).²

¹ A notable exception is the UK administration used with the so-called pre-packaged plans, which is a means of restructuring with an external expert and court confirmation, but without any creditor consent. On the various aspects of this kind of restructuring see the UK National Report, available at www.codire.eu.

² 'A 'forecast' means prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions)', while 'a 'projection' means prospective financial information prepared on the basis of: (a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place..., such as when some entities ...are considering a major change in the nature of operations; or (b) A mixture of best-estimate and hypothetical assumptions' (see International Standard on Assurance Engagements (ISAE) 3400, 'The Examination of Prospective Financial Information'). As a consequence of managerial actions expected to

Moreover, when drafting a plan, one should consider that the restructuring plan is not an ‘ordinary’ business plan:

(a) when in distress, the business, and its managers’ actions are subject to significant legal constraints. The plan must take into account these constraints;

(b) the restructuring plan describes a series of actions that have a precise legal significance and content (e.g. debt reduction or rescheduling);

(c) the implementation of the plan purports to affect not only the equity holders, but also creditors and other third parties, either directly (e.g. in case of stay of individual enforcement actions or cram-down of dissenting creditors) or indirectly (e.g. authorised sale of assets that results in creditors not being satisfied, exemption from avoidance or liability actions).

The plan will be read and examined by a number of people with different backgrounds and expertise, not all of them knowledgeable in business and finance (non-financial creditors, lawyers, judges). Therefore, besides being accurate, the restructuring plan must be clear, readable and unambiguous. The plan aims at convincing every reader that it is adequate to successfully restructure the business, and that the debtor is not merely trying to postpone the occurrence of other more drastic measures, such as, typically, insolvent liquidation. It is a delicate task.

The importance of the restructuring plan is relevant at various levels:

- obtaining the creditors’ consent;
- obtaining, where required, the opinion of the expert and/or the confirmation of the court;
- guiding the proper implementation of actions and measures aiming at restoring viability, by enabling proper monitoring and, if necessary, corrective actions;
- being able to resist challenges, not only during the possible confirmation proceeding, but also in case of ex-post judicial review (e.g. in case of failure during execution and subsequent insolvent liquidation).

In this Chapter, methodological issues will be addressed relating to devising and drafting restructuring plans. Other

take place in the course of the plan, restructuring plans may contain both kinds of financial information with respect to the future of the business.

equally (and possibly, more) important issues (e.g. the treatment of specific categories of claimants, fairness, abuse, negotiation and confirmation of plans) are the subject of other Chapters.

Further, in line with the scope of the research, in this Chapter the focus will be on restructuring plans. Liquidation plans, by which debtor and creditors opt out of insolvent liquidation with a view to maximising asset value (e.g. by providing for market sales instead of auctions), play an important role in dealing with business distress.³ However, such plans pose different sets of issues and problems that fall outside our analysis, which focuses on semi-formal tools aimed at rescuing distressed, but economically viable, businesses.

2. The critical role of advisors

2.1. Professional qualification and experience

Debtors in distress should seek adequate industrial, financial and legal advice. Restructuring a distressed business requires conducting a sound and thorough assessment of the situation of the debtor and suggesting the appropriate steps to be taken in order to ensure the success of the restructuring process; all this, while at the same time taking in due consideration all the relevant risk factors and, to a certain extent, the interests of the parties involved. Professional qualification and significant experience are necessary. Qualitative data from the empirical research show that the lack of adequate professional qualification and experience can be a critical aspect in restructuring and can cause the debtor to choose inadequate or inappropriate courses of action.⁴

³ For instance, the empirical research shows that in Italy judicial composition with creditors (*concordato preventivo*) is purported to achieving a piecemeal liquidation in the vast majority of cases (69% of the cases): see an analysis of the data of this research in A. DANOVI, S. GIACOMELLI, P. RIVA, G. RODANO, 'Strumenti negoziali per la soluzione delle crisi d'impresa: il concordato preventivo', in Banca d'Italia, *Questioni di Economia e Finanza*, No. 430, March 2018. In Germany, on the other hand, liquidation plans (with regard to a piecemeal liquidation) are virtually non-existent.

⁴ This is particularly the case for MSMEs, as demonstrated by the data and information collected in the context of the empirical research conducted in Spain (see the National Findings for Spain, available at www.codire.eu).

Quantitative empirical research from the UK shows a staggeringly positive effect on outcomes where the insolvency practitioner conducting the proceedings belongs to a major accounting firm, and it is plausible that a similar effect holds for other types of advisors.

Different enterprises require different professional advice. The advisors' profile and experience should be proportionate to the kind of restructuring that is envisaged (e.g. continuation of the business vs. sale of the business as a going concern), different financial structures, the number and heterogeneity of creditors, the existence of cross-border issues – in other words, the complexity of the case, also in order to ensure cost effectiveness of professional assistance. In some cases, a single financial advisor may suffice. In other cases, it may be necessary to hire a separate industrial advisor, and in other cases it may be expedient to hire a chief restructuring officer.⁵ Legal advisors are almost always necessary, given the intrinsically legal nature of any restructuring plan.

Before accepting a case, advisors should assess whether their competence and experience is adequate. It is appropriate for debtors to require that advisors submit a statement in writing that they have performed such a self-assessment.

Advisors should also have an adequate structure and staff and should only accept cases to the extent that they will be able to perform all necessary tasks in a competent, timely, and efficient manner (the positive impact of experience and organisation seems confirmed also by the above-mentioned results with regard to major accounting firms being appointed as insolvency practitioners).

Guideline #4.1 (*Professional qualification and experience of the advisors*). It is advisable for the debtor to quickly acquire the clearest possible representation of the situation of the distressed business and of the general context in which the restructuring is expected to take

Current German law requires insolvency practitioners in formal proceedings to be natural persons which excludes the major accounting firms (and unlike some law firms, they do not even seek appointment of their individual partners or employees). While they do advise debtors and stakeholders, there is no data available allowing a comparison of their results with those of other advisors.

⁵ See Chapter 7, par. 2.3.

place. Such representation should guide the selection of the advisors and be shared with them at the earliest stage, requiring the hired advisors to state in writing that they have the required expertise and resources.

Policy Recommendation #4.1 (*Professional qualification and experience of the advisors*). The legal framework should ensure that advisors possess an expertise adequate to the cases they advise on.

2.2. Position and independence of advisors

Advisors should be sufficiently independent. While it is common for the law to require independence of insolvency practitioners, either appointed by the debtor, by a third party, or by an administrative or judicial authority (see also Art. 25 of the draft Restructuring Directive), there is usually no such requirement for advisors, who are hired by the debtors and are, from a formal point of view, mere consultants to the debtor.

When the debtor is in distress and is seeking to devise a restructuring plan, however, the situation is different from the ordinary course of business. As mentioned above, the plan may directly or indirectly affect creditors and other third parties and may involve actions that may give rise to civil and criminal liability and to other adverse effects (voidable acts, etc.). Therefore, advisors should have a detached and dispassionate perspective on the case and should not lend their reputation and expertise to the drafting of a plan that is not purported to be in the best interest of all parties involved.⁶ On the other hand, given that debtors (and directors of the debtor company, in particular) should conduct business in a way that protects the interests of creditors (or, at least, is not prejudicial to them – see recital 36 and Art. 18 of the draft Restructuring Directive), advisors should not aid directors to take any action that is not in line with their duties towards third parties or the public interest.

⁶ In this perspective, the plan is in the best interests of a party if such party is not worse off under the restructuring plan than it would be in the event of liquidation, whether piecemeal or sale as a going concern (see also Art. 2(9) of the draft Restructuring Directive). This issue is addressed in Chapter 2 of this Report.

Finally, the cost of advisors (except in the rare cases in which someone other than the debtor is paying them) is ultimately borne by the creditors, to the extent that creditors are not paid in full.

In general, a rule of thumb is that advisors should have the ability to say ‘no’ to a request of the debtor, and maintain such ability throughout the whole process. This ability could be impaired for various reasons.

Firstly, when the advisors selected for the restructuring process are the same advisors of the debtor in the ordinary course of business their detached and dispassionate perspective may be impaired. In this case, besides the inevitable cognitive biases, they may lack independence due to self-review or be captive to possible involvement in past actions that may result in a liability risk, or financial constraints (e.g. for past due fees). On the other hand, however, previous consultants may have invaluable insights into the business that may be lost or recreated only at a high cost by changing consultants entirely, so a balance must be sought.

Secondly, independence of judgment could be impaired by personal or professional links with persons other than the debtor. In some cases, this may be self-evident and prevented by legal or professional rules on conflicts of interests: e.g. when there are connections between the advisors and one or more creditors. However, there may be more subtle links that may be not be prohibited as a matter of law but may nonetheless threaten the ability of the advisor to suggest the best restructuring plan, e.g. connections with creditors, whose adverse effects might not be neutralised by the consent of both such creditors and the debtor (such consent does not eliminate the risk for the other creditors); connections with directors or officers, or controlling shareholders (risk for all shareholders or for minority shareholders respectively or, more frequently, risk of actions that may be prejudicial for creditors).

The degree of ‘independence’ is a matter to be discussed and should probably be weighed against the kind of restructuring process. When there is an independent ex-ante review, as happens in formal judicial proceedings, independence may be less of an issue. When there is not, independence may be more important to avoid that the restructuring process is used in order to favour the interests of parties that, under the law, are not entitled to a preferential

treatment (e.g. the full payment of a claim supported by a director's personal guarantee at the expense of other creditors). In all cases, however, the minimum requirement to have a well-drafted plan is that advisors should be in a position to conduct an independent evaluation of the situation and an assessment of the necessary measures.

Advisors are not gatekeepers, however. If the debtor – after the advisors' evaluation and notwithstanding the advice to the contrary – intends to pursue a restructuring attempt, advisors should seriously consider refusing the assignment.

It should also be noticed that, depending on the applicable law, advisors risk incurring liability (like the debtor and its directors and officers) and may have their fees disallowed or clawed back if an insolvency proceeding is opened following the unsuccessful restructuring attempt.

Guideline #4.2 (*Independence of the advisors*). The quality and effectiveness of a restructuring plan, both from an ex-ante and an ex-post standpoint, is positively affected by the capability of the advisors to preserve a detached and dispassionate perspective, thereby being able to draft a fair restructuring plan based on accurate assessments and realistic predictions. In general, it is appropriate to hire advisors that have not been counselling the debtor in the ordinary course of business, possibly in addition to previous consultants.

2.3. *The advisors' approach*

The role of advisors is to: (i) assess the debtor's condition; (ii) suggest the actions to be taken and the proposal to be made to creditors.

The two activities are linked but separate.

When assessing the situation of the debtor, advisors should conduct a review of the debtor's assets and liabilities and analyse carefully the causes of the distress. Advisors should be able to rely on existing reports and surveys but should for no reason defer blindly to them and should always exert their professional scepticism *vis-à-vis* the assurances of the debtor. The scope and depth of the review, as well as the reliance on existing data or third-party reports, may depend on many

factors, e.g. the size of the debtor, the completeness, accuracy and trustworthiness of internal reporting and control systems, whether or not there are any red flags. In some areas which are typically more critical and tend to be overstated in the balance sheet (accounts receivables, inventory) examination should be more thorough. When relying on internal data and on existing reports (if unrelated to the restructuring), advisors should state that they are confident of the accuracy of data. If they are not, or do not have time or resources to make an assessment, they should state this clearly. However, the ability to avoid an assessment should be restricted to peculiar and normally transitory circumstances.

In fact, a plan cannot be drafted properly if it is based on incorrect or insufficient data and, indeed, it should be a duty of any advisor to draft a plan that is not only theoretically adequate, but is also reasonably likely to lead to a successful outcome of the envisaged restructuring. For this reason, disclaimers to the effect of not taking responsibility on whether or not the data on which the plan is based are accurate should not be the norm. Advisors should accept full responsibility for the plan and especially for the data upon which it is based.

As regards the perspective of the plan (assumptions, forecasts and projections), advisors should be cautious, if not conservative. In particular, when making an assumption based on information from the debtor, advisors should be particularly thorough in checking its plausibility.

It is important to clarify that advisors should be able to rely in full on reports drafted by specialised experts appointed by the debtor, in view of the restructuring, when their expertise is necessary to complement that of the advisors' and in the view of the restructuring process (e.g. evaluation of real estate assets, machinery, goods or materials, financial instruments; legal opinions with regards to special issues). Such reliance is anyway conditional upon the fact that the expert is independent (in the meaning above) and adequately qualified.

Guideline #4.3 (*Review of financial and economic data*).

Advisors should draft the restructuring plan on the basis of data that have been subjected to a thorough review by the advisors themselves or by other professionals specifically hired with a view to restructuring the distressed business. Internal data or

data resulting from reports unrelated to the business restructuring should be used only exceptionally, provided that they are considered accurate and that the advisors expressly state that they have relied on unverified data.

2.4. *The issue of costs*

A very general and recurring issue is the cost of advisors (as well as insolvency practitioners), which tends to be high given the skills and time required and the responsibility shouldered by advisors. Given the undisputed scaling effect, for MSMEs in particular these costs may become excessive.⁷ Expert advice, however, is promptly needed when the situation of the debtor has deteriorated (but before the moment when the situation becomes not remediable).

The draft Restructuring Directive considers costs only with regard to insolvency practitioners (Art. 27(2)) and sets a very general principle by which fees should be ‘governed by rules that incentivise a timely and efficient resolution of procedures’.

A similar principle should apply also to compensation agreements with advisors. Agreements should be drafted in a way that at least to some extent links compensation to the ultimate success of the plan.⁸ There are many caveats that should be pointed out, however. It should also be noted that empirical evidence from different jurisdictions shows that compensation of advisors is, on average, usually not disproportionate and lower than that of court-appointed insolvency practitioners (e.g. Italy).

⁷ In Italy, restructuring costs for professionals and advisors are generically regarded as high and may be particularly burdensome for MSMEs. Two could be the main possible explanations: (a) the complexity of insolvency law, together with repeated law reforms, requires specialisation and continuing education and practice; (b) only a few number of professional are specialised in restructurings, despite the increasing demand for this type of professional services.

⁸ In Italy, evidence gathered from qualitative research (mainly interviews with judges) have pointed out the fact that professionals do not exert sufficient pressure to filter out bad cases from restructuring candidates. The explanation given is that professionals’ remuneration is time-based (and not success-based).

First, there is a risk of adverse selection of advisors if the success-based compensation is pushed too far. High-level advisors will not accept a payment that is disproportionately success-based, because, for whatever reasons, the doubts concerning the actual possibility of getting to a restructuring plan are often not negligible and advisors will understandably refuse to bear a (part of) risk they cannot control at all. Therefore, qualified advisors could be disincentivised from contributing to the rescue of viable businesses if offered such compensation packages.

Second, when opting for success-based fees one must make sure that too strong incentives towards pushing the plan through do not result in favouring the interests of parties that do not deserve a preferential treatment to the detriment of other creditors or stakeholders. The issue here is to define correctly what is ‘success’ and how to measure it. Ideally, compensation should be linked to success in the sense that, at the end of its foreseen course, the plan has been correctly implemented. Of course, deferment of payment until the complete implementation of the plan is not possible (see *infra*, par. 5.2, for the duration of the plan). It will therefore be necessary to strike a correct balance between the competing needs of timely payment and correct incentives.

Third, in some cases it may be necessary to hire advisors in order to know whether or not the business is viable and, more generally, whether it is possible to draft a feasible plan. In this case, success-based compensation is not appropriate.

Policy Recommendation #4.2 (*Costs of advisors*). The law should ensure that advisors’ fees are reasonable and designed in a way that, in general, links compensation to the success of the plan. Exceptions to success-based fees should be made for advice relating to preliminary analysis of the case.

3. The peculiarities of restructuring plans

3.1. The peculiarities of restructuring plans vis-à-vis ordinary business plans

We can assume that the drafter of the plan, in evaluating the debtor's business and prospects for recovery, will employ the best practices in the fields of due diligence reports and of business and financial plans, with a particular focus on plans concerning distressed businesses (see also par. 4.1). Such best practices will not be examined here.⁹ The focus here will instead be on:

(a) the peculiarities linked to the fact that the plan concerns a business in distress;

(b) the specificity lying in the fact that the plan must be designed to be judicially reviewable, either *ex ante* (if judicial confirmation is necessary) or *ex post*.

On the first point, the plan must pay adequate attention to a set of essential elements that should always be present but, according to the results of the empirical research, are sometimes overlooked or not adequately dealt with. Particular attention, for instance, should be given to cash flow forecasts, contingent liabilities and to the impact of future and uncertain events (see below, par. 6).¹⁰

On the second point, unlike 'ordinary' business plans, which if proven unrealistic may give rise to a loss of managerial

⁹ See e.g. for an excellent set of indications, CONSIGLIO NAZIONALE DEI DOTTORI COMMERCIALISTI ED ESPERTI CONTABILI (National Council of Business Consultants and Certified Accountants), 'Principi per la redazione dei piani di risanamento', September 2017.

¹⁰ According to the draft Restructuring Directive (Art. 8), a restructuring plan submitted for confirmation by a judicial (or administrative) authority must contain information on the 'present value of the debtor or the debtor's business as well as a reasoned statement on the causes and the extent of the financial difficulties of the debtor', on the identity of affected and of the non-affected creditors, on the proposed duration of the plan, on any proposal by which debts are rescheduled or waived or converted into other forms of obligation, and on any new financing anticipated as part of the restructuring plan.

In addition, the plan must include 'an opinion or reasoned statement by the person responsible for proposing the restructuring plan which explains why the business is viable, how implementing the proposed plan is likely to result in the debtor avoiding insolvency and restore its long-term viability, and states any anticipated necessary pre-conditions for its success'.

reputation (and only seldom to liability of directors), restructuring plans cut into the flesh of creditors and other stakeholders. In case of non-execution, it is quite likely that disputes arise and, possibly, an insolvent liquidation is opened in which what has been done will be reviewed (often with hindsight bias). Even before implementation, creditors who do not believe in the restructuring plan will try to oppose it, either by voting against it or, when applicable, by challenging it in court during the confirmation process.

To avoid any doubts, this Chapter deals with restructuring plans drafted when the enterprise, though not insolvent, has reached a relatively high degree of distress. ‘Internal’ restructuring plans, those that are simply concerned with recovering (or increasing) profitability of a business without affecting creditors, for the purpose of this Chapter fall into the category of ‘ordinary’ business plans.

3.2. Drafting restructuring plans in the shadow of judicial reviewability

Given the reasons above, the plan must be drafted in such a way that the court can understand it, not with a view to second-guessing the findings of the business experts, but rather to reviewing its completeness, accuracy, and internal consistency. In particular, under the applicable law the court usually has all or some of the following powers:

(a) following a *prima facie* review, denying confirmation of a restructuring plan should that plan lack the reasonable prospect of preventing the insolvency of the debtor and ensuring the long-term viability of the business (see, in the same vein, Art. 8(3) of the draft Restructuring Directive, which mandates the attribution of such power);

(b) monitoring the proper implementation of a restructuring plan, authorising, as the case may be, deviations and taking redressing actions where necessary;

(c) if requested, evaluating the effects of the implementation of a failed restructuring plan against the backdrop of the information available to the parties involved. In fact, acts implementing a restructuring plan are usually exempt from avoidance actions (see also Art. 16 and 17(4) of the draft

Restructuring Directive),¹¹ but, on the one hand, there may be exceptions for acts carried out ‘fraudulently or in bad faith’ or with gross negligence, and, on the other hand, such acts may give rise to personal (civil, administrative and criminal) liability.

The last profile is particularly critical, as the prospect of being prosecuted *ex post* has powerful *ex-ante* effects, discouraging honest people from taking part in business rescues. To this purpose, it is advisable that the applicable law provide for clear exemptions also from civil, administrative and criminal liability to everyone involved in a restructuring attempt and acting in good faith.¹²

It may be argued that since the exemption of an act from avoidance actions is due to its being beneficial to creditors, the same act cannot give rise to liability actions. This is reasonable, but cannot automatically be considered valid for all Member States. Hence the importance of a well-drafted plan, that will protect against challenges and accusation of such kinds.

To facilitate judicial reviewability, the plan should be *clear*, also by drawing summary conclusions from necessarily complex economic and financial analyses, *unambiguous*, using an appropriate legal terminology, and if possible *concise*, if necessary by making ample reference to annexes.

Qualitative empirical research has shown that in some cases judges find plans inadequately drafted and supported by ambiguous assertions or accompanied by extensive

¹¹ A similar provision is present in Italian law (Arts. 67 par. 3(d) and (e)), and in Spanish law Arts. 71 bis and Additional Norm 4th IA). In Germany, only cash transactions (‘Bargeschäfte’, sec. 142 InsO, requiring equitable consideration within a short time span) are relatively reliably protected from all avoidance actions; promising restructuring attempts in good faith may, however, at least provide a defence against the far-reaching avoidance in cases of wilful disadvantage (‘vorsätzliche Benachteiligung’, sec. 133).

¹² To this purpose, while the draft Restructuring Directive provides an explicit exemption from ‘civil, administrative and criminal liability’ to the grantors of new financing and interim financing (Art. 16(3)), it does not grant the same exemption: (a) to the debtor *receiving* new and interim financing; (b) to the person(s) carrying out ‘any transaction, payment, debt-equity swap, guarantee or security carried out to further the implementation of a restructuring plan confirmed by a judicial or administrative authority or closely connected with such implementation’: such acts are merely shielded from avoidance actions (Art. 17(4)).

disclaimers.¹³ Unclear or ambiguous plans make it more difficult for the judge to exert his or her review and cause suspicion among readers, which may lead to read the whole restructuring attempt under a negative light.

Guideline #4.4 (*Focus on judicial reviewability*). **The restructuring plan should be drafted with a view to facilitating ex-ante and ex-post judicial review. Therefore, the plan should be clear, unambiguous and concise to the extent possible.**

4. The restructuring plan

4.1. The restructuring plan: the past, the present and the future of the business

While being a single document, a properly drafted restructuring plan consists in a business part and a financial part. The first is more properly concerned with the business, and illustrates how the causes of the distress will be eliminated and profitability will be restored. The second is concerned with the financial position of the firm, and illustrates how the debt burden will be reduced to a sustainable level, i.e. a level that the debtor can sustain in the ordinary course of business (i.e. when cash flow from operations net of maintenance investment and taxes allows serving the debt).¹⁴

The restructuring plan should include a summary and synthetic description of the main actions that must be implemented to pursue the strategy chosen in the plan. Its goal is to translate strategic goals into specific actions, which facilitates the valuation of consistency between goals, strategies and actions. This summary, often labelled ‘Action Plan’, should describe the projected actions and their impact on the

¹³ See for instance the Italian empirical research, available at www.codire.eu.

¹⁴ See e.g. CONSIGLIO NAZIONALE DEI DOTTORI COMMERCIALISTI ED ESPERTI CONTABILI (National Council of Business Consultants and Certified Accountants), ‘Principi per la redazione dei piani di risanamento’, September 2017, par. 2.2.5.

organisation, the responsible person(s)/unit(s) for each action and the necessary resources, the time frame.¹⁵

The plan as a whole must deal with three different sets of issues:

- why the business is currently in distress and why it can be restructured;
- what exactly is the present situation with respect to assets and liabilities;
- how the business will be run in the future and how (and in which measure) the creditors will be satisfied.

Each set of issues poses unique challenges, which will be analysed in the following paragraphs. Specific attention will be devoted in a separate paragraph to the third point, focusing particularly on the problem of uncertainty.

Guideline #4.5 (*Summary and description of main actions*).
The restructuring plan should include a summary and brief description of the main actions that must be implemented to pursue the strategy chosen in the plan.

4.2. The past: explaining the causes of distress and why they can be overcome

The restructuring plan aims at convincing third parties that the business, notwithstanding its current distress, should continue.

Therefore, a properly drafted restructuring plan must deal with the causes of distress (in this light, see Art. 8 of the draft Restructuring Directive, which states that a restructuring plan must contain ‘a reasoned statement on the causes and the extent of the financial difficulties of the debtor’). Why did the business end up in the present situation? Was it a normal, albeit adverse, business circumstance (e.g. all the business in a certain sector may be affected), or rather was it bad luck (specific adverse factors affected the business), managerial incompetence (clear business mistakes) or, even worse, fraud?

¹⁵ See CONSIGLIO NAZIONALE DEI DOTTORI COMMERCIALISTI ED ESPERTI CONTABILI (National Council of Business Consultants and Certified Accountants), ‘Principi per la redazione dei piani di risanamento’, September 2017, sec. 8. A Gantt Chart may be a useful tool.

Transparency regarding the causes of the distress is a requirement that goes beyond the immediate consequences for the prospect of the restructuring plan.¹⁶ Indeed, the creditors may be perfectly rational in consenting to a restructuring plan of a company whose managers have been clearly incompetent or even dishonest, but they will need to know it in order to make an informed business decision. They may decide that consenting to the plan is the best option to recover their money, but they would probably want to know if the managers have been dismissed and, when applicable, whether they have been called to restore the damage.

Exposing the causes of distress allows the debtor to explain why the future, although probably still difficult, looks brighter than the past. The restructuring plan, with a view to convincing the creditors and, when applicable, the judge, will therefore explain the actions that mark a clear discontinuity with the past, which are a precondition to its success.

Guideline #4.6 (*Transparency regarding the causes of the distress*). The restructuring plan should identify the specific causes that have led to the distress of the enterprise, with a view to (i) facilitate the creditors' assessment on whether the plan adequately deals with such causes and prevents them from arising again, and (ii) allow creditors to make an informed decision on the proposal.

¹⁶ We assume that the law of Member States does not bar companies affected by managerial incompetence or fraud from accessing the applicable restructuring tools. The fate of the managers and that of the company may well be separate. In Italy, in formal insolvency proceedings there must be a full disclosure of possible causes of liability of directors, so that the 'best interest of creditors' test can take into account also possible recoveries from damages awarded against them. In Spain, an opinion about the causes of insolvency must be included in the general report of the insolvency practitioner. On a different note, when the *concurso de acreedores* opens a liquidation stage or a plan is agreed to that is burdensome to creditors, the court and the IP will look into the possible liability and disqualification of directors. There is, however, as such, no previous calculation of amounts that directors may be liable to compensate. It must be remembered that Spain's formal insolvency proceedings do not include a best interest of creditors test. In Germany, according to sec. 156(1) InsO, the insolvency administrator's report to the creditor shall contain a statement regarding the causes of the insolvency. The insolvency administrator has to assess and pursue claims against the directors.

4.3. The present: valuing assets and liabilities

No plan can credibly project the future without an evaluation of its own basis. A complete assessment of the business data is preliminary to any evaluation of the effectiveness of the plan for the solution of the crisis.

The restructuring plan must therefore devote specific attention to the reliability of the initial data on which it is based, both on the assets side and on the liabilities side. This is one of the fields in which advisors can significantly contribute to the overall quality of the restructuring plan.

A few remarks are necessary:

(a) assets must be evaluated according to the specific structure of the plan. In this case accounting value (especially if based on historic cost) is no longer *per se* an indication of the value of an asset. The value of an asset depends on what its destiny is under the plan: if it is meant to be liquidated (e.g. is a non-strategic asset), then its value will be the asset's liquidation value; if instead it is meant to remain part of the business as a going concern, its value will be a part of the value of the whole business;

(b) liabilities must be evaluated at their face value, even if they were trading on the market at a lower value due to the debtor's distress;¹⁷

(c) interest due to accrue in the future and the amount of the principal must be evaluated according to the applicable law (e.g. the law may or may not stop the accrual of interest, and the law or the contract may or may not provide for the acceleration of deferred payments);

(d) contingent liabilities must be properly accounted for, providing for adequate resources for the case they eventuate in actual liabilities (see also par. 6).

A full review during the process of drafting the plan, carried out according to generally accepted auditing principles

¹⁷ A lower trading value of the enterprise's liabilities, although generally having no relevance in the perspective of the restructuring, may represent an opportunity for the business to strengthen its economic situation by buying (if allowed under the applicable law) its own liabilities on the market at a lower price than the relevant face value (usually defined 'liability management exercise'), ultimately generating a windfall gain. Apart from this situation, in which the liabilities are effectively extinguished, the enterprise cannot benefit from a lower trading value of its liabilities, which must be accounted for (and dealt with in the plan) at face value.

and practices, would be ideal. Especially for large businesses, however, it is impossible to assess all the business data within a reasonable time and without excessive costs. Therefore, in such cases, as mentioned above, the plan can be built on the data yielded by the internal reporting system, as long as:

(a) there are no 'red flags' that may raise doubts on the correctness and reliability of the reporting system;

(b) the main items, with particular regard to the items of the working capital (in consideration of the importance of expected cash flows), have been verified.

The plan may be supplemented by external appraisals, assessments and opinions by qualified parties, which may be deemed necessary according to the circumstances.

4.4. The future: the business plan and the satisfaction of claims

As said above, the restructuring plan is a project for the future, in two directions:

(1) it provides for a set of coordinated actions aimed at resolving the distress, and projects the resulting cash flows;

(2) it allocates such cash flows to the creditors, for each of which (or for each *class* of which) it must provide for a specific treatment (schedule of payments for principal and interest, waiver of amounts, conversion into other forms of obligation or into equity). The plan may provide for some flexibility in satisfying the creditors (as of time and/or amount), to allow for uncertainty.

A critical part of the restructuring plan is dealing with the value of the distressed business. If the value of the assets is higher when sold piecemeal (i.e. separately, rather than all together), then the business is not only financially but also *economically* distressed. In this case, the quicker the business is discontinued and the assets are sold, the better it is for the creditors.¹⁸

If, however, the value of the assets is higher if all or some of them are kept together and used in running the business instead of being sold piecemeal, then the business is *financially*

¹⁸ Here creditors are considered as a coherent group, whose interests are aligned. In fact, we know that creditors whose claims are entirely underwater always have an interest in extending the time of reckoning, to keep the option value of their claims alive.

distressed but economically viable, and has a going concern surplus.¹⁹ In this case, it is in the best interests of the creditors to preserve the value of the business by allowing it to continue trading. Such value can be transferred to creditors either by a going concern sale (which yields more than a piecemeal liquidation) or by giving the creditors part of the future cash flows generated by the direct continuation of the business, either by paying (in whole or in part, and in various forms) the pre-existing debt once the viability of the company is recovered, or by giving the creditors equity in the restructured company.²⁰

The restructuring plan must therefore clearly and credibly state why the assets are worth more kept together than sold piecemeal. It must, in other words, explain why restructuring is a better solution for the creditors than insolvent liquidation. Articulating the reasons why the business is deemed economically viable is important both in perspective of providing elements to the creditors' assessment on the plan and in the perspective of judicial reviewability.

Guideline #4.7 (*Assessing and stating the economic viability of the distressed business*). The economic viability of the distressed business needs to be accurately ascertained by the advisors drafting the plan. It is advisable to make explicit in the plan the positive assessment on the economic viability of the business so as to allow an informed assessment of the plan by the creditors and, if applicable, by the court.

4.5. *The focus on cash flow forecasts*

The viability of the restructuring and, even before, the practicability of the negotiation process relies on the ability of the debtor to pay debts as they fall due. Absent this, creditors

¹⁹ M. CRYSTAL, R.J. MOKAL, 'The Valuation of Distressed Companies. A Conceptual Framework', (2006) 3 *International Corporate Rescue*, Issues 2 and 3.

²⁰ See also par. 5.2 criticising the draft Restructuring Directive with respect to the choice of limiting the scope of the restructuring tool provided therein to 'sales of assets or parts of the business', therefore excluding the sale of the whole business.

will probably foreclose, invoke acceleration and/or file for insolvency. In some jurisdictions, moreover, the debtor is required to file for insolvency in case of illiquidity.

By definition, financial distress implies that the debtor is not able to pay its obligations as they fall due. There are several tools to deal with this problem (mainly, the stay on creditors and interim and new financing: see also par. 5.2). A high-quality restructuring plan devotes particular attention to cash flows and how the enterprise plans to keep a financial balance throughout the whole process (confirmation, if applicable, and implementation).

Detailed forecasts of cash flows must be made and included in the restructuring plan. The chosen interval (week, month, quarter) depends on the nature and size of the business, ideally being shorter at the beginning (when the business is more fragile) and may become longer over the time frame of the plan. Such intervals must be sufficiently short to show the viability of the process and allow almost instant monitoring of the evolution of the enterprise's financial position.

It should be noted that according to qualitative empirical evidence cash shortage is the main trigger for restructuring, thus denouncing a lack of cash-flow planning in 'ordinary' times. Cash-flow projections in restructuring are even more critical considering the frequent inability of businesses, especially MSMEs, to plan adequately on the point.

Guideline #4.8 (*Preparing accurate cash flow forecasts*). The success of a restructuring plan may be jeopardised by inaccurate cash flow forecasts that, setting the rescued enterprise in the position of being unable to satisfy claims as they fall due, often lead to insolvent liquidation of the business. Therefore, the plan should include accurate cash flow forecasts, which should be comprehensively illustrated in the restructuring plan so as to allow an informed assessment on the plan by the creditors and, if applicable, by the court.

5. Dealing with uncertainty

5.1. Uncertainty as an unavoidable component

A restructuring plan is, at its essence, an articulated set of actions and measures whose implementation is due to occur in the future and is expected to solve the business' distress. As with any planning activity, the scope of the time frame taken into account affects the quality and reliability of the plan: the longer the plan, the greater the chance that there will be obstacles to its implementation and/or that the effects of its implementation will be different from those expected. Nonetheless, as better clarified below, uncertainty is intrinsic to restructuring plans and needs to be adequately dealt with.

The nature of such uncertainty is related to the circumstance that any plan requires that one or more actions be executed in the (near or distant) future. Therefore, even the most accurate and complete restructuring plan cannot establish with certainty:

- (i) that all the actions or measures provided in the plan will actually be implemented as scheduled, and
- (ii) that the plan, if implemented, will indeed allow for the complete recovery of the enterprise.

There are endless factors that may come into play and interfere with what the plan envisages. Some factors are unpredictable and independent from the control of those involved in the business distress (e.g. the evolution of the relevant market, changes in the legal framework affecting the business). Quite often, deviations from the forecasts and projections made in the plan depend on an imperfect or incomplete perception of the situation of the enterprise and/or of the relevant context. Indeed, many deviations are originated by the limits of human ability to predict the future or fully understand the present (e.g., a sudden collapse of the real estate market when the restructuring plan is based on the ex-ante reasonable assumption that the sale of some properties will generate a certain amount of proceeds).

In order to devise a high quality and effective plan, such physiological uncertainty associated with the business restructuring should be reduced as far as possible and, most importantly, properly governed.

Of course a restructuring plan that has very few chances of succeeding should not be allowed (rather it should not be allowed in terms directly or indirectly affecting those who have not consented to the plan). In contrast, a plan that has some well-defined elements of uncertainty, even if significant, may still be a quality plan when it properly and effectively deals with such elements.

Particularly, in that perspective, the plan should acknowledge the uncertainty that is always associated with the restructuring of a business and, thus, be drafted:

1) clearly stating the fundamental assumptions the plan is based on, identifying for each of them the factors that may interfere with their occurrence and quantifying the relevant risk that such assumptions do not materialise, also by means of carefully drafted stress tests (see below, subpar. 5.5.2);

2) choosing a structure that facilitates monitoring by the relevant stakeholders (i.e. creditors, shareholders) and/or by the court (e.g. setting milestones that help to evaluate the performance of the plan during its implementation);

3) providing for adjusting mechanisms, either automatic or subject to creditor consent, that allow the plan to reach its ultimate goal (namely, rescuing the business), even if one or more of the assumptions do not materialise.

The following paragraphs address the structure and content that appear optimal in the perspective of properly and effectively governing uncertainty. However, before analysing the most common tools to minimise and govern the uncertainty associated with restructuring plans, it is appropriate to focus on the time frame taken into account by restructuring plans and, in that respect, distinguish three different levels.

5.2. The time frame of the restructuring plan

The process of restructuring a business may be ideally divided into three parts, whose objective and duration may differ significantly.

First, during the negotiation (and, if applicable, confirmation) phase, the financial equilibrium of the enterprise must be maintained. If this is not the case, the value of the assets may quickly diminish due to the inability to manage the firm in an orderly fashion and/or to the aggression of creditors.

Such equilibrium must be achieved either via a stay on creditors (automatic or imposed by the court, according to the applicable law) or via interim financing aimed at keeping the business alive while the best solution is negotiated.²¹ The draft Restructuring Directive facilitates this task, both by allowing a short stay of individual enforcement actions (Art. 6), and protecting interim financing (Art. 16). Particular attention should be dedicated to this issue, as cash flow insolvency during negotiations may make the whole effort of restructuring worthless.²² Therefore, the obligations that arise during the negotiation phase must be satisfied as they fall due.²³

Second, an approved (and, if applicable, confirmed) restructuring plan needs to quickly restore the financial balance of the enterprise. The plan should provide for actions and measures that ensure that while pre-existing liabilities may be rescheduled or reduced, those claims that arise after the conclusion of the plan must be promptly satisfied as they fall due. To this purpose, the plan should expressly state how the expected cash flows will be matched (e.g. obtaining new financing allowing the enterprise to gain enough time to

²¹ Interim financing is defined as the ‘short-term funds that are necessary for the debtor to cover administrative expenses after the commencement of restructuring or insolvency proceeding until either the implementation of the restructuring plan or the sale of the debtor’s business as a going concern’: B. WESSELS, S. MADDAUS, ‘Instrument of the European Law Institute. Rescue of Business in Insolvency Law’, (2017) p. 58.

²² For instance, the applicable law may provide for an obligation to file in case of cash-flow insolvency: see Art. 7 of the draft Restructuring Directive: ‘1. Where the obligation of the debtor to file for insolvency under national law arises during the period of the stay of individual enforcement actions, that obligation shall be suspended for the duration of the stay... 3. Member States may derogate from paragraph 1 where the debtor becomes illiquid and therefore unable to pay his debts as they fall due during the stay period...’

²³ A thorny issue is that of ‘critical vendors’, i.e. suppliers and counterparties of the debtor that will not perform their obligations unless they are paid also for the pre-existing debts. The draft Restructuring Directive does not deal with this directly, but leaves some flexibility to Member States: see Art. 7, Par. 4, which states, ‘Member States shall ensure that, during the stay period, creditors to which the stay applies may not withhold performance or terminate, accelerate or in any other way modify executory contracts to the detriment of the debtor for debts that came into existence prior to the stay. Member States may limit the application of this provision to essential contracts which are necessary for the continuation of the day-to-day operation of the business’.

implement the business plan that is expected to increase the revenues and/or reduce the costs).²⁴

Third, a restructuring plan generally needs to provide for a set of actions and measures aimed at remedying those circumstances that have caused the crisis (in particular, those that are internal to the firm, e.g. the exercise of unprofitable business lines). This part of the restructuring plan may be implemented in a longer term than the one mentioned above, and it is ultimately intended to restore the economic and financial value from a long-term point of view (e.g. allowing the enterprise to generate enough revenues to honour the liabilities existing before the plan that had been rescheduled).

The actions and measures falling in what we have called the ‘third phase’ of a restructuring plan are further along in time and thus exposed to a greater risk of interference coming from unforeseen factors. Such interference could result in making action and measures provided under the plan not implementable or unable to produce the expected effects.

In light of the above, plans providing for a shorter time frame for implementation are those having more chances to be fully implemented and to lead to the expected results (e.g. in terms of creditor recovery rate). However, it should be considered that a longer duration of a restructuring plan is intuitively associated with greater chances to rescue the business. A plan that has a short horizon may not always be pursuable (e.g. a purchaser for the business may not always be available) or anyway unsuitable to offer a sufficient probability concerning its capability to rescue the distressed enterprise (e.g. being based on highly speculative investments that, in case of a quite likely failure, would worsen the enterprise’s insolvency).

The existing trade-off between, on the one hand, a long time horizon offering more chances to rescue the enterprise and, on the other hand, the obvious limits to the possibility of accurately forecasting long-term trends requires that a proper

²⁴ Structuring a plan suitable to (almost) immediately restore the financial balance should be possible for any viable business, if we assume that (i) lenders are completely rational, are free to negotiate the interest rate and there is no information asymmetry, and (ii) suppliers are willing to agree to a longer period for payments. Indeed, the empirical research performed show that this is not the case. Furthermore, the Italian legal system does not allow for the free negotiation of interest rates on loans beyond a certain threshold, therefore not allowing the distressed debtor to obtain financing at a price that reflects the real risk.

balance be found. The indications coming from well-established professional practices suggest that a restructuring plan should not provide for an implementation timeframe longer than 3-5 years.²⁵ That timeframe is the period usually necessary to restore a business, as commonly recognised by well-founded industry practices, and it would allow preserving a reasonable degree of reliability concerning the forecast and projections made in the plan.

A restructuring plan having a longer horizon should still be possible, although its quality would be negatively affected. However, there are certain measures that can be put in place to reduce the quality deterioration resulting from a long implementation phase. We refer particularly to the adjusting mechanisms described in par. 5.6 below.

Conversely, for the same reasons stated above, a restructuring plan based on the sale of the entire business as a going concern to a third party may often be an effective solution. In that case, when the purchaser is identified in the plan, the plan is implemented almost instantly, significantly limiting uncertainty (which still exists all the same since, for instance, the sale could be invalid and/or avoided should the purchaser become insolvent and subsequently liquidated).

In light of the above considerations, the draft of the Restructuring Directive draws criticism with respect to the choice of limiting the scope of the restructuring tool provided in it to ‘sales of assets or parts of the business’. The empirical analysis conducted has evidenced that restructuring based on the sale of the entire business is common in several jurisdictions (namely Italy, UK, Spain and, with limitations, in Germany²⁶) and in certain cases has proven to be an effective response to

²⁵ See for instance the results of the qualitative part of the Italian empirical research, published on the website www.codire.eu. The implementation timeframe of the restructuring plan should not be confused with the time frame for the payment of creditors: in Spain, for instance, plans usually include a rescheduling of the debts, both in court and out of court, that extends up to 10 years. This has not been a concern of the stakeholders interviewed: on the contrary, repeat creditors such as financial creditors seem to strongly favour lengthier plans if they are associated with a smaller write-down of the debt. The situation may change as a consequence of the new rules on provisioning and classification of non-performing exposure, extensively discussed in Chapter 5, par. 3.

²⁶ In German law, contracts and licenses cannot be transferred without the counterparty’s consent, not even in formal insolvency proceedings.

business distress.²⁷ Further, the research has not identified any justified reasons (which cannot be dealt with otherwise) that suggest banning the restructuring of a distressed enterprise through the sale of the entire business as a going concern.

Guideline #4.9 (*Time frame of the plan*). The restructuring plan should pursue the goal of rescuing the distressed business through a set of actions and measures due to take place within a period of time not exceeding 3-5 years. Unless justified on the basis of specific circumstances, a longer implementation period is not advisable due to the increasing risk of unforeseeable events.

5.3. Time frame of the restructuring vs. time frame for paying creditors

On a different note, it is important to clarify that the maximum time frame recommended for the implementation of a restructuring plan does not include the payment of all the liabilities existing at the moment when the plan is drafted, as mentioned above (par. 5.2). Two considerations are necessary.

First, restructuring does not aim to pay all the debts, but to reduce them to a sustainable level (see above, par. 4.1). No business is debt-free, and a certain level of indebtedness is physiological and efficient. This said, it must be noted that the empirical experience shows that to achieve the consent of creditors on the restructuring plan, distressed businesses almost always deleverage too little, and that they are left with an

²⁷ For Italy see A. DANОВI, S. GIACOMELLI, P. RIVA, G. RODANO, 'Strumenti negoziali per la soluzione delle crisi d'impresa: il concordato preventivo', in Banca d'Italia, *Questioni di Economia e Finanza*, No. 430, March 2018.

Spain offers a different and somewhat more complex scenario. Going concern sales work well within formal insolvency proceedings, where special rules have been included to facilitate this type of transactions (e.g. the automatic transfer of contracts or licences). A going concern sale of business units is a possibility within out-of-court proceedings, but not of the whole business. A similar result can be achieved by means of a debt-for-equity swap, and it happens with relative frequency.

excessive burden of debt after the restructuring is (at least formally) completed.²⁸

Second, even the payment of the excessive debt may well occur beyond the 3-5-year period suggested, it rather being only necessary for all the ‘extraordinary’ measures (such as the disposal of assets, the transfer or rationalisation of business lines, the redundancy of workers, etc.) to be put in place and that the relevant corrective effects have occurred. In other words, the enterprise’s debts may well be satisfied as originally scheduled, or as rescheduled by the restructuring plan, beyond the term of 3-5 years without any adverse effect on the quality of the restructuring plan.

In this regard, however, the case where the enterprise is required to pay a relevant debt, in a single instalment (‘bullet payment’) at a date beyond the suggested implementation time frame should be carefully considered (such debt may either result from anew financing awarded in the context of the restructuring or from claims existing at the time of the restructuring). This circumstance needs to be properly addressed in the restructuring plan so as to ensure that the

²⁸ For Italy, the empirical research on contractual resolution of distress (*accordi di ristrutturazione dei debiti*) shows that within 2 years from completion a high percentage of firms either undergoes a new restructuring or files for in-court restructuring (*concordato preventivo*).

The situation is similar in Spain, where one-third of refinancing agreements follows a previous refinancing agreement (this is the case, for instance, of the restructuring of *Abengoa*). In case of consecutive restructurings, the span of time between one refinancing and the next one is about two years. It must be noted that numbers may actually be higher: it has not been possible to capture all the refinancing agreements (purely contractual, collective or homologated) that took place before the homologation of another. Since by definition these agreements need no court intervention, obtaining the data has proven extremely difficult. As to the content of consecutive refinancing agreements, they mostly consist of revisions of financial covenants (in order to ease their fulfilment by the debtors) and a revision of the payment conditions (grace periods, new interest rates, etc.).

Even taking into account the lack of pre-insolvency tools, the situation appears slightly different in Germany. The empirical research shows that it does happen that a few years after an *Insolvenzplan* there is a second insolvency proceeding (usually ending in liquidation); no reliable statistics on the frequency exist, but it should not concern (even remotely) a majority of cases. Regarding the sustainability of out-of-court agreements, experts admit that re-negotiations are frequent (if maybe less frequent than apparently in Italy); however, they still believe the majority of agreements to be more or less sustainable.

debtor has regained the ability to pay (or refinance) the ‘bullet’ at maturity, and that the plan is not merely disguising the fact that the existing debt burden is not properly reduced to a sustainable amount.²⁹

Empirical evidence shows that it is common for business to undergo consecutive rounds of restructurings, often using a more ‘invasive’ tool in the second or third round. One possible explanation is that measures in the first attempt were insufficient, both on the asset side and on the liability side (inadequate rescheduling, rescheduling instead of write-downs, inadequate write-downs, etc.). Particular care should be given when assessing what a ‘sustainable’ level of debt is.

Guideline #4.10 (*Reduction of the indebtedness to a sustainable level*). The restructuring plan should illustrate the level of debt that the debtor may serve in the ordinary course of business and how the debtor will achieve such level. Particular attention should be devoted to plans in which a significant part of the debt is merely rescheduled and left payable at a certain future date.

²⁹ Indeed, although a long rescheduling of significant liabilities improves the suitability of the plan to reinstate a proper financial balance for the enterprise (which benefits from a reduced cash flow in the short term), it poses a significant threat to the long-term effectiveness of the plan. The enterprise is required to find an adequate amount of resources to duly satisfy the claim when it falls due and this may be challenging. Particularly, the enterprise needs either to obtain new financing from a bank or to be able to accumulate enough resources to satisfy the claim over the years of the plan. If the enterprise is not able to achieve either of these results, the restructuring plan ends up only hiding a crisis for a certain number of years that in fact has not been resolved, just postponed. Therefore, with a view to reducing the above-described element of uncertainty, the restructuring plan should clearly describe how the debtor plans to obtain the resources necessary to honour such long-deferred claims (e.g. disposing of one or more important assets, setting aside the proceeds of the continuation of the business). Should the plan provide for the satisfaction of the long-deferred claims by refinancing them at maturity, in whole or in a significant part, the restructuring plan should contain an analysis of the actual probability of receiving such refinancing in light of the expected creditworthiness of the enterprise at the relevant maturity date.

5.4. Setting out clear assumptions, forecasts and projections

5.4.1. The case for clarity

As mentioned above, all restructuring plans are meant to be read, examined and assessed by many persons: creditors, other third parties, the insolvency practitioner and the judge. Therefore, special care should be taken to make the plan comprehensible to persons with different backgrounds and expertise and to make its assertions (both of facts and of hypotheses) easy to be checked.

An educated reader should be able to understand and check assertions with relative ease and should be in the position to ask the advisors (or any expert in charge of checking technical aspects of the plan) to assess the impact on hypothesised scenarios of the variation of one or more elements of the plan.

As also mentioned above, advisors should take responsibility for the plan also as a matter of concrete fact and not only as a theoretical exercise. Disclaimers on factual aspects should be limited and should never be so broad that the advisors can avoid this responsibility.

5.4.2. Conditions of the plan

The feasibility of the restructuring plan is often determined by specific future and uncertain events that might make the plan feasible or, on the contrary, undermine its feasibility. When there are necessary preconditions for the success of the plan (e.g. the consent of creditors x, y, z or the consent of a certain percentage of creditors) this should be clearly stated. The occurrence of such preconditions should be readily ascertainable, so that the readers of the plan can understand whether or not the plan is effective and ready to be implemented.

It should be noticed that when stating a precondition for the success of the plan there are two possible options, whose structures and consequences are totally different.

The first situation occurs when a relevant event, although subject to uncertainty, is considered more likely than not to occur and therefore is an integral part of the plan (e.g., the disposal of a non-strategic asset at a price no less than X within

the next 12 months).³⁰ In this case, the plan can be immediately implemented, but the plan must state clearly that the non-realisation of the event will endanger (in terms to be described) the further implementation of the plan, so that those who are called to evaluate the plan can make an informed business decision on whether to accept/confirm the plan or not.

The second situation occurs instead when the plan does *not* state that an event key to the plan is highly likely to occur (e.g. the condition that an agreement with banks, in substantially the terms described in the plan, is executed within the next four weeks). In this case, the plan cannot be implemented until the conditioning event occurs, and it will become feasible only if and when the event takes place.

If the advisor has chosen the second option and the plan is subject to an expert's assessment or to court confirmation, the condition must occur before (or at the moment in which) the expert or the court issue their statement, because until the condition is met there is no proper and effective plan. Also, the plan can be considered effective only when such condition has taken place (e.g. for the purpose of protection from avoidance actions under Art. 17(4) of the draft Restructuring Directive).

³⁰ The level of likelihood of the relevant event is a very important issue and is subject to debate. An example will clarify the problem.

The success of the restructuring plan of a very famous and age-old distressed porcelain manufacturer, Richard Ginori, relied (also) on the extraordinary income deriving from the possibility of extinguishing its tax liabilities through the transfer of a corporate museum of recognised historical value to the Italian State, a possibility that the law expressly allowed. The expert certifying the feasibility of the plan declared that no agreement had been reached so far, but while the 'denial by the Ministry of Finance of the possibility of the transfer [could] not be ruled out, due to the elements of seriousness and concreteness that [had] emerged so far, a denial [could] be deemed remote'. The Tribunal of Florence, refusing to open the composition proceeding, ruled that 'the Court and the creditors must rely on elements that are certain and on which they can with good reason evaluate the satisfaction of their claims' (Tribunal of Florence, 7 January 2013). Requiring certainty, or almost certainty, of future events that determine the success of the plan, however, would deprive the debtor and the creditors of the possibility of a successful restructuring, which is worthwhile pursuing if the plan, although subject to failure, is sufficiently serious, i.e. if the determinant event is more likely than not to occur. This is why the position expressed in the text is advocated.

Guideline #4.11 (*Distinction between conditions for the success of the plan and preconditions for its implementation*). The restructuring plan should clearly distinguish between events that, although subject to uncertainty, are considered more likely than not to occur and therefore do not preclude the plan from being implemented, and events that are proper conditions precedent and thus must occur for the plan to come into effect.

5.5. Governing uncertainty

The plan is projected in the future and is subject to inevitable uncertainty. However, some measures may help minimise the impact of such uncertainty on the plan: stress tests, monitoring devices, adjustment mechanisms and provisions. First of all, however, one must take into account the need to describe the actions to be carried out under the plan.

5.5.1. Describing the actions to be carried out pursuant to the plan

In certain jurisdictions, and soon throughout the EU as a matter of principle (see Art. 16 and especially Art. 17 of the draft Restructuring Directive), restructuring plans can have the effect of exempting from avoidance or liability actions (and from criminal liability).

It is therefore important that the main acts and transactions to be implemented with third parties under the plan be described (e.g., sale of one or more assets, new financing, new guarantees, etc.). The requirement is more stringent than the mere best practice of having a summary of the main actions (Action Plan: see above, par. 4.1), as third parties may need to contract with the debtor by relying on the circumstance that the transaction they are entering into is exempted from avoidance and may not give rise to liability.

Should the plan fail (and the debtor go into insolvent liquidation), a detailed description of the acts and transactions implementing the plan will make it easier for interested parties to defend the plan or its effects by proving the tight connection

between the plan and the act, payment, pledge or transaction carried out within its implementation in an ex-post review, in which hindsight bias is the norm.

Somewhat intuitively, the level of detail in the description of the single transaction should be proportional to the importance of the act to be carried out for the success of the plan.

Guideline #4.12 (*Description of acts to be implemented under the plan*). The plan should describe the acts to be carried out in a detailed manner. The level of detail should be proportional to the importance of the act to be carried out.

5.5.2. Testing for the variation of assumptions

As mentioned above, as a matter of method and style the plan should be drafted in a way that allows any reader to check the validity of assumptions and to measure the impact of any variation.

This aspect is also very relevant from the point of view of the contents of the plan. In order to minimise the impact of the inevitable uncertainty of the future, the plan should consider different scenarios. Advisors should run stress tests on, at a minimum, the main assumptions and forecasts of the plan in order to assess whether and to what extent the results indicated in the plan remain stable when changing variables. Expressly providing stress tests in the plan will demonstrate to what extent the hypotheses are sensitive to the variations, and, ex ante, may lead to increase the robustness of the plan by encouraging the provision for adjustment mechanisms.

Plans on which stress tests have been performed tend to be more robust; even if the hypothesised stress event does not actually take place, experience shows that other unforeseen events always take place and a robust plan may withstand unanticipated events better than plans that do not take into account possible negative events.

Robustness increases with adjustment devices and, especially, appropriate provisioning (see below).

Guideline #4.13 (*Assumptions and the effect of their variations*). In order for third parties to be able to check and assess its robustness, the plan should clearly state the assumptions and include tests that describe the effects of their variation.

5.6. *Deviations from the plan and adjustment mechanisms*

The plan is the starting point of the restructuring process and it therefore requires implementation and continuous monitoring (see Chapter 7). The implementation of a restructuring plan may face unforeseen problems and, in all cases, forecasts may not all become reality.

When there is a significant deviation between forecasts and reality, the plan cannot be further implemented as originally intended and the debtor should take the appropriate steps to cure the issues that may have arisen. The deviation should be considered significant when the hypothesis included in the plan as a milestone can no longer be implemented or can be implemented only under conditions that, from a financial or a timeliness point of view, are different from those assumed in the plan.

The achievement of the milestones through means other than those set forth in the plan (e.g. selling a different asset than the one anticipated) should not be considered an implementation of the plan. Rather, the whole plan would no longer be implementable, or anyhow not implementable as previously envisaged. Possible protective effects of the plan (see e.g. under Art. 17 of the draft Restructuring Directive) would not be applicable. The debtor will have to amend the plan in light of the new circumstances. As stated above, the debtor should take into account the events that actually took place rather than the events that were previously forecasted, while the new plan should not be based on the same assumptions that prevented its implementation.

In order to avoid the plan becoming unfeasible, the plan itself could include internal adjustment mechanisms or alternative solutions. For example, the plan remains feasible when it states that if transaction A (e.g. sale of an asset for a price higher than X) cannot take place, option B shall be implemented (e.g. a further reduction of debts, already accepted

by creditors in the case that a certain event takes place). The plan is therefore self-adjusting.

Covenants that are usually agreed on with financial creditors may be considered as examples of milestones embedded in the plan. Compliance with such covenants, especially when they include ratios or indexes, may therefore be used as an indirect tool to assess the implementation of the plan: non-compliance with the covenant may be considered as a deviation from the plan, whereas the creditors' waiver on enforcement may actually serve as an adjustment mechanism.

Guideline #4.14 (*Divergence between forecasts and reality*).

When a significant divergence between forecasts and reality occurs, the plan cannot be further implemented as originally intended and its protective effects no longer apply with respect to subsequent acts. All the acts implemented prior to the divergence are unprejudiced.

5.7. Provisions for adverse contingencies

Provisions can be seen as one peculiar type of self-adjusting mechanism: if event A does not occur, the lack of financial coverage deriving from this event can be taken care of by appropriate provisioning, without the need to modify the plan.

When possible, good plans should include provisions for contingencies. Such provisions should be reasonable: if too small, they do not give any appreciable degree of protection to the plan. If excessive, they subtract resources to current creditors without being (entirely) justified by the need to take care of potential negative effects.

Provisions should also be made for non-consenting creditors that oppose the plan, for contingent creditors, for known but untraceable creditors and, if appropriate, for unknown but foreseeable creditors (see Chapter 3, par. 5.10). Plans should provide for mechanisms by which resources tied up in provisions are appropriately distributed once the contingent event does not take place, in order to avoid opportunistically excessive provisioning by debtors. In complex cases and in some industries it may be necessary to resort to

actuarial analyses in order to assess risks of future claims originating from the business.

Guideline #4.15 (*Provisions for adverse contingencies*). The plan should include provisions for adverse contingencies, including alternate routes to achieve the goal of restructuring.

CHAPTER V

NEGOTIATING RESTRUCTURING PLANS*

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negotiations. – 6.2. Consequences of creditors’ rational apathy in negotiations. – 6.3. Measures to tackle passivity in negotiations. – 6.4. Measures specific to restructuring tools that aim at (or allow) binding dissenting creditors.

1. Negotiations and stay on creditors’ actions

1.1. Negotiations of restructuring plans: the need for good practices

Restructuring plans aim to obtain concessions from the creditors, or some of them, with the goal of making them better off than the available alternatives (usually the insolvency liquidation of the business). The debtor, therefore, must convince them that accepting the plan is both in their best interest as a group, and in the best interest of each affected creditor. This is a difficult task since it implies verifying and sharing complex information on the present situation and agreeing on the likelihood of future scenarios.

Negotiations are necessary whenever the plan must be agreed upon through an expression of consent. No sensible creditor would accept a plan without being adequately informed and, possibly, without having negotiated a counterproposal, or one or more amended proposals, that, in the creditor’s view, yield a better outcome.

However, negotiations with certain creditors (most commonly the main creditors) are common also in procedures in which the acceptance or rejection of a restructuring plan is done through a vote, which also binds dissenting creditors. In such procedures, it is usually the debtor who submits its proposal, which must meet the applicable standards of disclosure (set by the law and implemented by the court), and stakeholders vote on that proposal.¹ Even though in such a setting it is not necessary to envisage a negotiation before the vote, very often the plan put to a vote is the result of a process by which an initial proposal is modified in order to secure the required approval by the requisite majority.

¹ Applicable law establishes the required majority and how to count the votes (by value of claims only, or by value *and* number of claims) and how to consider those who have not voted (dissenting, consenting or simply non-voting). Some of these issues have been addressed in this Chapter, below.

In some cases, a negotiation phase is necessary for the debtor to choose the right tool to restructure its indebtedness. For instance, the debtor may approach its main creditors with a view to achieving a purely out-of-court restructuring only to realise that this path is not practicable due to the opposition by, and/or the passivity of, some of those creditors, resulting in the non-feasibility of a purely out-of-court solution.

This makes the negotiation phase extremely important. It must be noted, however, that there is seldom any written rule – besides general contract law – that states how the debtor and the stakeholders must deal with each other while negotiating a restructuring plan. Is there a duty to share with the other parties *all* information available (for instance, how much a creditor has provisioned against the claim that the debtor asks to restructure), or just the information that, if missing or misleading, would make a party's consent invalid? Is there a duty of the creditors to cooperate with the debtor in good faith? The answer to both questions is probably that, unless otherwise provided under the law, each party is entitled to act selfishly (see below, par. 2.3). This just renders more pressing the need for good practices applicable to the negotiations of contractual and quasi-contractual preventive restructurings.

1.2. Negotiations and stay on creditors

Negotiating with creditors does not require *per se* a stay on creditors' claims. Financial distress, which is the very cause for which the debtor engages in negotiations with its creditors, can have different levels of severity. In fact:

(1) financial distress may not be yet so serious as to prevent the debtor from paying its debts as they fall due. In these cases the debtor seeks to tackle future cash-flow tensions in a timely manner. It must be noted, however, that the time before such tensions begin to emerge may well be shortened by the creditors' reaction to the start of negotiations (banks, for instance, may stop rolling credit lines over). In this case, and until the situation deteriorates, a stay on creditors' enforcement actions is not necessary if not to prevent the opportunistic behaviour of one or more specific creditors;

(2) in other cases, financial distress may prevent the debtor from paying *all* its current debts, but some creditors (usually,

financial creditors) have agreed on a ‘standstill’ and/or to interim financing so as to allow the debtor to remain solvent during the negotiations, e.g. by paying suppliers and workers in order to maintain the business as a going concern, with benefits for all the creditors. In this case, a sufficient number of creditors deems it in their own interest to sustain the debtor’s efforts to restructure, and therefore a stay on creditors’ enforcement actions is not necessary;

(3) finally, financial distress may be so serious as to prevent the debtor from paying its current debts, an insufficient number of creditors (or no creditor) have agreed on a standstill and no interim financing is available on purely contractual terms. In this case, a stay on creditors’ enforcement actions may be necessary to preserve the business value in the interest of the creditors as a whole and thus sustaining the debtor’s efforts to restructure.²

The difference between the two last situations is that while in case (2) the creditors have reached an interim conclusion that the debtor’s efforts to restructure are worth upholding and are bearing the risk for doing so, in case (3) the creditors have *not* reached such a conclusion. Therefore, granting a stay on creditors is done on the (not unrealistic, but not obvious) assumption that the creditors have not reached the conclusion that the debtor’s efforts to restructure are worth upholding due to collective action problems and/or transaction and coordination costs, and they would have done so if they were acting as a cohesive and informed group.

Requesting (or availing itself of the legal possibility of) a stay on creditors requires responsibility by the debtor, which must be reasonably convinced that by doing so it is preserving value for the creditors and it is not merely worsening the situation. The debtor must also be clearly aware of the cost of the stay, both in terms of limitation of creditors’ rights and in terms of potential losses for all the stakeholders deriving from

² In this sort of case, the conflict existing between the individual interest of each creditor and the interest of the creditors as a whole is a well-known collective action problem, often labelled as the ‘tragedy of the commons’. It is a well-established view that from the perspective of each individual creditor of an insolvent debtor the most rational course of action would be to act as quickly as possible to grab the firm’s assets (or its equivalent liquidation value) and satisfy its claim, even though this would disrupt the business going concern to the detriment of all the other creditors.

continuing a loss-making business. This is due to the fact that a stay directly impinges on creditors' legal and contractual rights, limiting them. The level of necessary confidence in the beneficial effect of the stay is directly proportional to the length of the stay: the longer the stay, the higher the confidence should be in the fact that the stay is maximising value for the creditors.

As seen above, the issue of the stay on creditors is strictly linked to the issue of interim financing. A debtor may not need a stay if it receives financing specifically aimed at keeping the business solvent. The conditions and effects of such financing will be examined in the next paragraph.

Two remarks are necessary:

(1) a significant degree of uncertainty is unavoidable, and while keeping the business going is reversible, stopping the business may not be. Therefore, at an initial stage, a stay on creditors may be useful merely to preserve the *possibility* of maintaining value for the creditors, a possibility that must be verified as soon as possible to avoid an unnecessary destruction of value. Such a verification should be made by someone independent having adequate business expertise, most commonly an external examiner (appointed by the court, by the creditors or by the debtor, provided that the examiner is independent);

(2) there might be cases in which, although the business is worth more as a going concern than liquidated, a stay on creditors does not solve the problem, as the short-term cash outflows relating to expenses that must be incurred after the moment when the stay would take effect exceed inflows and no interim financing is reasonably available. In this situation, liquidation is unavoidable. Such cases make the case for timely coping with distress particularly strong.

Guideline #5.1 (*Requesting a stay on creditors*). The debtor should request a stay only when there is a going concern value to preserve. The degree of certainty with regard to the existence of going concern value should be stronger when the requested stay has a long duration, has been extended after a previous request, or when the procedure to lift the stay is burdensome for creditors.

Guideline #5.2 (*Projecting cash flows during the stay*). Before requesting a stay, the debtor must draw a cash-flow projection showing in detail what the cash-flow inflows and outflows will be during the period creditors are stayed. Such projection must take into account the likelihood of harsher commercial terms by suppliers (possibly, dealing with the debtor only if paid upfront) and, if available, interim financing.

Guideline #5.3 (*Avoiding a harmful stay on creditors*). If the projected short-term cash outflows exceed inflows and no interim financing is reasonably available, the debtor should abstain from requesting a stay and should quickly resort to the best available option to preserve the business value, either as a going concern or as a gone concern.

Policy Recommendation #5.1 (*Stay on creditors*). The law should provide for a court to have the power, at the debtor's request, to grant a stay on creditors to facilitate restructuring efforts and negotiations. The initial order of the stay, the court's decision not to terminate the stay despite creditors' motions, and any extension of the stay should depend on the assessment that the stay is beneficial to the creditors as a whole.

1.3. Negotiations and protection of transactions connected to negotiations

Regardless of the granting of a stay, the continuation of the business pending negotiations requires that the debtor be able to carry out transactions in the ordinary course of its activity (e.g. paying workers and suppliers) as well as transactions specifically aimed at furthering negotiations (e.g. paying reasonable fees and costs to the advisors). To this purpose, the counterparties to the debtor should be able to rely on the protection of such transactions, if equitable, in the scenario of a subsequent insolvency proceeding following the failure of the restructuring attempt. In certain jurisdictions, this comes from the requirements envisaged for avoidance actions, which

provide that payments by the debtor made in close timely connection to receiving an equitable consideration (e.g. a certain service or an asset) are not avoidable.³ Whereas in other jurisdictions where such transactions could be voided should the restructuring not succeed,⁴ it is important for the law to provide an express exemption covering these cases as well.

This is important to avoid third parties refraining from dealing with the firm as soon as the distress has come to light, once the firm has started negotiations. No one would rationally assume the risk of the success of the restructuring attempt unless he or she is already exposed to the firm and/or obtains contractual terms remunerating such a risk. As a result, engaging in negotiations would cut most firms out of the market, even if still cash-flow solvent, thereby preventing the continuation of the business during negotiations, making it impossible to obtain the required professional advice, and ultimately determining the non-viability of the restructuring attempt.

In light of the above, the law should provide for safe harbours and/or mechanisms allowing third parties to rely on the effects of the transactions carried out during restructuring negotiations. It is advisable for the law to directly set forth exemptions of certain types of transactions that are clearly aimed at making restructuring negotiations possible (e.g. payments of workers and strategic suppliers, reasonable fees and costs in seeking professional advice). The law should also include a provision creating a more general safe harbour (as a result of either the requisites for avoidance actions or an exemption to avoidance) for all other transactions that, while not specifically exempted, are carried out to further negotiations on a restructuring attempt that does not appear *prima facie* non-viable.⁵

³ This is the choice made by the German legislature. See sec. 142 InsO.

⁴ This is the case of Art. 67(2) of the Italian Insolvency Act, providing that equitable transactions occurring six months before the beginning of the insolvency liquidation are declared void if the trustee provides evidence showing that the counterparty was aware (or should have been aware) of the debtor insolvency.

⁵ An alternative would be to provide that the judicial or administrative authority, upon the debtor's request, may grant an exemption for any transactions not expressly exempted by the law, if the debtor provides evidence of the fact that the transaction is useful to further negotiations on a restructuring attempt that does not appear *prima facie* non-viable. However,

It is not advisable for the law to make the exemption from avoidance actions and/or unenforceability conditional on the confirmation of the restructuring agreement by the competent judicial or administrative authority. Such a solution, which has been adopted by certain jurisdictions and may be the one chosen by the European legislature,⁶ only partially neutralises the risk borne by third parties for the success of the restructuring attempt. Indeed, those dealing with the firm during negotiations continue to share the risk, beyond their control, that the restructuring negotiations will be aborted or, in any case, will not lead to a confirmed agreement, while being discharged only of the risk of non-implementation of the restructuring agreement once confirmed.⁷

The legitimate purpose of allowing the avoidance and/or unenforceability of transactions carried out when there was no reasonable perspective of achieving a restructuring agreement

such a solution appears suboptimal, since it might either clog the courts further or (also given the urgency of these decisions) become a rubberstamping of transactions without proper scrutiny, inviting abuse.

⁶ Pursuant to Art. 17, par. 1 of the proposed Directive on preventive restructuring ‘transactions carried out to further the negotiation of a restructuring plan confirmed by a judicial or administrative authority or closely connected with such negotiations are not declared void, voidable or unenforceable as acts detrimental to the general body of creditors in the context of subsequent insolvency procedures’. It is not clear from the language of such provision whether the transactions ‘*closely connected with such negotiations*’ may not, in any case, be ‘*declared void, voidable or unenforceable*’, regardless of confirmation by the judicial or administrative authority.

The provision of the Proposed Directive, which appears to subordinate the protection of ‘*restructuring related transactions*’ to the (later) judicial or administrative confirmation of the restructuring plan (Art. 17), seems inconsistent with the provision on ‘interim financing’ (Art. 16), which does not qualify judicial or administrative confirmation as a condition for granting protection, even though interim financing is just one particular type of restructuring-related transaction.

⁷ Granting protection to third parties regardless of the plan adoption and confirmation could be, at first glance, perceived as unfair to those creditors that are impaired as a result of the transaction (i.e., those creditors whose recovery would have been higher if the restructuring-related transaction had been avoided). However, should the law allow for the avoidance of such transactions, the third parties suffering an additional risk would either (i) not negotiate with the debtor, since it would be irrational for them not to be remunerated for such additional risk, or (ii) pretend that this additional risk be remunerated, to the result of carrying out transactions that would be regarded as inequitable and, thus, would more likely be voided.

and obtain its confirmation should be pursued otherwise. Invalidating the protection of all transactions reasonably carried out to further a restructuring agreement, which eventually is not reached or confirmed, would be ‘overkill’. The exemption from avoidance and/or unenforceability should be lifted only with respect to those transactions that are deemed fraudulent or in any case carried out in bad faith.⁸

Policy Recommendation #5.2 (*Protection against avoidance and unenforceability*). The law should provide protection against the risk of avoidance and/or unenforceability of reasonable transactions carried out during negotiations and aimed at making restructuring negotiations possible, by either providing exemptions or designing the requirements for avoidance and/or unenforceability accordingly.

1.4. Negotiations and interim financing

Interim financing helps keep the business solvent while the debtor is negotiating with its creditors. As mentioned, interim financing shares the same goal of the stay, namely preserving value for the creditors, and may be obtained by the debtor independently from a stay or in combination with it.

Financing a distressed debtor, however, entails serious risks:

(1) the financing may destroy value, giving a hopeless debtor new fuel to burn. Liquidation may then occur with fewer assets left for the creditors and/or more debts to satisfy out of the debtor’s estate;

(2) the lender can incur the risks of recovery, as the debtor may not be able to reimburse the financing received and the security, if any, may be declared voidable.

Therefore, from the debtor standpoint, interim financing should be sought only when the debtor is confident that it is in

⁸ The proposed Directive on preventive restructuring already provides that the exemption should concern only transactions that have not been ‘*carried out fraudulently or in bad faith*’ (Art. 17, par. 1), thereby making the case for removing the provision of the judicial or administrative confirmation of the restructuring agreement as a condition for the protection of the transactions carried out during the negotiations.

the best interests of creditors. Such belief must be strong and founded on data and independent analyses when the amount of the financing is likely to affect the outcome of a liquidation.

From the lender standpoint, granting interim financing ordinarily entails a recovery risk. Except for the case when the law reduces or neutralises the lender recovery risk (see below), no sensible creditor, be it a creditor already exposed or an external market player, would grant new financing unless it is reasonably confident the debtor will be repaying it (admittedly, creditors already exposed have a utility function more inclined to granting financing than external creditors). The lender is a market player that does not assess just the debtor's estate from a static perspective, but also the future prospects of the business once restructured. Hence, when a lender grants interim financing, it strongly signals that the restructuring attempt is worth sustaining.

As interim financing may contribute to preserve the business value, the law may help the debtor in obtaining it by reducing the risk borne by the lender. To this purpose, the law may give the grantor of interim financing an exemption from avoidance and liability actions and/or provide for priority to its claim (see e.g. Art. 16 Draft Directive).

However, shielding the lender extending interim financing from the recovery risk may yield some undesired results, namely the loss of the above-described signalling value and allowing for the continuation of a business that should instead be ceased, since the restructuring attempt is not viable/credible. These undesired effects are partially tempered by the circumstance that, according to certain general legal principles common to most jurisdictions, measures protecting the lender would not operate when there is evidence that the interim financing has been extended fraudulently or in bad faith.⁹

⁹ The Proposed Directive expressly sets forth that 'new and interim financing shall not be declared void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures, unless such transactions have been carried out fraudulently or in bad faith ... The grantors of new financing and interim financing in a restructuring process shall be exempted from civil, administrative and criminal liability in the context of the subsequent insolvency of the debtor, unless such financing has been granted fraudulently or in bad faith' (Art. 16, par. 1 and 3).

Guideline #5.4 (*Existence of the conditions for interim financing*). Interim financing should be sought only when the debtor assesses, on the basis of sound data and, if possible, expert advice, that this is in the best interest of creditors, especially to preserve the business's value.

2. Information and cooperation

2.1. The need for a complete 'information package'

An issue that has consistently surfaced in the qualitative empirical study is the need for the debtor to present creditors with adequate information in order for them to be able to decide in an informed and timely manner.

In general, reliable and updated information is necessary in order to draft a correct plan. Businesses should have adequate reporting systems (see Chapter 1) that are able to allow detection of distress in a timely fashion and provide updated data at a level of granularity that is sufficient to design the plan in a suitably sophisticated manner.

However, *having* the data is not enough. When drafting a restructuring plan, debtors should always be aware that they are addressing creditors and other third parties (advisors, insolvency practitioners, courts, as the case may be) that may not be immediately aware of all the business's details and the plan's aspects and implications. Information regarding the business and the plan, therefore, should not only be reliable, updated and complete, but should also be presented in a way that is easily understood and deal with all aspects relevant for the creditors and the other third parties.

Completeness of the information package touches upon another key aspect, i.e. the timeliness of creditors' response. Restructuring plans almost always require consent of at least some creditors as a prerequisite for the plan. However, completeness of the information package, while always being of great importance, becomes pivotal when negotiation occurs outside formalised proceedings. When there are formal proceedings, with set timelines and a moment in which creditors can cast their vote or otherwise express their position, the proceedings themselves solve the issue of timeliness. To the

contrary, outside of formal proceedings, it is even more important for the debtor to spontaneously adopt a timely and transparent approach from the start, especially with regard to the information they provide to creditors.

An issue that is commonly raised is the difficulty for businesses to receive comprehensive and final responses in a reasonable time, especially from banks and other financial creditors. Of course almost any restructuring implies the involvement and participation of institutional creditors, in particular of banks. These difficulties increase *(i)* when there are several creditors or, in any case, the average value of each claim is not large, which is frequently the case in some jurisdictions (typically, in Italy, Spain, where usually businesses resort to various banks on equal footing also for credit facilities in the ordinary course of business and there is no leading bank, as is instead common elsewhere, e.g. Germany, and there are more micro and small enterprises), and *(ii)* in times of crisis, when banks are flooded by requests. In this respect, regulatory rules setting requirements for banks on NPLs provisioning may exert a significant influence on the incentives to the lender banks and the debtor during negotiations.¹⁰

It should be noticed that timeliness is of the essence not only for the debtor, but for the whole restructuring process. Time plays a crucial role in the reliability and effectiveness of the plan: it is not uncommon that, due to defects and delays in the negotiation process, plans that were drafted taking into account a certain time horizon are no longer current when creditors consent to the plan, because the underlying situation has changed. The implementation of the plan is, of course, immediately affected as well.

The availability of high quality, complete and understandably presented information (a) is a prerequisite for the drafting of a good plan and (b) may facilitate obtaining positive, or at least timely, responses by creditors, and in particular by financial creditors.

Timely responses from creditors have a positive effect to the extent that they make it possible to:

¹⁰ See *infra* par. 3 for an assessment of the effects of the incentives posed by regulatory rules on NPLs provisioning. It is worth to mention that such incentives would operate by fostering a quick reaction by the bank but, at the same time, creating an incentive for the debtor to slow down negotiations, as time increases its leverage in negotiating with banks.

(1) abandon plans that appear defective or for any reason unfeasible from the beginning, avoiding further costs and detriment to creditors, and facilitating the filing for formal insolvency proceedings;

(2) correct and improve the plan, when it is feasible, or at least appears as such theoretically (of course in order to be useful such amendments should be carried out promptly);

(3) increase the certainty on the possibility of success of a feasible and well-balanced plan.

The exact content of the information package to be provided to creditors and third parties will vary from case to case. However, some basic information should not be missing:

- the causes of the crisis, if possible highlighting whether the crisis has a mainly financial origin or not;
- the initial situation: all information and data on the debtor must be clearly and objectively outlined. Such data should rely upon some form of professional review;
- a summary description of the proposed plan;
- a more detailed description of key aspects, with a focus on key elements (such as the minimum amount of debt that needs to be written off or rescheduled, the minimum amount of creditor acceptance, whether the plan envisages the direct continuation of the business, etc.) and risks (including legal risks);
- financial information;
- prospective financial information, including the assumed cash flow projections;
- key assumptions of the plan.

A more detailed description of some of the elements of the plan outlined above is contained in Art. 8 of the draft Restructuring Directive.

In the negotiation phase, the plan need not be complete and an outline will be enough. However, it is important that the basic information be given from the start so that creditors can immediately form an opinion about the plan. Any delay in this respect may result in postponing the restructuring and, thus, engaging in negotiations when a turnaround is no longer possible, or anyway when the debtor's conditions have deteriorated.

Once negotiations have started, as soon as possible the debtor should:

(a) prepare information to be disclosed to creditors, especially financial creditors, and related supporting documentation;

(b) carry on negotiations in good faith; in return, creditors should promptly and critically evaluate the information received and ask for further information and documents, when needed;

(c) define the plan in all its details, fine-tune it and define the proposals to be made to creditors;

(d) if the plan includes the business continuing as a going concern, highlight whether standstill agreements or additional financing are necessary for the plan to go forward. Special attention should be given to the reasons why new financing is needed (with regard to the best interests of creditors);

(e) highlight possible contributions provided by shareholders or third-party investors (in the form of risk capital or credit facilities) or show the reasons why asking for these contributions is not feasible.

In more general terms, the debtor should be able and ready to provide all necessary supporting documents to creditors or other interested parties that may request them.

2.2. Disclosure and good faith

When a restructuring plan is needed, the debtor is in distress. This causes the usual relationship between the debtor and its creditors or contractual counterparties to be altered. The extent to which this happens, however, depends primarily on how deep the crisis is.

In general, directors have a duty to minimise losses for creditors (and, says Art. 18 of the draft Restructuring Directive, for workers, shareholders and other stakeholders).¹¹ How does this translate into a duty to disclose all relevant information? In other words, can directors, acting in the interest of shareholders (who have appointed them) engage strategically with creditors and fail to disclose information that they are not required to

¹¹ It should be noted that the goal of minimising losses, being referred to stakeholders having very different interests, is only seemingly unitary. Indeed, due to the provision of Art. 18, directors may often be subject to conflicting duties whose importance is not graded by the proposed Directive. In this respect, see the amendments proposed to the draft Directive.

disclose by law? Does negotiation with creditors follow the same pattern of negotiation when the company is not in distress?

The answer is probably no. Creditors are captive counterparties to the debtor and are asked to give up something they had bargained for. The debtor is often already breaching the credit contract or may be about to do so; the only issue in a restructuring is how big this breach will be. Creditors have no proper alternative to negotiating, because enforcement of the claim is not an option as a matter of law (when there is a stay and a collective proceeding) or as a matter of fact (the debtor is already underwater). Given that this negotiation is not between parties free to choose their counterparty and is therefore somewhat coercive, and given that there is also a collective action problem when there are many creditors, it is fair to say that an adequate procedure and disclosure are proper tools to mitigate these issues.

However, there are some nuances. There is no doubt that the debtor must negotiate in good faith, even more than with ordinary negotiations. Many national laws provide for a similar duty either specifically to restructuring or, more commonly, as a general principle (this is the case, for instance, of Art. 1375 of the Italian Civil Code, Art. 7 of the Spanish Civil Code, or sec. 242 of the German Civil Code). It is not self-evident, however, whether debtors owe a duty of complete candour to creditors – which they certainly would not owe if not in distress. If the equity has not been completely wiped out, directors continue having a duty to maximise shareholder value, whilst not causing further losses to creditors. Therefore, it is arguable that directors do not have to reveal their ‘reserve price’ when bargaining with creditors. But even assuming that equity *has* been completely wiped out, directors may have a duty not to reveal *all* circumstances to all creditors, because this could frustrate the optimal overall outcome of the restructuring plan, especially when negotiating without the protection of a stay on creditors’ actions, but not only. Revealing too much information to creditors could cause negotiations to fail due to opportunistic behaviour of some creditors or just due to lack of coordination among them.

These cases are likely not to be so frequent. As a general rule, therefore, one can say that debtors have a duty to disclose

all relevant information to creditors and other interested parties, and to do so in a clear and complete manner.

2.3. Cooperation by creditors?

Creditors should negotiate in good faith with the debtor. It is debatable, however, whether creditors have a duty to cooperate also when the law does not provide for coercive instruments. For example, can a creditor behave opportunistically absent a cram-down mechanism? Can a creditor refuse to accept (and sink) a restructuring plan that would make it better off just because it wants to uphold its notoriety as a hard player?

Probably, good faith does not mean that creditors should actually *cooperate* with the debtor. As long as they do not take advantage of a position they may have acquired during negotiations and of information gleaned from the debtor during negotiations and they are not conflicted, creditors should be free to pursue their personal interest, which may differ from a standard definition of what their interest should be (i.e., the interest of an average creditor in the same position). Opportunistic behaviour should probably only be prevented by majority decision coupled, as the case may be, with a best interest of creditors test, and perhaps by specific interventions to make sure that creditor voting (or participation in decision-making) is ‘sincere’, i.e. making sure that the creditor has no ‘external’ interests but is acting in its own interest *as a creditor of that debtor*.¹²

Apart from these limits, there is a risk that by broadening the scope of good faith and deriving from it a duty to cooperate with the debtor, curbing all forms of dissent from what is a (supposed) average creditor’s best interest, too much discretion is given to courts or to authorities that oversee plans. Instead,

¹² It is very difficult to exactly draw a line between legitimate external interests (e.g. for repeated players, such as banks, conveying a message to the market that would maximise the recovery of the entire portfolio, even though impeding the adoption of a viable restructuring plan and thus having a negative effect on the recovery rate in that specific case) and external interest that may not be legitimately pursued to the detriment of other creditors (e.g. willingly pushing the firm into insolvency with the purpose of triggering credit default swaps).

courts should always defer to a free and unconflicted decision of those whose interests are at stake, even if this entails a suboptimal outcome in the specific case.

Guideline #5.5 (*Relationships with creditors during negotiations*). Especially when the restructuring plan that the debtor plans to submit to creditors requires the creditors' individual consent, from the outset of negotiations the debtor should provide the creditors involved with adequate and updated information about the crisis and its possible solutions. Information should be provided concerning the causes of the crisis, a description of the plan and its key elements and assumptions, financial information both past and prospective.

3. Dealing with banks and credit servicers

3.1. The special role of banks in corporate restructurings

Banks are a special category of creditors. Perhaps with the exception of microbusinesses in some jurisdictions, they often hold a remarkable share of the company's indebtedness, which makes them a key counterparty in the negotiation of restructuring plans. They may also act as providers of new money, whose decision to financially support a restructuring attempt through interim or 'new' (post-confirmation) financing may be crucial for its success and, ultimately, for the survival of the distressed debtor.

Banks' approach to restructuring can therefore deeply influence the outcome of a crisis management strategy. However, decisions of financial creditors in this field are not fully discretionary and debtors need to be aware of the various elements (factual and regulatory) that – given the present regulatory context – may affect banks' willingness to engage in constructive negotiation for a restructuring plan.¹³

¹³ Banks' 'specialty' is primarily rooted in the fact that extending loans is the core business of these entities and an activity subject to regulatory constraints due to its connection with the public interest. As credit exposures incorporate elements of risk, applicable regulations impose on lenders to reflect such risks at balance sheet level (e.g. capital ratios, provisioning) and

The banking environment has changed markedly following financial and sovereign crises in the European Union. Concerns have arisen about forbearance policies and the management of non-performing exposures (NPE) across the EU, as the then existing rules on these matters were seen as having prevented banks from timely recognising the impairment of outstanding debt and therefore as having contributed to the huge increase of risky exposures in banks' balance sheets.

In particular, the EU has been enacting a set of new standards and rules to ensure that banks pursue timely strategies in managing non-performing loans (NPLs)¹⁴ and derecognise bad loans from their financial statements, mainly for the purpose of coping with the existing NPL burden under an 'emergency' prospective – amplified in number and size by the stagnation of the corporate loan market – and preventing a further increase in the amount of deteriorated loans by applying the same emergency approach. In this respect, the most relevant recent changes concern:

(i) the introduction of new accounting standards to increase transparency of banks' financial statements,¹⁵

(ii) a convergence across Europe, in part still to be achieved, around the notions of 'forbearance' and 'non-performing exposures',¹⁶

to adapt their internal organisation to effectively monitor and contain credit risks. This in turn affects the manner in which banks may react when dealing with counterparties in distress.

¹⁴ In the ECB language (NPL Guidance and addendum), 'NPL' and 'NPE' are used interchangeably.

¹⁵ In 2014, the International Accounting Standards Board (IASB) published IFRS 9 *Financial Instruments*, which includes a new standard for loan loss provisioning based on 'expected credit losses' (ECL).

¹⁶ Definition convergence has been achieved so far for supervisory reporting purposes, pursuant to Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014, laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No. 575/2013 of 26 June 2013 on prudential requirements of institutions (CRR). Convergence, however, is expected to be soon extended to the prudential framework within a package of measures to be adopted to tackle the problem of NPLs in Europe (see Commission communication of 11 October 2017 on completing the Banking Union). In particular, a Commission proposal for a Regulation on amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures – COM(2018) 134 final; from now on, CRR Amending Regulation – provides for the introduction in the CRR of a new definition of NPE, which is largely based on the current framework set forth in Commission implementing Regulation

(iii) setting out new legislative requirements to ensure the fulfilment of common regulatory provisioning levels for NPLs (i.e. amounts of equity capital that loans – depending on the risk category – are to be backed by).¹⁷

In the meantime, EU supervisors have issued guidelines drawn from best practices relating to NPL management to urge banks to monitor their credit exposures in the entire course of their relationship with borrowers, and to adopt prompt measures when signs of distress emerge.¹⁸

Finally, the Commission has recently proposed a directive on credit servicers, credit purchasers and the recovery of collateral with the aim of developing a EU secondary market for NPLs and ensuring a more efficient value recovery for secured creditors through accelerated out-of-court enforcement procedures (from now on, *Credit Servicers Directive*).¹⁹

In this changing landscape banks' willingness to participate in corporate workouts and, more generally, their attitude towards restructuring attempts has been deeply impacted and is expected to change further. This trend is confirmed by national findings. They show that prudential rules on NPLs have become the major driver for banks in evaluating restructuring plans, as

(EU) No 680/2014. Provisions will be added in the CRR to define the notion of 'forbearance measures' as well as in relation to cases where NPEs subject to forbearance measures shall cease to be classified as NPEs. It is worth noting that, in contrast with ECB Guidance, the CRR Amending Regulation does not deal with legacy NPLs, but it still questionably includes the 'emergency approach' under the Guidance to 'ordinary' credit management.

¹⁷ The proposed CRR Amending Regulation will impose a 'Pillar 1' minimum regulatory backstop for the provisioning of NPEs by EU banks – which is meant to apply to all exposures originated after 14 March 2018. Any failure to meet such provisioning floor will trigger deductions from Common Equity Tier 1 ('CET1') items.

¹⁸ On 20 March 2017 the ECB published its *Guidance to banks on non-performing loans* addressed to credit institutions it directly supervises under the Single Supervisory Mechanism ('significant institutions'). Such *Guidance* presents ECB's expectations and best recommendations on dealing with NPLs. In the context of the published requirements, banks should reduce their NPL portfolios by applying uniform standards, thereby improving the management and quality of their assets. An addendum to the *Guidance* has been published in March 2018 dealing with loss provisioning expectations. For 'less significant institutions' some national supervisors (e.g., the Bank of Italy) have adopted or are adopting guidelines consistent with ECB *Guidance*.

¹⁹ Proposal for a directive of the European parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral - COM(2018)135 published on 14 March 2018.

keeping NPLs on their balance sheet is increasingly costly for banks.

3.2. Legal constraints to forbearance and prudential requirements for NPL provisioning

3.2.1. A prudential framework partly inconsistent with the 'rescue culture'

Intensified regulation on the management of NPLs (notably stricter supervisory guidance and regulatory capital requirements) will likely reduce banks' leeway to give concessions without an immediate pay-out (i.e. without tangible effects on their balance sheet). In light of the current regulatory landscape it may be expected that banks would be primarily led to consider how to quickly free up their balance sheet from the burden of risky exposures, even though such solutions would not entail the maximisation of the present value of the exposure.

The risk of such a sub-optimal outcome is amplified by a high degree of uncertainty about the scope of the envisaged prudential provisions. The rules proposed by the Commission in the draft CRR Amending Regulation are partially inconsistent with the ECB expectations laid down in the 2018 Addendum. Namely, the ECB guidelines apply to the existing credit stock, i.e. those classified as NPE after 1 April 2018, while the parallel provisions of the proposed Regulation will only apply to exposures arising after 14 March 2018.

In addition, it is worth recalling that the regulatory framework on NPLs is deeply affected by the fact that it is conceived as an emergency discipline (created in response to an extraordinary situation), whose draconian severity would no longer be justified in an ordinary, post-recession scenario. The fact remains that at this point in time – and regardless of any reservations one may have on the content of the rules and standards at hand – this is the regulatory background operators must deal with and whose implications with respect to preventive restructuring need to be assessed.

The attitude of banks in the context of restructuring may be influenced by a number of factors, which are to a great extent beyond the control and even the perception of the debtor. In particular, the behaviour of the bank in restructuring

negotiations is indeed affected not only by the amount at stake or the nature of the claim (e.g. secured or unsecured), but also by the overall financial situation of the bank, the composition and soundness of its credit portfolio, and the internal NPL strategy it has in place.

Pursuant to recent supervisory guidelines, banks are also urged to implement several organisational changes and operational arrangements to achieve a more effective handling of ‘problematic’ exposures (i.e. not only of exposures for which insolvency proceedings or foreclosure proceedings have already been initiated, but also for those that could still be remedied in full or in part through an out-of-court restructuring or other measures). Such organisational changes and operational arrangements exert a remarkable impact on the banks’ approach to restructuring negotiations.

For instance, supervisors strongly recommend:

- the adoption of NPL strategies and the implementation of operational plans setting out the options for NPL management;²⁰
- the establishment of dedicated NPL workout units, which need to be separated from the loan granting units and would engage with the borrower along the full NPL lifecycle and take on, according to the guidelines, a different focus during each phase of that cycle. This measure would eliminate potential conflicts of interest and the risk of any bias in assessing the best strategy to deal with a problematic exposure, ensure the presence of staff with dedicated expertise and experience, and somewhat standardise the approach to credit management in debtors’ distress scenarios. The other, less direct, consequences of such measure are making the bank-firm relationship more impersonal in case of distress and replacing, to a large extent, soft information with scorings and other risk assessment techniques in assessing and addressing the firm’s distress;²¹

²⁰ By way of example, ‘hold and forbearance’ approaches might have to be combined with portfolio reductions and changes in the type of exposures (e.g. debt to equity swapping, collateral substitution, foreclosure); moreover, the operational plan might allow only certain activities to be delivered on a segmented portfolio.

²¹ This approach may be perceived as causing a decrease in the likelihood of debt restructuring compared with cases in which lending units are involved and relationship banking prevails. International experience (like the case of Royal Bank of Scotland, see A. DARR, ‘Internal Contractual

▪ the internal implementation of a number of credit monitoring tools and early warning procedures and indicators (at both portfolio and borrower level) so as to promptly identify signals of client deterioration. Banks are also recommended to develop specific automated alerts at the borrower level to be triggered in case of breach of specific early warning indicators. When such breaches occur, banks should involve the dedicated NPL workout units to assess the financial situation of the borrower and develop customised recovery solutions at a very early stage.²²

Of course, the existence of a sophisticated system for managing problematic exposures internal to the banks does not prevent a debtor from taking autonomous initiatives prior to the occurrence of those triggering events (e.g. initial arrears), which would activate the bank NPL workout unit and cause it to take preliminary contacts. Indeed, a debtor might always be aware of other sensitive events unknown to creditors that may affect the soundness of the credit relationship (see Chapter 1), and in such case it should immediately start to plan remedies on its own, possibly with the assistance of financial advisors.

However, under the above-mentioned circumstances, a debtor might waste time and resources in devising a plan based upon concessions that its financial creditor would not accept, due to general regulatory/operational constraints, or to idiosyncratic factors such as its own NPL strategy or the results

Mechanisms for Addressing Insolvency: a case study of RBS', available at www.codire.eu) and economic analyses on the effects of separate decision-making on debt restructuring and systematic use of scoring techniques show that these practices, on the contrary, can substantially improve financial restructuring of viable companies. See G. MICUCCI, P. ROSSI, 'Debt Restructuring and the Role of Banks' Organizational Structure and Lending Technologies', (2017) 3 J Financ Serv Res 51.

²² It is worth recalling that these supervisory expectations are aimed at promoting efficient and prudent conduct by intermediaries in the management of credit risks; banks' action or the lack of appropriate initiatives in this respect will be assessed by supervisors and might trigger supervisory actions. They cannot be interpreted, however, as imposing on banks specific duties to inform debtors or to launch any initiative in substitution of inactive debtors. Banks may offer their assistance or require borrowers to engage in finding solutions and are recommended to do so for prudential reasons, but only borrowers are responsible to manage distress, as part of their entrepreneurial activity, and may consequently be held liable towards stakeholders for their lack of prompt action. For their part, banks should avoid any form of interference with the business management of their clients, both in good times and bad.

of internal assessments on the recovery prospects of that segment of exposures or, in some cases, of that specific exposure.

3.2.2. A cooperative approach between debtors and banks

As we have pointed out in Chapter 1, it is important to promote a cooperative approach between debtors and banks, which may lead to the early identification of crisis and, therefore, to more value-maximising solutions. Therefore, it is important for the debtor to promptly approach (i.e. with the earliest signs of distress) its financial creditors to verify with them the existing (regulatory or operational) boundaries within which any negotiation would have to take place should the situation get worse. Debtors should be ready to provide – subject to proper confidentiality arrangements – any information that may impact their soundness and that might be useful for a prompt assessment by lenders of the financial situation of the debtor and the possible triggering of early warning mechanisms.

In turn, banks should be available and willing to provide any relevant information in this respect. In this vein, banks should share with interested debtors the results of financial assessments, including sectorial analyses, that have been internally conducted in the context of their NPLs management activity, whenever such results may anticipate the evolution of the crisis and may help the debtor in identifying the most effective and feasible remedies. This would be particularly beneficial to MSMEs, whenever it is practically feasible, which might not have in place adequate risk monitoring mechanisms or may not avail themselves of the assistance of qualified financial advisory services.

This does not mean that financial creditors should disclose their negotiation strategy in advance before sitting at the bargaining table. However, it would be good practice for lenders to promptly share with the debtor (already in preliminary contacts, whenever feasible) any concern (either deriving from specific supervisory measures or connected to internal NPL policies and operational plans) which would impact on their agreement to certain measures to turn around the firm.

Admittedly, a cooperative approach requires a change of attitude of banks and businesses. The empirical research shows that far-reaching covenants that allow banks a wide discretion (especially for large firms) and fear of pressure to reduce the exposure as a consequence of detecting the first indications of an impending distress (for all firms) cause a widespread tendency of debtors to procrastinate communication with banks.²³ This behaviour is understandable, given that, although rare, there have been cases of banks abusing their strong position.²⁴ In parallel with achieving more transparency by debtors banks should be under a duty of good faith not to exploit the information they receive to ameliorate their position at the expense of other creditors, thereby making restructuring more difficult or impossible.

Guideline #5.6 (*Awareness of the regulatory constraints specific to the banks involved in the restructuring. Cooperative approach between banks and debtors*). Debtors should promptly gain awareness of the regulatory considerations their lenders would make from a regulatory point of view, including in connection with elements of their NPL strategy and operational plan that under given circumstances may materially affect their approach to workout. To achieve such awareness, a debtor should promptly approach its lenders and share with them, under appropriate confidentiality arrangements, any relevant information that might adversely affect the soundness of its business or the value of collateral and require, in turn, to be promptly informed, at the outset of any negotiation and to the extent possible, of elements of the lender's NPL strategy and other general constraints that might influence the willingness of the latter to make concessions, or certain types of concessions, in a given crisis scenario.

²³ The results of the qualitative part of the empirical research, published on the website www.codire.eu, go in this direction, especially with respect to Spain.

²⁴ Again, see the qualitative part of the empirical research. Abuse is rarely brought to light, although there are some notable exceptions (see A. DARR, 'Internal Contractual Mechanisms for Addressing Insolvency: a case study of RBS', available at www.codire.eu).

Banks should not exploit the information they receive from debtors to ameliorate their position at the expense of other creditors, thereby making restructuring more difficult or impossible.

Guideline #5.7 (*Internal financial assessments conducted by the bank on the debtor*). Banks should share with interested debtors (upon reasoned request from the debtor and to the extent possible) any results of internal financial assessments, including industry analyses, conducted on the debtor's situation or on the status of a specific loan segment, which might foster a better understanding by the debtor of the seriousness of the crisis and a reasoned identification of its possible remedies.

3.2.3. The long road to exiting the classification as non-performing exposures (NPEs)

As earlier described, NPLs are also subject to rigid reporting and supervisory expectations aimed at facilitating earlier recognition of actual and potential credit losses as well as ensuring a capital structure that gives adequate coverage to them.²⁵

In general terms, exposures are qualified as non-performing (NPLs) when:

(a) the bank deems them to be unlikely to pay in full without recourse to collateral realisation, regardless of the existence of any past due amount or the number of past due days;

²⁵ Exposures are balance sheet assets that banks must weigh by reference to the underlying risk (typically a credit and counterparty risk) under the applicable regulatory framework. Risk-weighted assets count within capital ratios as the quantitative reference for calculation of the own funds banks must hold, as a minimum, in order to absorb potential losses. For that purpose, banks must classify exposures by reference to their riskiness, i.e. their (un)likelihood to be paid in full at maturity. This is the micro-prudential perspective of each bank. Risky exposures are also periodically reported to supervisors for macro-prudential supervision purposes, i.e. monitoring of systemic risks, if any, to the financial sector as a whole or the real economy.

(b) they have a material past due amount of more than 90 days, where materiality is defined by competent authorities to reflect a reasonable level of risk (currently in Italy 5% of the overall exposure).²⁶⁻²⁷

Regardless of their performing or non-performing status, exposures may be classified as forborne if the debtor, while experiencing (or about to experience) difficulties in meeting its financial commitments, benefits from concessions (typically made in the form of loan modifications and/or refinancing).²⁸

Banks indeed enjoy a margin of discretion, in certain cases, as to whether exposures that benefitted from concessions should be classified as non-performing loans or (performing) forborne credit.²⁹

²⁶ In accordance with Art. 178(2)(d) of Regulation (EU) No 575/2013 (CRR), the materiality of a past due exposure shall be assessed against a threshold defined by the competent authorities. The conditions according to which a competent authority shall set the threshold referred to in paragraph 2(d) have been further specified in the Commission Delegated Regulation (EU) n. 2018/171 which will be applicable no later than 31 December 2020. This Regulation sets out an absolute and a relative threshold: the past due amount of an exposure is deemed material when both thresholds are breached. The absolute threshold should not be higher than 100 EUR for retail exposures and 500 EUR for non-retail exposures, and the relative threshold can be set at a level lower than or equal to 2.5%.

²⁷ In certain jurisdictions, NPLs may be subject to additional classifications for national supervisory purposes, e.g. by reference to their riskiness, calculated as a function of both the severity of the debtor situation (distress, crisis, non-viability or insolvency) and the banks' initiatives, or lack thereof, to overcome such situation. In Italy, for instance, NPLs are divided into the following sub-categories: bad loans; substandard loans and past due loans. All these sub-categories satisfy either of the EBA criteria as described above sub a) and b).

²⁸ By way of example, banks *must* use the 'forbearance' category at least for debtor-friendly amendments to loan agreements or write-offs. They are *expected* but they are not *required* to do so when existing concession clauses are triggered to cure or prevent exposures more than 30 days past due or when modifications are made due to actual or potential payments on performing exposures are more than 30 days past due. In Italy, national regulatory provisions envisage that when a pool of banks temporarily 'freezes' credit facilities in anticipation of restructuring, this is not *per se* a forbearance measure. The 'frozen' period, however, must be counted as days past due.

²⁹ Some examples may help understand the practical situations banks may face. In particular, as the applicable credit classification is a principle-based standard, it leaves some room for judgement. This typically happens when it is disputable whether certain exposures have the characteristics to be classified as unlikely to pay. In those instances, banks choosing to use the 'performing forbearance' category must make sure that their choice does not

However, with respect to forborne non-performing exposures, consistent with this regulatory framework it would be essential to identify the conditions under which restructured exposures may exit from the non-performing category and enter into the forborne performing category. Only when the conditions for a restructured exposure to exit from the non-performing category are met will the bank be able to free up resources and reflect the classification change in its balance sheet. The shift of a forborne exposure from non-performing to performing status is neither immediate nor automatic, as it rests on the debtors' capability to repay, i.e. reinstating a situation where the repayment is sustainable for the borrower. Such an effect depends on whether both (i) the bank deems that no more defaults/impairments exist after one year from the forbearance, and (ii) there is not, following the forbearance measures, any past-due amount or concern regarding the full repayment of the exposure according to the post-forbearance conditions at the end of one year (so called 'cure period').³⁰

Achieving the end of the NPL status is therefore a long and difficult path that can adversely affect the willingness of banks to take an active role in restructuring processes. Lenders indeed might refrain from consenting to even profitable (and value maximising) crisis resolution arrangements, as granting a forbearance measure under a rescue plan would not entail – due to the one-year cure period - an immediate benefit in terms of NPLs reduction, which is the fundamental goal that all banks' NPL strategies must have.³¹ This is a particularly undesirable

instead delay a required loss recognition, nor conceal the actual asset quality deterioration.

In other cases of restructuring through concessions, exposures are to be identified as forborne non-performing. Certain restructuring models, however, can lead to different consequences.. For instance, pursuant to Italian prudential rules, in the case of a court-approved *business sale* to a non-related third party on a going-concern basis, the exposure that is taken up by the transferee is to be reported as performing.

³⁰ This means that the mere expiration of the one-year time period is not sufficient, as other conditions need to be met. As a consequence, the cure period can even be longer than one year.

³¹ In addition (and more importantly), keeping the non-performing status for one year from forbearance would substantially alter – as discussed below in par. 3.2.6 – the negotiation dynamic in connection with the harsh effects of the exposure's ageing (i.e., 'vintage' according to the terminology used in the ECB documents) on the provisioning requirements currently under development.

outcome in cases where objective elements show that the debtor, despite suffering from temporary difficulties, is still viable and upon restructuring full and timely repayment of the forbore loan would be highly probable. As under these circumstances the underlying risk would go back to normal levels, a mitigation of the classification regime would be essential to prevent the failure of a workable rescue attempt of a troubled debtor.³²

3.2.4. A possible abbreviated path

A possible way to mitigate the adverse effects of the forbearance classification regime might be that of either shortening the cure period (e.g. to six months) after a well-founded and credible restructuring measure with concessions made effective, or – alternatively – to provide for the immediate exit of the loan from the NPL category and its shifting into a new status that should signal that concessions have been granted under a feasible and short-term plan. In both options, specific safeguards should be required in order to demonstrate that the debtor is still viable and that the restructured debt is sustainable. In particular, in order to prevent potential misuse of forbearance measures to hide impairments and given the implication of NPL classification for the stability of the financial system, the milder classification regime suggested here should be restricted to concessions granted under restructuring arrangements that have some degree of

³² In 2014, Spanish legislators took a step to incentivise the use of refinancing agreements (collective and homologated) by softening the regulatory framework of banks. Exposures subject to a refinancing agreement could be re-classified as ‘normal risk’ insofar as there were objective elements that made the payment of the amounts owed under the agreement appear probable (see Additional Rule 1 of Royal Legislative Decree 4/2014 and developed by the Bank of Spain in its Regulation (*circular*) 4/2014, of 18 March 2014). The rule was very ‘generous’ since it expressly stated that in order to assess the increased probability of repayment, the write-downs and additional time to repay had to be taken into consideration. And, more importantly – and also more controversially – the reclassification could be executed from the very moment of formalisation of the refinancing agreement: there was no need to wait a prudential period of implementation to lower the risk in the bank’s balance sheet. The regulation was repealed in January 2018 as it was deemed to not be compliant with the EU rules on exposure classification.

‘reinforced’ assurance with respect to their ability to reinstate the viability of the business and the ability of the debtor to duly perform. Therefore, the proposal is to reduce or abolish the cure period only in connection with restructuring plans confirmed by the court, in which an independent professional appointed by the court or otherwise designated within the framework of the restructuring procedure has confirmed the financial soundness of the debtor post-confirmation, as well as the future capability of the plan to ensure the timely and full repayment of the debt (in its original or modified amount).³³

The option of the automatic exit from the NPL category would be more effective in fostering the participation of banks in restructuring negotiations as it would entail immediate benefits in terms of exposures classification for reporting purposes.³⁴ In addition, this solution would not seem to increase the risks of a late recognition of impairments, provided that appropriate safeguards are established to verify the soundness of the plan and assess the borrower creditworthiness. Indeed, the policy suggestion at hand should be regarded in light of the new supervisory framework on NPL management, and in particular in light of the strict monitoring and assessment requirements discussed earlier, which should allow banks to promptly detect changes in the debtor’s financial conditions during the entire life-cycle of credit exposures and to modify its classification status accordingly.

Policy recommendation #5.3. (Exemption from the one-year cure period after forbearance). For the purpose of incentivising banks’ participation in the negotiation of restructuring plans, regulatory provisions or standards

³³ It is worth noting that we are not proposing a different instrument than those envisaged by the Directive Proposal, which do not necessarily require an independent expert’s opinion. We believe that the debtor and the creditors should not be deprived of the possibility of a successful restructuring, which is why a plan that, although subject to failure, is sufficiently serious (i.e. is more likely than not to succeed), should be confirmed (see Chapter 4, par. 5.4.2). However, given the relatively high failure rates shown by the empirical research (www.codire.eu), we suggest that exceptions to the one-year cure period should be limited to cases where there is a high probability that the debtor will remain solvent.

³⁴ Further, it would be difficult to identify objective parameters under which deciding that 6 months or any other time reduction would be reasonable.

for the exit of credit exposures from non-performing status should not apply when concessions are made within the context of a restructuring plan confirmed by the court, in which an independent professional appointed by the court or otherwise designated within the framework of the procedure has confirmed the financial soundness of the debtor post-confirmation, as well as the future capability of the plan to ensure the timely and full repayment of the debt (in its original or modified terms).

3.2.5. The long road to exiting the forborne status

Under the current framework the regained performing status of a restructured exposure (after the one-year cure period) does not affect its classification as forborne.

Pursuant to the ITS, a performing restructured exposure can be classified as purely performing (i.e. exiting even from the forborne performing status) only when it is deemed performing during an additional probation period of two years, within which regular payments of more than an insignificant aggregate amount of principal or interest were made for at least half of the time, and provided that at the end of the probation period no exposure of the debtor is more than 30 days past due.

This rule too may be cumbersome, as during the probation period banks are expected to perform stricter monitoring over the exposures and, in addition, the forborne status has repercussions for asset quality assessments. The monitoring of forborne performing exposures in probation period is very important, not only in order to verify whether requirements for the exit from the category are fulfilled; there may be events that can cause an automatic change in the status of the exposure and bring it back to non-performing. In particular, if a forborne exposure in probation period that has exited non-performing category is subject to additional forbearance measures or is more than 30 days past due, the overall exposures of the debtor have to be classified again as non-performing, thereby nullifying the benefits of the initial restructuring.

The length of the probation period, however, does not seem to have discouraging effects – as such – on the participation of banks in restructuring negotiations. It appears to require banks

to carry out an in-depth and careful assessment of the long-term prospective viability of the debtor, thereby affecting the willingness of the former to consent to a plan that would not provide enough assurance in this respect.

Regardless of possible future changes in the treatment of certain types of forbore exposures (along the lines suggested above with respect to the so-called ‘cure period’) debtors should thus be aware that any concession they intend to request has to be conceived having regard, *inter alia*, to the reporting implications for lenders. This requires, in particular, that restructuring measures be drafted under sound and credible terms, especially with regard to their attitude (in combination with other remedies, if needed) to restore the debtor’s financial soundness and ensure that its ability to regularly perform is maintained in the medium-long term. In particular, current rules imply that a time horizon of at least one year of regular performance (or of ‘no concern’ about the debtor) should be granted, as a minimum, because this is the length of time necessary for the exposure to cease being qualified as non-performing. Banks, however, would likely pursue a more ambitious goal, i.e. the restoration of a full (not forbore) performing status, for which a three-year time horizon would be the minimum standard. Even this standard might not, indeed, be sufficient, as financial creditors might reasonably expect the debtor to pursue a longer-term viability, so as to avoid – in particular – the risk of using forbearance more than once, as this might be an obstacle to exiting from non-performing status.

Guideline #5.8 (*Minimum duration of expected regular performance under the plan*). When negotiating concessions with banks, debtors should consider the feasibility of the proposed distress resolution actions in light of their predictable effects for lenders in terms of exposure classification and reporting requirements. For this purpose, any restructuring measure proposed by the debtor should be conceived under credible terms and on the basis of a sound assessment as to the ability of the measure to restore and maintain the debtor’s financial soundness and ability to perform in the long run and, in any case, for a time horizon of at least three years.

3.2.6. The discouraging effects of provisioning rules on the banks' participation in restructurings

Based on exposures' classification and related risk weighting, banks are also required to set aside minimum levels of capital to cover losses caused by loans turning non-performing in order to meet supervisory expectations. If a bank does not meet the applicable minimum level, deductions from own funds would apply.

In this regard, recent supervisory guidelines establish substantially rigid quantitative common levels of provisioning.³⁵ These supervisory expectations have been devised for the purpose of *de facto* eliminating the degree of discretion that credit institutions still have in determining NPE coverage levels, thereby achieving convergence of provisioning practices among banks.

According to recently issued guidelines, the levels of provisioning expected by the supervising authority depend on:

- (i) whether the loan is collateralised (in full or in part) or otherwise incorporates forms of credit risk mitigation, and
- (ii) time passed since the exposure has been classified as NPE.

In particular, the bank is expected to provide full provisioning coverage for secured exposures (or portions thereof) after seven years from the moment when they became non-performing, and for unsecured exposures (and portions thereof) after two years from the moment when they became non-performing. The provisioning coverage for secured exposures must progressively increase according to ageing (so-called "vintage", based on the terminology used in the ECB documents), i.e. 40% after three years, 55% after four years, 70% after five years, and 85% after six years (provisioning factors). These supervisory expectations apply to all exposures of significant banks classified as new NPEs since April 2018,

³⁵ A similar approach is followed by the draft CRR Amending Regulation. While the proposed Regulation is aimed at introducing common provisioning requirements applying to all credit institutions established in all EU Member States (as the aforesaid EBA draft guidelines), the ECB Addendum – as noted - specifies the ECB's (non-binding) supervisory expectations for significant credit institutions directly supervised by the ECB under the Single Supervisory Mechanism.

but the ECB will start monitoring compliance with these requirements only from 2021 onwards.³⁶

It is reasonable to expect that these harsh measures will significantly increase the volume of NPL disposals by banks, as keeping NPLs on their books will ultimately result in a higher cost of capital. Recourse to massive sales – with high depreciation effects – will likely be more severe for credit institutions established in EU Member States suffering from time-consuming and inefficient insolvency and debt recovery regimes.³⁷

What seems to be clear at this stage is that the role and involvement of banks in restructurings is anyway likely to be deeply impacted by the new prudential rules on calendar provisioning.

Banks, indeed, would likely be interested in engaging in the negotiation of restructuring plans³⁸ provided that the restructuring process and the implementation of the plan be expected to occur before full provisioning coverage is required (i.e. within two or seven years, respectively, for unsecured and secured exposures after the claim is classified as NPL). After full impairment is made and the bank's capital is affected so as to absorb the loss, banks might have little incentive to actively participate in negotiations and may be interested in collecting whatever recoverable amount on the impaired exposures is available, being ordinarily more inclined to pursue the easiest ways out, irrespective of whether they may be detrimental to debtors' chances to recover.

³⁶ The statutory prudential backstop under the proposed Regulation would instead apply to all banks and only to exposures originated after 14 March 2018, and not to prior legacy exposures.

³⁷ Level playing field concerns caused by this divergence in the effects of common provisioning requirements across Europe would be mitigated – in the intention of European institutions – by the impact of other reforms that are being devised to tackle the problem of NPLs. The draft Restructuring Directive, first of all, with its aim to lead to the establishment in all Member States of common preventive rescue measures, should contribute to improve the efficiency of restructuring procedures within the EU. In addition, the performance of collateral foreclosures should considerably benefit from the introduction of out-of-court accelerated enforcement procedures, such as the one envisaged in the proposed Credit Servicers Directive.

³⁸ Unless they have a strong incentive to help the survival of a debtor, in order to maintain a long-term relationship with a strategic client that they consider still viable.

Further, it is worth noting that, even *before* the moment when the bank is required to ensure full provisioning, the rules on provisioning may significantly alter the incentives for the bank to engage in restructuring negotiations. Taking into account the existing classification regime as described above, unless the plan provides a write off and immediate repayment of the debt, the bank may not have sufficient interest in restructuring (at least with respect to unsecured exposures), to the extent that the end of the one-year probation required to exit the non-performing category could hardly occur before the two-year term for full provisioning.

As a result, a proposed restructuring, as far as unsecured exposures are concerned, is more appealing for the banks from a prudential perspective if it is reached and brought into effect at the latest within one year from the classification of the loan as non-performing. In fact, any forbearance agreed thereafter would not prevent the full provisioning effect at the two-year deadline (as mentioned, the loan may exit the NPE category only after one year of regular payments, or when the debtor – at the end of the year – has otherwise demonstrated its ability to comply). If a restructuring plan cannot be reasonably expected to be adopted and implemented, the bank would likely be mainly interested in an immediate partial payment rather than other concessions (e.g. a rescheduling) that would anyway result in full provisioning.

With respect to secured exposures, banks could factor in the effects of partial provisioning from the third to the sixth year of ageing, thereby being more inclined to accept – in principle – sacrifices that already incorporate the percentage of partial provisioning required. Again, however, any forbearance agreement should be reached at the latest one year before the deadline for full provisioning (i.e. within the end of the sixth year of ageing), as after that moment a financial lender might no longer be willing, at least in principle, to grant concessions that would aim at preventing the insolvency liquidation of the debtor without however affecting the NPL status of the exposure (which would remain non-performing until the deadline for full provisioning).³⁹

³⁹ Still, it has to be recognised that for secured exposures a restructuring agreement due to become effective a year before the full provisioning deadline would also not be very appealing for banks, since at that point in time they should have provisioned already 85% of the exposure.

3.2.7. Conclusion: the need to start negotiations early

The current classification regime and the recommended operational practices for the management of NPLs, coupled with the severe provisioning regime, seem clearly oriented to convey the message that problematic loans should be addressed at a very early stage and trigger prompt action by banks in their own interest. Indeed, any negotiation, to be usefully undertaken by a debtor, should start before the exposure enters the NPL category, i.e. as soon as tensions emerge. After that moment, room for concessions by banks would be in fact considerably limited.

However, in general terms, imposing a rapid full provisioning of NPLs will likely induce banks to pursue short-term solutions that may be detrimental to debtors' chances to recover, which in turn may prove inefficient for the system as a whole.

Furthermore, due to the described prudential rules, in certain cases a debtor could have incentives to engage in strategic delay, since the bank could be deemed more inclined to grant concessions after the classification of the loan as non-performing, under the threat of full provisioning. However, on the one hand, this might be true, as highlighted above, only to the extent that the delay would not affect the possibility to adopt and implement (at least with respect to the bank claim) a credible restructuring plan within the one-year period required to enable the exposure to exit from the non-performing category before full provisioning is required. On the other hand, debtors should consider that because of legal constraints banks might implement an 'exit strategy' by selling the NPL to third parties, as soon as they deem a timely and satisfactory restructuring unfeasible. In such a case, the purchaser, a new contractual counterparty, would sit at the bargaining table with the debtor.

Also, the aforesaid incentives for banks might be less significant in respect of loans secured by collateral under the form of movable or immovable assets benefitting from 'accelerated extrajudicial collateral enforcement' (AECE), which could be envisaged in the proposed Credit Servicers Directive currently under discussion. Indeed, secured financial lenders that have included an AECE clause in their credit agreements could decide to activate that clause rather than participate in negotiations with the debtor. The current text of

the draft Directive clarifies that the AECE cannot be activated if a preventive restructuring proceeding has been initiated and a stay of actions has been granted. However, this would not prevent lenders from activating the AECE despite pending negotiation of an out-of-court workout, thereby hindering a debtor's attempt to restructure. Any workout strategy including financial creditors that could avail themselves of that special enforcement clause should therefore consider that it would be hard to obtain their consent unless they are granted recovery of the full market value of the collateral as quick as in an extrajudicial enforcement.

Guideline #5.9 (*Early start of restructuring negotiations*).

Negotiations of restructuring plans should start as soon as the first signals of distress emerge and, if possible, before credit exposures are classified as non-performing. The plan should be designed so as to ensure that any concession is agreed and brought into effect no later than one year before the moment when the bank is expected to ensure full provisioning.

3.2.8. Banks as important partners of restructuring and the questionable push to sell NPLs that may be successfully restructured. Policy recommendations

The introduction of stricter provisioning requirements, as noted, will give incentives to banks to sell NPLs more frequently to reduce the costs of handling problematic exposures. This outcome may be justified in the short term, as long as the aforesaid emergency approach is necessary to solve the problem of the extraordinary NPL volume in banks' balance sheets. However, continuing to abide by such an approach in the future with respect to NPL management in the context of ordinary bank operations would be questionable from a policy point of view. The research shows that turnaround specialists see the continuation of the banking relationships of the distressed firms as very important, both for the firm-specific information they possess and for their ability to maintain and extend credit, supporting the business during the

implementation of the plan.⁴⁰ Transferring the credit agreement to credit servicers may be neutral if the most efficient strategy is the pure recovery of the loan, but may imperil otherwise possible restructurings that still require active banking partners.

In theory, banks might still play a role in all cases in which discussions with debtors start at very initial stages of distress, i.e. when, in light of the framework described above prompt action by the banks could prevent the deterioration of a credit exposure and its entry into the NPL category. In these situations (which might occur, essentially, in the first 90 days of past due, and only if banks do not already deem the exposures to be unlikely to pay), the banks' approach should aim at supporting the debtor in restoring the long-term viability of the business rather than granting concessions on a purely bilateral debtor-creditor relationship, let alone increasing their protection (collateral/guarantees). To achieve this in the short time span above, however, might be difficult when the distressed debtor has a large and complex structure and has to deal with a multitude of lenders. Under those circumstances coordination might be extremely problematic and costly and a prompt sale to professional credit purchasers might again be a more efficient solution.

In this regulatory framework, banks might then be forced to simply deem unrealistic the perspective of a timely restructuring, and just refuse to engage in (prospective or actual) negotiations. This would pave the way for credit servicers as the main actors of restructuring, which is probably not a welcome consequence given that they are less equipped to serve exposures (e.g. through interim financing or simply with the rollover of existing credit lines) that, while problematic, might still undergo a positive evolution. The unintended result would be that fewer firms would be able to overcome a temporary situation of financial distress, and more would become insolvent even if that could have been avoided.

⁴⁰ The risk that the loan transfer to credit servicers may force the transition to the status of 'bad loan' of UTPs that may be restructured is strongly perceived by Italian professionals interviewed, and was highlighted by one of the speakers (Stefano Romanengo, turnaround manager) at the Rome Conference of 27 June 2018 in which the research was presented to Italian stakeholders. See P. CARRIÈRE, 'Il prevedibile impatto per il sistema finanziario e imprenditoriale italiano della proposta di direttiva sullo sviluppo dei mercati secondari di NPL', (April 2018) available at www.dirittobancario.it.

As stated, to prevent such an outcome, which among other things would distort the very role of banks as institutional credit providers and professional risk-takers, a milder regime for provisioning should be considered. For instance, and especially if no exceptions were introduced to the one-year cure period after forbearance (at least in cases, as suggested above, of court-confirmed, well-founded restructuring plans),⁴¹ not only a longer time span should be defined before which full provisioning is required, but such an effect should take place when there is no reasonable prospect to recover any amount from the loan. Along the same lines, quantitative levels of provisioning should not be set rigidly in correspondence with ageing, regardless of the real financial situation of the debtor and its recovery prospects.

Ageing itself should be adapted to the fact that the debt has been restructured. Therefore, after any forbearance taken in connection with a restructuring, the ageing for the exposure that has been restructured, be it in the original or modified amount, should be suspended, and should be resumed only if the exposure is still non-performing at the end of a reasonable period needed to carry out a successful turnaround. Regulators could establish, for instance, that the ageing should be resumed if the exposure is still non-performing after three years, which in common practice is considered a time span after which a plan, if successful, is able to restore the viability of the business.

Such time is considerably longer than the one-year minimum cure period provided by the EBA ITS, which, however, is not the only condition to be satisfied to exit the NPL-forbearance category, but there are other necessary conditions to be met,⁴² that in practice could make the cure

⁴¹ In any case, the cure period would continue to apply with respect to any other forbearance measures, e.g. to restructuring measures agreed in an out-of-court workout.

⁴² According to the EBA ITS, when forbearance measures are extended to non-performing exposures, the exposures may be considered to have ceased being non-performing only when all the following conditions are met:

(a) the extension of forbearance does not lead to the recognition of impairment or default;

(b) one year has passed since the forbearance measures were extended;

(c) there is not, following the forbearance measures, any past-due amount or concerns regarding the full repayment of the exposure according to

period for these exposures even longer. Furthermore, the applicable provisioning factors should be calibrated around the real recovery prospects of the exposure, considering also the collateral recovery value in case of secured exposures, as identified by banks under the special monitoring tools for NPLs that they are required to have in place pursuant to supervision guidance. Indeed, rather than adding bank risks on top of the ordinary counterparty risk that they take and duly factor in at the moment of the initial granting of credit, the new supervisory standards on NPL management (as laid down in the ECB guidance and in national level provisions for less significant banks) should be emphasised and properly implemented so as to make sure that the expected in-depth assessments, monitoring techniques and alert mechanisms under the newly introduced supervisory standards are properly employed by banks to detect the slightest changes in risk levels during the entire life cycle of the credit relationship.

Policy Recommendation #5.4 (*Prudential effects of exposures' ageing*). Provisioning requirements should be calibrated around the real level of risks underlying credit exposures, as continuously verified and assessed by banks on the basis of reliable and objective parameters.

After any forbearance measure taken in connection with a restructuring plan under which payment of the original or modified amount is envisaged, ageing counting should be suspended once the forbearance measure is granted and should be resumed only if the exposure is still non-performing at the end of a reasonable period needed to carry out a successful turnaround (e.g., after three years).

In any case, full provisioning should be required only if and to the extent that risk assessments pursuant to

the post forbearance conditions. The absence of concerns has to be determined after an analysis of the debtor's financial situation. Concerns may be considered as no longer existing when the debtor has paid, via its regular payments in accordance with the post-forbearance conditions, a total equal to the amount that was previously past due (if there were past-due amounts) or that has been written-off (if there were no past-due amounts) under the forbearance measures or the debtor has otherwise demonstrated its ability to comply with the post-forbearance conditions.

objective and reliable parameters show that no residual prospect of recovery within a reasonable time exists.

3.3. Handling coordination and hold-out problems in negotiating with banks

The intense regulation to which banks are subject and the specific requirements they have to fulfil in managing distressed debt substantially differentiate the position of banks from that of other creditors. Financial creditors tend to share in most cases similar constraints and, at least in broad terms, similar interests.

In light of the above, legislators may consider regulating restructuring procedures or measures specifically devised for financial creditors or, at least, permitting the restriction of the group of affected creditors exclusively to financial creditors.⁴³ These restructuring agreements – commonly negotiated out of court and limited to financial creditors as to their effects⁴⁴ – should be aimed at overcoming a situation of liquidity distress and preventing insolvency while protecting all the involved parties from claw-back actions for the case of subsequent insolvency proceedings.⁴⁵

However, although financial creditors tend to have aligned interests, there may be circumstances where certain creditors oppose a restructuring pursuing the best interests of the creditors as a whole, either holding out opportunistically or on the basis of different economic interests and constraints.⁴⁶ This

⁴³ This is the case of the UK scheme of arrangement that, even though not specifically devised to deal with financial creditors (and, indeed, not even a restructuring procedure from a formal standpoint), may be used to push through a restructuring affecting only certain categories of creditors, including financial creditors.

⁴⁴ See the Italian *accordo di ristrutturazione con intermediari finanziari* and the Spanish *acuerdo de refinanciación homologado*.

⁴⁵ As shown by empirical evidence in all jurisdictions involved, financial creditors are usually more inclined to agree on a restructuring than the other type of creditors.

⁴⁶ For instance, different lenders may have a different relationship with the debtor (some may have an interest in continuing doing business with the debtor in the future, others may have a short-term interest to recover their claim). They may also find themselves under a different level of pressure to resolve a problematic loan due to certain features of their credit portfolio or their exposure to the specific corporate sector in which the debtor operates. In

sort of misalignment is obviously more likely when there is a high number of banks involved in the restructuring process. Indeed, the existence of different interests and constraints may hinder financial creditors' coordination and may give rise to hold-out issues capable of compromising the restructuring process. For this reason, it is important to have legal mechanisms in place whereby an agreement can be reached with a defined majority of financial creditors and made binding over dissenting or non-participating lenders, subject to fair and reasonable terms and conditions.

In addition, in order to facilitate negotiations with banks (and, actually, also negotiation among banks) on a restructuring, banks should be encouraged to agree on codes of conduct or common procedural protocols (somehow inspired by the so-called London Approach). This would bind banks to a set of procedural rules to foster cooperation, such as:

- appointing a steering committee to facilitate the dialogue among banks in view of pre-defined objectives and abiding to scheduled deadlines;
- basing discussions on reliable information to be verified by an independent expert;
- ascribing a duty of fairness to the other banks involved (e.g. not selling claims to a purchaser that the bank knows would impede restructuring, and/or requiring the purchaser to continue participating in coordination committees established by the banks and take a cooperative approach with the banks' coordinator).

Policy Recommendation #5.5 (*Restructuring limited to financial creditors*). The law should provide for restructuring procedures or measures producing effects exclusively on financial creditors, without affecting non-consenting non-financial creditors.

addition, if any of the financial creditors have credit protection – credit insurance or credit default swaps – their interest may conflict with the rest of the group, and they may have incentives to force the restructuring into a form that triggers their rights against hedge counterparties or even push the debtor into formal insolvency.

Policy Recommendation #5.6 (*Adoption of codes of conduct by banks*). Banks should be encouraged to adopt codes of conduct to foster coordination among lenders, independent verification of information and fairness during negotiations.

3.4. *Dealing with credit servicers*

EU institutions are basing the strategy to address the problem of NPLs on, among other things, encouraging the development of efficient secondary markets for those loans.

In this vein, the proposed Credit Servicers Directive provides for a common set of rules regulating specialised credit purchasers that will be authorised to operate within the EU. Their plausible more active presence in the market for distressed debt is expected to further change the scenario in which restructuring negotiations can take place. On the one hand, professional NPL funds and investors might have a more speculative and less cooperative approach *vis-à-vis* debtors during restructuring negotiations; on the other hand, however, these specialised actors could be better positioned to support the debtor in a crisis situation compared to banks.

For sure, credit servicers could act with more flexibility than banks, as they do not face the same regulatory constraints. In addition, by investing in ‘single name’ corporate NPLs with the goal of gaining control over the restructuring process, they may improve the likelihood of a successful turnaround. Private funds are also better equipped than commercial banks (due also to less intrusive regulatory constraints on share ownership) to invest in shares allocated under debt-equity swaps as they are more likely to be committed to overhauling the companies concerned.

However, having banks totally replaced by professional credit purchasers in managing restructurings does not appear to be – as indicated above – a desirable outcome. A more balanced approach, one which sees a NPL handled by the entity (bank or credit servicer) that in each specific case is most able to recover value from it, seems advisable.

4. Dealing with other kinds of creditors

4.1. Diversification of creditors' incentives and preferences

As mentioned above while discussing the duty to act in good faith (par. 2.3), creditors may have very different incentives and preferences. The traditional view that creditors as a whole are driven by the goal of maximising the present value of their claim is a simplification, indeed very useful but still not conveying the wide array of utility functions of creditors.

For example, it is apparent that banks are motivated by the goal of maximising their entire portfolio of distressed loans rather than maximising recovery with respect to a specific case of business distress. As a result, banks may sometimes take positions that are ineffective from the perspective of a certain restructuring deal but are regarded by the bank as efficient with a view at maximising the present value of the distressed portfolio as a whole (e.g. sink a restructuring to convey to the players in the market a certain internal policy that is deemed suitable to allow a higher recovery from an aggregate standpoint). Further, workers may be inclined to accept solutions that are not providing them the best possible recovery if they allow the continuation of the business. In this vein, the possible examples of legitimate creditors' interests diverging from the apparently inflexible purpose of maximising the present value of claims are countless.

As a result of such diversity of incentives and preferences of creditors, the debtor should assume a different approach in conducting negotiations over the restructuring plan according to the different kinds of creditors.

4.2. Dealing with workers

In any crisis, effectively negotiating with workers is very important for the success of the restructuring attempt due to their particular role and position.

On the one hand, workers are generally strongly in favour of restructuring since its success is often essential to allow them

to retain their jobs.⁴⁷ They could consider in their best interest to support a plan, although this be unfavourable *vis-à-vis* the alternative scenario of formal liquidation from a recovery standpoint, whenever the adoption of the plan allows them to retain their jobs (especially since several jurisdictions, including Italy and Spain, grant to workers' claims priority on the business estate).⁴⁸ Workers would inevitably factor into their decisions the risk of losing their jobs and the likelihood of finding a suitable alternative workplace. Furthermore, particularly in small and medium firms, workers may also have personal bonds to the entrepreneur that discourage them from turning down the restructuring proposal.

On the other hand, workers are virtually always 'suppliers' of strategic inputs in view of the continuation of the business, therefore making their consent to the restructuring extremely important. In other words, the successful implementation of the restructuring strongly depends on retaining key employees, who incidentally are those employees that are more likely to dissent to the restructuring plan since they probably have other alternatives to reaching a deal with the entrepreneur.

It should also be noted that negotiations with workers are usually regulated under the law more heavily than with respect to other categories of creditors. The most relevant trait is that such negotiations in many jurisdictions cannot normally take place on an individual basis, but rather must be conducted on a collective basis, involving, for example, trade unions.⁴⁹

⁴⁷ The cooperative (and resigned) behaviour that employees show during restructuring negotiations has been unanimously emphasised during the interviews conducted in Spain. See the Spanish National Findings available at www.codire.eu.

⁴⁸ The priority granted to workers' claims is well-grounded on both social and economic arguments (such as the fact that workers are not free to diversify their investment).

⁴⁹ In Italy, trade unions are involved in negotiations whenever future claims would be affected by the restructuring. Instead, when the restructuring would only affect workers' individual claims that are already existing, trade unions are entitled to negotiate on behalf of the workers only when so designated by the interested workers.

In Germany trade unions play no *formal* role in restructuring negotiations with workers, whenever a works council (*Betriebsrat*) exists. The explanation lies on the circumstance that the works council in practice usually consists (also) of unionists, and they turn to the trade union for representation and advice.

In order to effectively negotiate with workers, the debtor should focus on offering attractive incentives that can dissuade the most skilled employees from accepting alternative work offers. This is important to neutralise, or at least reduce, the risk for adverse selection, which would lead the firm to retain only less qualified or less productive workers once the restructuring plan has been adopted, thereby significantly undermining its chance of survival. Such a risk is particularly strong with respect to businesses heavily relying on highly specialised skills. In these businesses the real intangible assets are the workers' know-how and capabilities. This is the reason why, paradoxically, when the firm is in distress and restructuring negotiations are started, implementing an effective incentive scheme is crucial. With a view to retaining the best employees, it is also very important to conduct negotiations in a transparent and fair manner so as to preserve the value of trust in the relationship between the debtor and its employees.

As noted in Chapter 3, the restructuring plan may envisage the reduction of the workforce, which could be temporary or permanent. This is often a very important measure for achieving a turnaround of the business: deferring industrial corrective actions, such as not addressing redundancies, may result in a further round of negotiations, or even in the non-viability of the business. This may be a very delicate issue, and when informing the workers about the fact that the plan envisages such a measure the debtor should reflect very carefully on the best communication strategy.⁵⁰

The reduction of the workforce may take place either by incentivising the voluntary resignations of certain employees (most commonly through offering a certain amount of money as compensation or an alternative job)⁵¹ or by unilaterally dismissing certain workers.⁵² In this latter case, most

⁵⁰ In the interviews conducted in Germany, several experts recommended being as open as possible with employees and sharing plans regarding redundancies as soon as possible.

⁵¹ It is quite common practice in Germany, mostly in the case of large insolvency cases, to incentivise voluntary resignation by certain employees offering another workplace at a different firm (often found by the debtor itself, with or without public subsidies). This gives the transferred employees an opportunity to qualify for, and look for, other jobs without being formally unemployed and while receiving a remuneration, although often reduced.

⁵² In certain cases, the reduction of the workforce may take place without reducing the number of employees, rather reducing the number of

jurisdictions require the debtor to conduct a negotiation with the trade unions or other collective bodies representing workers' interests. When engaging in this sort of negotiation, the debtor should be adequately informed on the existing social safety nets, such as long or short-term public redundancy schemes, ordinary unemployment benefits and early retirement. Indeed, the debtor's proposals should be structured in such a way as to increase the chance of approval, in light of the possible effects of the existing social safety net.

In light of all the above, it is worth considering that in certain cases workers, in their capacity as creditors of the firm, might be interested in filing for insolvency. When no perspective of retaining their jobs is available (either because of an envisaged reduction of the workforce or the apparent non-viability of the business), benefitting from a safety net is an attractive option (e.g. for workers close to retirement), the workers have no claims left unpaid (or such claims enjoy priority that would in any case lead to full satisfaction), and/or there is a strong conflict between the entrepreneur and the workers, pushing the firm to insolvency liquidation may be an option for the workers. Although this is not very common and may sound theoretical, the number of involuntary petitions filed by employees have significantly increased in Italy over the recent years.⁵³

Guideline #5.10 (Dealing with workers during negotiations).

The debtor should devote particular attention to dealing with workers during restructuring negotiations, possibly providing incentive mechanisms and, in any case, dealing with them in a transparent way with a view to preserving or gaining their trust.

working hours for all or some employees. The research conducted in Spain shows that this solution is quite common and, in many cases, deemed superior by those involved, since it does not entail redundancies and is 'gentler' (although in several cases it eventually proves to be insufficient).

⁵³ The reasons underlying this trend are not easily understood, although it might be assumed that it is partially due to a greater number of firms that, in a context of diffuse economic crisis, are unsuitable for a turnaround, and thus the restructuring attempt is seen by the workers as being frivolous. Another reason could be that if the employer is declared insolvent, the social security pays the employees the last six months of salary plus any deferred compensation that is still due (approximately one month of salary for each year of work with the same employer).

4.3. Dealing with tax authorities

Dealing with tax authorities has become increasingly important in light of the huge amount of tax claims that many troubled firms have accrued. This phenomenon is particularly severe in those jurisdictions where tax authorities are quite slow in recognising and enforcing tax claims. Indeed, such a delay creates an incentive for distressed firms to withhold payments to the tax authorities to deal with the cash-flow tension (at least in the short term, before the slow but inevitable reactions of the tax authorities).⁵⁴

Where tax claims enjoy a strong priority, such as in Italy, the passive approach of tax authorities is well justified from their perspective. A delay in reacting to the debtor withholding tax duties does not affect recovery, since the distressed firm's estate is devoted primarily to the satisfaction of tax claims, whereas monitoring actions entails a cost (even though such cost would be quite neglectable for tax authorities, since tax authorities are anyway required to monitor all taxpayers to curb tax evasion). However, the undesired effect is building up a significant stock of unfulfilled tax claims that become relevant when the firm engages in restructuring negotiations.

Although there might be concerns on the efficiency of the policy choice of granting priority to tax claims, such choice, where it is made, is related to a diffuse and deeply-rooted understanding of public interests as prevailing over private interests, which goes well beyond the issue of business restructuring.

In any case, even though with a stronger or weaker position according to the existence or otherwise of a priority for tax claims in the applicable legal framework, tax authorities should be involved in restructuring negotiations. With a view to not preventing efficient restructuring, the legislature should provide for the possibility for tax authorities to reduce or waive claims, if this would allow maximising the long-term interest of the tax authority (which is not limited to maximising the present value of existing claims, but includes also keeping in business a firm

⁵⁴ The results coming from the empirical research in Spain show that the most common trigger leading distressed MSMEs to seek for specific advice in insolvency is the occurrence of a seizure in favour of tax authorities (see the National Findings for Spain, available at www.codire.eu).

that would generate other revenues by continuing to operate).⁵⁵ It might be the case to require that an independent party examine the situation and concur with the assessment of the tax authority(ies) willing to reduce or waive the claims.

In order to facilitate the negotiation of the restructuring plan and make it effective, it would be advisable to provide that the decision on the restructuring proposal be taken by few, ideally only one, entities that are competent for all tax claims.⁵⁶ Such rule would allow having only a single counterparty, facilitating the procedure. Even when the claim may indeed be waived, there should be safe harbours for tax authority employees agreeing on a write off or a rescheduling.

Policy Recommendation #5.7 (*Effective negotiation with tax authorities*). The debtor should be able to negotiate the restructuring with the least possible number of tax authorities, possibly just one, the negotiation should be aimed at maximising the interest of tax authorities as a whole in the long term. The responsible employees of tax authorities should be able to make an objective decision on whether reducing or waiving certain tax claims would pursue the above-mentioned goal. To this purpose, responsible employees should be made exempt from any risks, possibly upon receiving confirmation of their assessment by an independent professional.

⁵⁵ As mentioned, during restructuring negotiations tax authorities should base their decisions on maximising their long-term interests (which is the position that tax authorities should adopt considering that there are, by definition, repeated players). It would not be appropriate for tax authorities to pursue a more general public interest (e.g. preserving jobs, supporting the economy of less-developed areas), even when this would conflict with the economic interest of tax authorities. Indeed, tax authorities lack the democratic legitimacy and technical standing to make this sort of decision (i.e. how to employ public funds in the public interest), which would be better made through more transparent decisions affecting everyone instead of decisions taken on a case-by-case basis that could raise issues of unlawful discrimination.

⁵⁶ Identifying one or few decision makers for all tax authorities, although advisable, may not be feasible in certain jurisdictions because of impediments related to their constitutional order or to other national characteristics. For instance, this would be the case of Germany, which has a federal system that would not make possible to concentrate the power to decide on the restructuring in one or few decision makers in all cases.

5. The role of external actors: mediators and independent professionals

5.1. Facilitating the negotiation through external actors

The negotiation between the debtor and its creditors may be facilitated by involving external actors, such as independent professionals examining the plan and/or mediators assisting the parties in the negotiations.

These two types of figures play significantly different roles in the context of restructuring negotiations. As a result, their respective qualifications and, especially, their attitudes to negotiations should be different.

As will be more extensively discussed in Chapter 6, the professional entrusted with the task of examining the restructuring plan is required to provide an independent assessment on the best interests for creditors of what the debtor has proposed in the plan.

This assessment entails the following evaluations: (i) whether the plan is feasible in the terms described by the debtor and, thus, whether it would eventually lead to its expected results, and (ii) whether the plan allows for a better outcome than the one creditors could expect in the context of the most likely alternative scenario should the plan not be approved (this being either an ordinary or insolvency liquidation, or the continuation of the business without any deleveraging, but instead excluding the scenario of a merely hypothetical further restructuring plan).⁵⁷

As a prerequisite of the first evaluation, the independent professional is also required to ascertain that the plan is based on reliable and accurate data by checking assets and liabilities of the business or, where so provided by the law, certifying the data under her or his own responsibility. In short, the role of the independent professional is to reduce the information asymmetry between the debtor and creditors and provide creditors with guidance on whether it is in their best interest to support, or rather to oppose, the restructuring plan. The role of the examiner is particularly important when a significant number of creditors lacks the required competences to assess the proposed plan and/or, due to the size of their claims, lacks

⁵⁷ For more on the best interest of creditors test, see Chapter 2.

adequate incentives to perform such an assessment. The empirical evidence gathered in this study clearly shows that independent professionals' opinions exercise a significant influence on creditors, who are noticeably more inclined to approve the proposed plan when a favourable opinion has been issued.⁵⁸

The mediator is entrusted with a very different task. His or her tasks will be discussed in par. 5.2 below. However, it is worth noting that the mediator has a far deeper involvement in the negotiations than the examiner. The mediator's main undertaking is to facilitate the reaching of an agreement between the debtor and its creditors based on the terms and contents of the restructuring plan. To effectively carry out such an endeavour the mediator must be granted full access to all information, including the information that the debtor and the creditors wish to keep confidential. In order to make it possible for the parties to reveal such information to the mediator, it is pivotal to grant him or her a strong, broad professional privilege, similar to attorney-client privilege.

In light of the above, the role of the independent professional and the role of the mediator should not be coupled into one single person, otherwise either the examiner would lack the required independence, or the mediator would be ineffective due to the foreseeable resistance of the parties, particularly the debtor, to openly share all relevant information.

The coupling of the two roles may be considered only in the case of micro and small enterprises, where the increase in cost of retaining two different professionals involved may outweigh the resulting benefit.

⁵⁸ However, it is quite interesting to note that the right to require an independent expert report on the feasibility and viability of a restructuring agreement (which is given both to the debtor and to the creditors under the Spanish Insolvency Act, art. 71 bis.4) is seldom used (see the National Findings for Spain, available at www.codire.eu). In Germany, banks often require an independent expert evaluation of an existing plan or, in the first place, an independent expert drafting the plan before committing to a restructuring – no least as a protection against liability and avoidance.

5.2. The mediator

Negotiating a plan could be challenging due to the involvement of different stakeholders that often have competing interests, thus making their coordination difficult. Furthermore, the parties' emotional reaction to the firm's distress, especially for MSMEs where on average the parties are less sophisticated, makes them act selfishly instead of cooperating, thereby causing delays and expensive litigation (this is a quite well-known collective action problem). The more time that is spent in building trust during the negotiation phase, the better the chances are that participants will reach an agreement on an effective and fair solution. In this regard, the appointment of an independent professional with skills and substantial expertise in facilitating interaction among multiple parties is strongly beneficial.

Consequently, over the past years certain jurisdictions have introduced rules that allow debtors to seek the appointment of a mediator both in pre-insolvency situations and after the commencement of insolvency proceedings. Mediation is well established in the United States, where a mediator is often involved to facilitate plan negotiations (e.g. in the practice of the Chapter 11 proceedings). American bankruptcy judges can even mandate mediation (and any party can ask the judge to make such an order) to resolve contested disputes and claim objections that can hamper insolvency proceedings.⁵⁹

A different approach has been adopted by those European countries that have enacted rules on mediation in the context of business restructuring. In Europe, the intervention of a mediator is regarded as limited to pre-insolvency procedures and for the purpose of helping the parties to reach an agreement on the terms of the restructuring.⁶⁰ Moreover, the appointment of a mediator, or a conciliator, is deemed mainly useful in the

⁵⁹ On the US experience, see, L.A. BERKOFF *et al.*, 'Bankruptcy Mediation', (2016) American Bankruptcy Institute.

⁶⁰ Insolvency mediation is spreading across the world as demonstrated in recent comparative studies, see L.C. PIÑEIRO, K.F. GOMEZ (eds.), 'Comparative and International Perspectives on Mediation in Insolvency Matters: An Overview', (2017) TDM 4, Special Issue; B. WESSELS, S. MADAUS, 'Instrument of the European Law Institute - Rescue of Business in Insolvency Law', (2017) p. 127-131, available at: ssrn.com/abstract=3032309.

context of out-of-court restructurings.⁶¹ However, it should be noted that in-court restructurings would also benefit from mediation: negotiations are common in those procedures and the appointment of a mediator could be helpful to speed up the process by coordinating creditors in voting on the restructuring proposal.

Qualitative interviews conducted with professionals advising debtors and creditors show that the parties very seldom choose to involve professionals with specific skills and expertise in facilitating restructuring negotiations. This is mostly due to a widespread unawareness amongst those involved in restructuring negotiations about what exactly a mediation procedure is and how it works and, above all, the beneficial effects determined by the presence of the mediator in this context.⁶² Furthermore, legal provisions mandating the appointment of a mediator in the context of business restructuring are quite uncommon in Europe.⁶³ Only in isolated cases, as in the Spanish out-of-court payment agreement (*acuerdo extrajudicial de pagos*), the law explicitly designates a mediation process to restructure small business (MSMEs) and

⁶¹ The use of mediation to facilitate plan negotiation finds clear endorsement in the European Commission Recommendation, see recital 17 and Section II B (2014/135/EU) and in the draft Restructuring Directive, which introduces two new insolvency professionals in the context of insolvency and business restructurings: a mediator and a supervisor, see recital 18 and Art. 5 of the draft Restructuring Directive (COM/2016/723 final). Mediation is also echoed in World Bank Principle B4 (Informal Workout Procedures), that encourages the involvement of a mediator in the pre-insolvency, informal workout period. See the World Bank 'Principles for Effective Insolvency and Creditor Rights Systems', (2016), available at: documents.worldbank.org/curated/en/518861467086038847/Principles-for-effective-insolvency-and-creditor-and-debtor-regimes.

⁶² The idea of having a mediator involved to facilitate negotiations between the debtor and the creditors still meets considerable constraints in the culture of the entire business community. To a large extent, the prevention of insolvency is still perceived as a matter for courts and judicial procedures. Besides, professionals, who should be adequately informed on the opportunities associated with the appointment of a mediator, rarely advise the parties to appoint one.

⁶³ The 2014 Commission's Recommendation, recital 32, only provides that: (a) the mediator functions consist in assisting the parties in reaching a compromise on a restructuring plan; (b) a mediator may be appointed *ex officio* or on request by the debtor or creditors where the parties cannot manage the negotiations by themselves. Most Member States have not yet enacted national rules purported to fulfil the 2014 Commission's Recommendation with respect to the appointment of a mediator.

identifies the specific requirements to act as a *mediador concursal* (who is often an expert in turnaround, insolvency or related aspects) as well as the tasks that are entrusted to him or her.⁶⁴

The appointment of the mediator should be made by the judge,⁶⁵ taking into account suggestions coming from the debtor or other parties having an interest in the restructuring. The professional appointed as an insolvency mediator must have the ordinary professional qualifications required to act as a mediator,⁶⁶ possibly in addition to specific competences in insolvency law and related expertise. In fact, the mediator may be required also to advise the parties concerning the choice of the measures to be included in the plan.⁶⁷ In other terms, the mediator should have specific mediation skills (e.g. listening and communication skills, ability to gain the trust of the parties

⁶⁴ Insolvency mediation was established in Spain in 2013 by the Spanish Insolvency Act (*Ley 14/2013, de 27 de septiembre, de apoyo a los emprendedores y su internacionalización*) arts. 231 et seq. Later, Spanish Royal Decree-Law 1/2015 enacted on 27 February, called the second opportunity Law, introduced some amendments both in the ‘out of court payment agreement’ (*Acuerdo Extrajudicial de Pagos*) regulation, as well as in the mediator role.

⁶⁵ The judicial appointment of the mediator should not always be mandatory, being decided on a case-by-case basis according to the specific circumstances. See Art. 9 of the 2014 European Commission Recommendation and Art. 2 of the draft Restructuring Directive.

⁶⁶ See the European Mediation Directive 2008/52/EC of the European Parliament and of the Council of 21 May 2008, which provides that the mediator must have specific training and be insured to cover the civil liability derived from his or her activities. Member States are left free to decide on the professional requirements and other regulations applicable to mediators’ training, although more requirements are likely to be introduced as a result of the revision of the same Directive that is currently underway.

⁶⁷ In order to facilitate the activity of the parties devising a plan, the mediator’s role often goes beyond resolving disputes and facilitating communication among the parties. Indeed, the mediator should also engage in several technical activities such as: (i) checking the existence and amount of the credits; (ii) preparing a payment plan and, where appropriate, a business viability plan; and (iii) coordinating creditors’ meetings to discuss and settle the agreement proposal. Those activities are typically addressed by the *mediador concursal* in Spain, see C.S. MOTILLA, ‘The Insolvency Mediation in the Spanish Law’, in L.C. Piñero, K.F. Gómez, ‘Comparative and International Perspectives on Mediation in Insolvency Matters: An Overview’, (2017) TDM 4, Special Issue, 5. Also in Belgium out-of-court restructurings often involve a *company mediator* to assist parties in the preparation of the restructuring plan, see Art. 13, Law on the Continuity of Enterprises of 31 January 2009 (*Loi relative à la continuité des entreprises*).

to make them more confident in sharing private information), which should be preferably combined with those competences typical of insolvency lawyers and other advisors involved in the restructuring process.⁶⁸

The appointment of a mediator may be advisable in light of the importance of a complete information package and of cooperation between the parties (see par. 2) coupled with the following considerations: (a) mediation responds better to the specific private nature of negotiations; (b) when mediation occurs at an early stage, the mediator can aid the parties in identifying the causes of the distress and becoming more receptive to making concessions in the context of the negotiations (one of the most common techniques to achieve this latter result is raising questions about the circumstances that have complicated relationships between the creditors and their debtor); (c) the involvement of a mediator at an early stage of the business distress reduces costs by allowing for a more timely selection of the appropriate tool, thereby avoiding the destruction of value associated with delays; (d) the mediator facilitates adequate sharing of preliminary information between the parties before they begin to discuss the substance of the plan; (e) while managing negotiations the mediator often resorts to specific trust-building strategies to help parties to move closer to the mediator and together; (f) business relationships are preserved and they could even grow.⁶⁹

The mediator encourages the parties to find their own solutions to the business distress by asking questions that could help identify the issues that form barriers to negotiations and, possibly, making suggestions or asking whether the parties have considered certain possible solutions that would facilitate the advancement of the negotiations. To this purpose, the mediator would organise an initial conference that permits the parties to share their views on the issues that are to be negotiated. Later separate meetings (caucus) will be useful to establish a common

⁶⁸ In those jurisdictions where mediation in insolvency does exist (e.g. Spain, Belgium, France) the mediator is usually a professional with specific knowledge and skills in facilitating negotiations, combined with substantial expertise in restructurings.

⁶⁹ In order to realise the latter goal, the mediator's contribution should consist in: (1) letting the parties craft creative solutions that might, for instance, increase debtors' resilience to business crises; (2) encouraging the parties to communicate effectively.

ground for cooperation with respect to specific issues and to open the channel for the transmission of information necessary for effectively conducting the negotiations over the restructuring plan. While managing meetings, the mediator often resorts to specific brainstorming strategies and activities with the intent of increasing trust.

Among others, the most important mediator skill consists precisely in constructing a consistent set of information provided by the group of stakeholders involved in negotiations.⁷⁰ Indeed, the parties will often share their sensitive data with the mediator, who becomes the vehicle of communication between the different groups and the ‘guardian’ of information. Therefore, the entire mediation process should be covered by confidentiality so as to keep the process private and preserve a sense of trust and substantive fairness between all the parties involved (e.g. confidentiality is one of the significant features of the French *mandat ad hoc* and conciliation procedures),⁷¹ whereas the Spanish *mediador concursal* does not enjoy such a strong confidentiality duty.⁷²

The issue of confidentiality is indeed crucial. Drafting a correct plan requires reliable and updated information. An issue that was commonly raised by professionals assisting debtors and creditors is the difficulty in quickly creating a comprehensive set of information. Debtors and creditors, especially at the first stage of negotiations, refrain from sharing

⁷⁰ This means that not all data transferred by the parties to the mediator will be immediately and directly reported to the other parties. Indeed, confidentiality of this information is protected by the mediator and will only be used with the consent of the interested party when (s)he realises – thanks to the contribution of the mediator – that it is reasonable to trust in the other partners. Trust is closely linked with the possibility of building a complete set of data, which represents the basis for a plan that maximises the satisfaction of all the parties involved.

⁷¹ See Art. D611-5 of the French *Code de commerce*.

⁷² A limitation to the mediator’s duty of confidentiality was adopted in the revised version of the Spanish extrajudicial settlement of payments, providing that the confidentiality duty is overcome in case mediation fails and the mediator takes the role of insolvency practitioner in the ‘consecutive insolvency proceedings’ (Art. 242.2-2^a of the Spanish Insolvency Act). This limited confidentiality of the insolvency mediator is perceived as problematic, See C.S. MOTILLA, ‘The Insolvency Mediation in the Spanish Law’, in L.C. Piñero, K.F. Gómez (eds.), ‘Comparative and International Perspectives on Mediation in Insolvency Matters: An Overview’, (2017) TDM 4, Special Issue, 5.

private information that is necessary to find an agreement on a restructuring plan since they are concerned with the risk that any statement or concession made during the negotiation process can then be used to their detriment. In this regard, the involvement of a mediator may be most beneficial: the mediator could facilitate the adequate sharing of information between the group of stakeholders, organising separate meetings with each party (i.e. debtor, creditors, or other third parties) and acquiring information with the reassurance of full confidentiality.

The mediator should then obtain express authorisation from the interested party to disclose the information deemed necessary with a view to rapidly getting to a restructuring agreement (it is important to note that such information, being necessary to reach an agreement, most certainly would have been eventually disclosed by the relevant party). Besides the information that arises from or in connection with the mediation process, in certain cases the mere circumstance of the occurrence of a mediation process should also be treated as privileged.

Policy Recommendation #5.8 (*Appointment of an insolvency mediator. Duty of confidentiality*). Whenever the law mandates or allows the appointment of a mediator, the latter should have those qualifications and skills specifically required to act as a mediator, in addition to being competent in restructuring and insolvency matters.

In order to facilitate the gathering of adequate information at an early stage thereby avoiding delays, the parties should be able to share all information with the mediator relying on a strict duty of confidentiality. If the mediator deems that certain information would better be shared among the parties in order to advance negotiations, (s)he should require the party revealing the relevant information to waive the confidentiality. If no waiver is expressly granted, the mediator must not disclose the information under any circumstance.

6. Consent

6.1. Passivity in negotiations

The creditors' decision not to participate in the restructuring negotiations may be commonly ascribed to one of the following situations:

(i) the inactive creditor has examined all the circumstances and assessed that staying inactive is a value-maximising strategy (e.g. when the creditor may rely on the fact that a restructuring plan not envisaging a cram down would likely be adopted notwithstanding the lack of that creditor's consent);

(ii) due to the size of the claim and the absence of any other interest (e.g. for employees, keeping their jobs; for suppliers relying on the business relationship with the distressed company, keeping this latter in business), the inactive creditor may find it costlier to actively participate in the negotiations – thereby investing resources and time – than accepting the outcome of the negotiations whatever this may be.

The behaviour described first is motivated by opportunistic yet informed considerations by the creditor and is considered a case of so-called 'free riding'. This strategy is unavailable when the restructuring is carried out through tools that bind dissenting or non-participating creditors (in other words, whenever some form of cram down is available). Therefore, when the debtor could opt for a procedure or measure envisaging a cram down, the debtor has a tool that it may use, or simply threaten to use, to pose a limit on creditors' 'free riding'. In light of the nature of the phenomenon that has just been described, passivity in negotiations ascribable to opportunistic considerations can effectively be dealt with by providing procedures and measures envisaging cram-down mechanisms (see Chapter 2).

The behaviour described second is commonly labelled 'rational apathy'. It may occur in the context both of consensual and of compulsory restructurings, when certain creditors do not have an incentive to engage in negotiations. Indeed, from the perspective of an individual creditor having a small stake in the distressed company's turnaround, there are no, or few, incentives to actively take part in the negotiations or to cast its vote on the plan. The cost of seeking professional advice and/or investing time in understanding and assessing the situation may well outweigh the cost of bearing the risk, and possibly

suffering the cost, of a disadvantageous solution to the business distress (e.g. an insolvency liquidation of the company when a turnaround was possible; a restructuring allocating relatively more value to other creditors).

In the paragraphs below, the focus is on this second type of creditors' passivity.

6.2. Consequences of creditors' rational apathy in negotiations

Although inactivity appears to be a rational behaviour for an individual creditor having a small stake in the distressed company, this conduct severely affects the efficiency of the business restructuring process. The negative effects of creditors' passivity in negotiations are different according to the compulsory or voluntary nature of the restructuring tool at issue (i.e. providing or not any form of intra- and/or cross-class cram down).

In the case of a compulsory restructuring tool, if the creditors' inactivity is deemed under the law as a consent or a dissent, creditors' passivity may respectively open the door to inefficient plans, which would be deemed approved notwithstanding only a minority of creditors actually casting a vote and making it virtually impossible for dissenting creditors to prevail, or, to the contrary, prevent efficient business turnarounds, although in the best 'collective' interests of creditors.⁷³ The third option to the strict alternative between deemed consent and deemed dissent is to count towards the majority required to adopt the plan only those creditors that

⁷³ The results of our empirical research show that the deemed consent rule in force in Italy until July 2015 for the in-court restructuring agreement (*concordato preventivo*) allowed for a certain number of abuses perpetrated to the detriment of creditors. On the other hand, after the deemed consent mechanism was repealed and replaced with a deemed dissent rule (and other limiting measures were adopted), the Italian system has faced a sharp decline in the number of in-court restructuring agreements (*concordato preventivo*), which is reasonable to assume that resulted in the winding up of a certain number of viable companies that, just a few years before, would have been saved. The repeal of the deemed consent rule has also translated into a lower rate of creditor consents to out-of-court restructuring agreements (*accordo di ristrutturazione dei debiti*), evidencing the nexus between creditors' opportunistic behaviour and the threat of the recourse to compulsory restructuring tools. See the Italian national findings available at www.codire.eu.

have actually cast a vote. This would sterilise the influence of passive creditors, making their inactivity irrelevant (see par. 6.4, below).

In the case of fully consensual restructurings, the effects of creditors' passivity are twofold:

(i) since the non-participating creditors are not bound by the terms of the restructuring, their inactivity has the effect of putting the burden of the business restructuring on a smaller group of stakeholders that are therefore required to bear a greater sacrifice. As a result, there is less space to strike a deal between the debtor and the creditors participating in the process, thereby making it sometimes more convenient for active creditors to go through an insolvency liquidation (although inefficient from a collective perspective) rather than supporting a restructuring. Indeed, when such a deal is entered into by a limited number of creditors bearing the entire cost of the reorganisation, it is statistically more likely that the restructuring plan – while assessed as being feasible by the court – may eventually not be successfully implemented.⁷⁴ A possible explanation is that due to the reduced bargaining space, the safety buffers provided by the plan may often be significantly shrunk;

(ii) there may be significant and unpredictable deviations from the *pari passu* principle (e.g. claimants having the same ranking may enjoy very different recovery rates due to the possibility or not of relying on the fact that other creditors will consent to the restructuring agreement and bear the cost thereof). This would make it difficult for lenders to quantify ex ante their loss given default (LGD) of the debtor. It is anecdotally well known that uncertainty is a cost for investors and, in this specific respect, such an uncertainty increases the interest rate required by lenders to the detriment of the entire economy.

⁷⁴ This has been clearly evidenced by the results of the empirical research conducted in Italy on out-of-court restructuring agreements (*accordi di ristrutturazione dei debiti*), which are fully consensual restructuring tools. Indeed, the greater the share of indebtedness held by the creditors consenting to the agreement, the more the possibility of the restructuring plan to be confirmed by the court.

6.3. Measures to tackle passivity in negotiations

Tackling rational apathy requires that the information to creditors be provided in the clearest possible way and made easily accessible for creditors substantially at no cost (see also *supra* par. 2).

In this vein, the information package that is made available to creditors should be complete and accessible also digitally, without providing any burdensome procedures that may discourage creditors, if not required with a view to protecting relevant interests (such as, for instance, the confidentiality of certain data regarding the debtor's business).

Also, an incentive to small creditors to take a stance in the process may come from the provision of an examination phase of the restructuring plan (see Chapter 6, where the possible features of such procedural phase and the relevant costs and benefits are analysed). The independent examiner, when there is any, should clearly and concisely express his or her opinion on the advantage of the restructuring plan for the company's creditors, avoiding precautionary formulas set in place to soften his or her position that may raise uncertainties among creditors.⁷⁵

Policy Recommendation #5.9 (*Opinion on the restructuring plan by an independent professional appointed as examiner*). The law should provide that when an independent professional is appointed as examiner to assess the viability of a restructuring plan, the examiner's opinion should (a) concisely and clearly

⁷⁵ The empirical research showed very different attitudes of the examiners across jurisdictions. In Spain, professionals appointed as examiners most commonly express a negative opinion on the restructuring plan, sharing concerns of the fact that the plan is compliant with the creditors' best interest. The prominent professionals interviewed ascribed this to the threat for the professional of incurring civil liability should the plan not be fully implemented. To the contrary, in Italy court-appointed examiners most commonly (86% of cases) express a positive opinion of in-court restructuring agreements (*concordati preventivi*). It is worth noting that only 4% of those plans that have been positively evaluated by the examiner are then rejected by creditors, thereby providing evidence of the influence of the examiner's opinion on creditors' votes. The above-mentioned data draw attention to the importance of setting adequate incentives for examiners, so as to ensure that their evaluation is as objective as possible, see Chapter 6.

express whether the restructuring plan is in the creditors' best interest; (b) be made promptly and easily available to all creditors; (c) avoid any disclaimer or other expression having the effect of making it equivocal.

Guideline #5.11 (*Opinion on the restructuring plan by an independent professional appointed on a voluntary basis*). When an independent professional is appointed on a voluntary basis by interested parties to assess the viability of a restructuring plan, the independent professional's opinion should (a) concisely and clearly express whether the restructuring plan is in the creditors' best interest; (b) be made promptly and easily available to all creditors; (c) avoid any disclaimer or other expression having the effect of making it equivocal.

Besides reducing the cost borne by creditors for getting informed, tackling passivity in negotiations requires also facilitating the process for creditors to express their consent or dissent on the proposed restructuring plan. The procedures that creditors are required to fulfil to cast their vote on a plan, or consent to a restructuring agreement, should be streamlined as much as possible. Proxy voting and virtual meetings should always be allowed (see Chapter 2).

The law may also envisage active measures to contrast creditors' passivity in restructuring negotiations in the form of penalties or rewards for creditors based on their timely and active participation in negotiations.

Such type of measures, especially when they operate through a penalty imposed on inactive creditors (e.g. making their priority ineffective), are applicable only to sophisticated creditors, particularly banks and other financial creditors. It would be unfair to penalise inactive creditors that do not engage in negotiations due to the absolute lack of the required tools, as may be the case for small suppliers.⁷⁶ Therefore, these sort of

⁷⁶ Although outside of the scope of this research, it may be worth mentioning the mechanism provided in the Kazakhstan insolvency framework. When the debtor informs the banks and other financial lenders about its distress, these have a short period of time (about 10 days) to accept

measures most often tackle opportunistic passivity (see above), rather than rational apathy.

6.4. Measures specific to restructuring tools that aim at (or allow) binding dissenting creditors

As mentioned, with respect to creditors not casting a vote on the restructuring proposal, in theory there are three possible rules:

(i) a ‘deemed consent’ rule, which favours the adoption of the restructuring plan at the risk of allowing some restructurings that are not efficient and, in case of a high passivity rate, making it virtually impossible for dissenting creditors to have the proposal turned down;

(ii) a ‘deemed dissent’ rule, which instead could result in the rejection of efficient plans due not to the dissent of the creditors, but merely to their rational apathy that, under the law, is considered tantamount to a negative vote;

(iii) a rule that states that only votes that are actually cast are counted.

In general terms, this latter rule seems the most effective one. It does not excessively favour one outcome over the other and responds to a common idea of democracy, which requires that the opinion of those that decide to express it prevails. From a more reasoned standpoint, the third rule listed above would allow the outcome (adoption or rejection) to prevail that is deemed best by those creditors that, in light of the specific circumstances, have decided not to stay passive. Although this may be only a subset of the creditors of the distressed firm, it is reasonable to assume – in a context where no deemed dissent or consent rule exists – that the determination taken by the majority of the creditors actually participating in the voting is a good proxy of the determination that would have been taken by all creditors.

As a second-best solution, it is worth noting that a deemed consent rule is preferable to a deemed dissent rule. Of the two types of negative consequences resulting from the application

the debtor’s invitation to start discussions on a possible restructuring plan. Should a bank or a financial lender remain inactive notwithstanding the debtor’s communication, the priority of their claims, if any, becomes ineffective in the possible subsequent insolvency.

of these rules, the threat of having some inefficient restructuring plans approved by creditors is less severe than the risk of preventing firms from pursuing efficient restructuring. Indeed, while the first consequence may well be handled otherwise, particularly through the role of court confirmation,⁷⁷ the second consequence is final and results in the permanent destruction of value.

In certain cases, such as for micro and small enterprises, the deemed consent rule may even be superior to a rule requiring that only votes cast be counted. In that case, basically all creditors have claims of small value and it is reasonable to expect that very few creditors would have an incentive to actively participate in the restructuring negotiations. As a result, the outcome of the restructuring proposal may often be determined by a very limited number of creditors, whose active participation could be grounded on interests other than those they legitimately hold as creditors of that firm. (See Chapter 8.)

When the law opts for a deemed consent rule, the following provisions could mitigate the effects of its application:

(i) strengthening judicial or administrative scrutiny with respect to those cases where the restructuring plan would not be deemed approved but for the application of the deemed consent rule;

(ii) allowing proxy voting and reducing the cost of soliciting proxies; in this respect, the rules and customary practices in place for shareholders' proxy voting could be taken as a significant model;⁷⁸

(iii) clearly informing creditors, in a direct and concise way, that the lack of a vote on the proposal would be tantamount to consenting to it.

⁷⁷ Indeed, in several jurisdictions the court is already entrusted with the task of assessing plan feasibility and, under certain conditions, also whether it is in the creditors' interest (see Chapter 6). In sum, an implicit consent rule would result solely in a larger number of cases subject to court evaluation.

⁷⁸ In theory, creditors bringing a challenge against the restructuring plan that proves ultimately successful could be given a priority claim towards the distressed business for the reasonable and proper expenditures incurred in order to solicit proxies, subject to the scrutiny of the court when duly challenged. In practice, this may prove difficult to introduce in many Member States.

Policy Recommendation #5.10 (*Exclusion of non-participating creditors from the calculation of the required majorities*). The majorities required for the adoption of a restructuring plan should be determined without taking into account those creditors that, although duly informed, have not voted on the restructuring proposal.

Policy Recommendation #5.11 (*Provisions mitigating the adverse effects of a deemed consent rule*). When abstentions of creditors are deemed consent, the law should provide for a more thorough judicial or administrative scrutiny of restructuring plans that would not have been adopted but for the application of the deemed consent rule.

CHAPTER VI

EXAMINING AND CONFIRMING PLANS*

SUMMARY: 1. Introduction. – 2. Examination. – 2.1. Voluntary examination. – 2.2. Mandatory examinations. – 3. Participation and plan approval. – 3.1. Participants in the restructuring procedure. – 3.2. The vote. – 4. Confirmation. – 4.1. Definition of the scope of the confirmation. – 4.2. Pros and cons of judicial or administrative plan confirmation. – 4.3. Who should confirm the plan? – 4.4. Content and different types of plan confirmation. – 4.5. Appeals against the decision to confirm or reject the confirmation of the plan.

1. Introduction

This Chapter provides a detailed analysis of two steps that are often found in the path that leads to the implementation of a plan: *examination* and *confirmation*. It also includes considerations concerning voting and the decision-making process, but the main substantive matters in this part (e.g. class formation or cram down) are to be found elsewhere in the report (see Chapters 2 and 3).

Typically, a debtor-drafted plan (on the face of it, the most common case) will be initially designed with no or only informal interaction between the debtor and its target creditors, and this incipient consultation is perhaps rarer when one or more creditors openly take the initiative of drafting the plan. This first draft is often followed by a series of contacts between the debtor and the relevant creditors, when everyone will be required to provide an input. A negotiation of different intensity and times depending on the case

* *Although discussed in depth and shared by all the members of the Co.Di.Re. research team, this Chapter is authored by Ignacio Tirado.*

shall follow, and amendments to the plan will normally be incorporated. Sometime between the informal drafting and the completion of the initiatory negotiation, the plan is frequently examined by third parties. This examination may happen later in the process, or be repeated several times during the path leading to the final approval.

In a normal case scenario, once the plan has been finalised, examinations completed and doubts clarified, a vote is taken. When the legally required majorities are met, some jurisdictions include the need for a final confirmation of the plan by a judge (or, more generally, by the competent court – which sometimes includes more than one judge). As will be examined later in this chapter, this confirmation finds its main justification in the need to protect relevant stakeholders (e.g. minority creditors or, in some cases, shareholders and other stakeholders) from abusive plans. The judicial analysis leading to confirmation (or to the rejection of the plan) tends to protect directly affected dissenting and non-participating creditors, but, in some instances, also creditors that are not directly affected by the plan. This is particularly the case when the plan, as is generally the case, includes not only a financial restructuring but also structural changes to the operating business, or in any case provides for exemptions from avoidance actions or priority financing (see Chapter 3). These types of measures and effects may indirectly affect those creditors not bound by the plan, namely altering their chances to recover.

Examination and *confirmation* are thus complementary and pursue similar aims. As we will see, neither of the two are strictly necessary, but at least one of them is present in every formally regulated system aimed at tackling the financial distress of businesses that we know of. Examination operates *ex ante* and seeks to provide the parties with independent information on the plan.¹ Confirmation takes place *ex post*, once the plan has been approved by creditors, and, in certain jurisdictions, also by equity holders, and seeks to ensure compliance with formal legal requirements as well as to exert some degree of control over the content of the plan with a view to protect certain stakeholders. The complementarity stems from the fact that

¹ Examination may also operate *after* the plan has been agreed and voted on favourably, but *before* confirmation, whenever the court seeks additional expert advice on the whole or part of the content of the plan.

examination (i.e. enhanced information) facilitates the analysis leading to confirmation. But there is a degree of potential trade-off between both institutions. This is clear, for example, when the examination is conducted by independently appointed experts and the analysis includes compliance with predefined legal requirements (e.g. the necessary majorities having been met out of court). The stronger and broader the examination, the less necessary it becomes to have a mandatory *ex post* judicial confirmation; and, conversely, confirmation becomes almost necessary when *ex ante* controls are weak. In any case, and regardless of the model chosen, the examination and confirmation cannot be deemed mutually exclusive. The jurisdictional nature of confirmation (the “*potestas*” function and the legal effects of the decision) as well as the type of analysis conducted by the court/administrative agency make both institutions inevitably different from a qualitative point of view and hence both may be necessary.

Policy Recommendation #6.1 (*Examination and confirmation of the plan*). Examination and confirmation of the plan are essentially complementary and it is good practice to include both in the same out-of-court regulated procedure. Under particular circumstances, one of the two may be formally excluded. Never both.

In the following sections we shall address examination and confirmation separately, considering the different models existing in the jurisdictions analysed in this report and others existing – or likely to exist.

2. Examination

By *examination* we mean the analysis and opinion about all – or at least the main – elements of a plan drafted by one or more experts.²

² The examination of the plan is not to be confused with the mandatory intervention of other professionals that may be envisaged by the law. For example, some jurisdictions make it necessary for a notary public to certify the plan; in other systems, the Registrar of companies, certain professional bodies/agencies or chambers of commerce are involved. The involvement of these additional institutions all too often respond merely to the lobbying of said professional bodies with the law maker,

The analysis normally results in a report or memorandum provided to the parties in written form. These reports may focus on separate parts of the plan (e.g. analysing the legal part, the valuation of assets and/or guarantees, future cash flows) or cover its entirety. The examination ought to provide an assessment on all the parts of the plan that may be relevant for its effective implementation. While the report may have a descriptive part, it should be mainly analytical and expressly state the expert's opinion on the validity of the assertions contained in the plan. Since the report is often the key informational tool of the out-of-court procedure, it ought to concentrate on those parts of the plan which are – on its face – more difficult to be self-gauged by creditors: the causes of the financial distress, the commercial reasonableness of the business restructuring measures proposed, and the link between the latter, the predicted cash flows and the effort required by creditors (i.e. the rescheduling time and – if applicable – the amount of debt write-down included in the plan proposed). While an independent assessment of legal compliance may be useful, it would not seem so relevant in those cases where an ex post judicial confirmation is mandatory.³ In all other cases, its relevance stands alongside the financial component of the plan.

For taxonomic purposes, we can consider two types of examinations: those that take place voluntarily in the context of the negotiation process between the parties, and which most often corresponds with non-regulated out-of-court restructurings (albeit not only), and those examinations required by law. We will briefly consider them separately.

2.1. Voluntary examination

In the late stages of the negotiation process or – more frequently – when a first full version of the plan has been completed, the debtor and/or one or more creditors may task professionals with the analysis of the plan, in a context where such assessment is not required by law (e.g. the parties are pursuing a purely contractual out-of-court restructuring, which does not require a mandatory examination).

and add unnecessary complexity and costs to the out-of-court procedure. This is a problem especially relevant in the restructuring of small and medium enterprises.

³ See Chapters 3 and 4.

When there are multiple examination reports, they may be used to support the negotiation by the parties with a view to fine tune the plan. The examinations may take place purely *ex parte*, in which case their credibility and usefulness are limited. In these cases – more common in the larger restructuring operations – there is a risk of a waste of time and resources. It is not uncommon that, at some point, the debtor is made to pay for such examinations, even when the experts have been retained by one or more creditors, worsening the debtor's financial position as a consequence. It is more efficient when the parties *agree ex ante* to have the plan analysed by an independent expert, retaining a professional agreeable to the different sides of the negotiation.

In the context of purely contractual out-of-court agreements, with no express legal protection and institutional control, the parties may seek an examination for purposes other than transparency in the negotiation. Company directors may seek to justify their proposal *vis-à-vis* their shareholders or other companies of the group; and, more frequently, directors, managers (or majority shareholders) and/or creditors may seek to reduce the risk of liability towards third parties (i.e. non-participating creditors). This is especially the case when the plan envisages a business restructuring alongside a debt or financial restructuring. The examination may also be requested with a view to reduce the probability of an ex-post avoidance action in case the unsuccessful restructuring has led to formal insolvency proceedings. Although it will depend on the case and the jurisdiction, the addition of a voluntary expert opinion may make the case for negligence of the parties more difficult to prove, but it seems highly unlikely for it to be considered enough to rule it out. Whilst there is obviously nothing wrong per se in the practice of requesting plan examinations for purposes other than increasing transparency in negotiations, it does create additional costs for an already financially distressed debtor, hence damaging the interests of non-participating stakeholders. An eye should be kept on such abusive behaviour.⁴

⁴ The issue of cost is essential in out-of-court proceedings, as it is within formal proceedings. Any legislative decision to include additional informational tools must be adopted considering this limit. The problems of cost have arisen in the surveys of all jurisdictions.

2.2. Mandatory examinations

As stated in the introduction to this chapter, jurisdictions that regulate out-of-court proceedings, conferring upon their successful completion a number of legal effects that go beyond those agreeing to the restructuring, rather producing effects also on third parties, often envisage the mandatory inclusion of an independent examination of the plan. To be sure, there are sound reasons for this imperative requirement, since examinations:

(i) reduce the transaction costs by adding transparency to the negotiation;

(ii) facilitate the decision-making process and help creditors, whom may not have the ability to properly gauge the validity of the plan (with the exception of professional lenders and others of similar kind);

(iii) protect dissenting and non-participating creditors bound by the plan, by ensuring compliance with legal requirements, influencing the ex-ante behaviour of the drafting parties and by providing said stakeholders with relevant information in case they decide to oppose the plan or take any other course of action to defend their interests;⁵

(iv) ease the work of the court at the time of the confirmation of the plan, by providing the court with an expert opinion on the material content of the plan.

Despite its many positive externalities, examinations can be costly, and usually the more reliable the expert, the more expensive the fees. While this might not be a significant problem in large restructuring operations, it is to be taken into serious consideration in

⁵ The fact that examinations add transparency and aid creditors in gauging the validity of the plan does not mean that in every jurisdiction the professionals drafting the reports owe duties to every participant in the process. Naturally, things will be different depending on whether the report is mandatory or voluntary, and also other circumstances such as who has made the appointment and who pays the fees. In any case, in some jurisdictions there would usually not be privity of contract between the expert and anyone other than the party commissioning the expert. Further, exclusions of contractual and tortious liability are common in such reports. Therefore, the extent to which third-party creditors may place reliance on the expert's examination report may be questionable. It is beyond the scope of this work, given that this depends also on the structure of the civil liability system of each legal system, ascertaining whether the examiner is liable directly to third parties with regard to the information contained in the examination report, or to suggest the introduction of such kind of liability. The same applies with regard to possible criminal or administrative liability.

the process leading to an out-of-court workout of small and medium enterprises. Therefore, mandatory examinations could be deemed only ‘potentially’ mandatory: the analysis of the plan would be contingent upon the request of a creditor, or, more generally, of an affected interested party.⁶ Thus there can be two kinds of mandatory examinations: potential or obligatory. In the former, the examination may take place or not, depending on the parties, who are legally empowered to request it; in the latter, the efficacy of the plan would always depend on the issuance of the examination report. Which of the two solutions is more correct depends on a number of factors. No doubt, the potential examination solution adds flexibility, may limit the costs of the procedure without undermining the rights of the parties, and seems like the preferred solution for the smaller debtors. Conversely, it may also delay the proceedings when the request for the examination takes place at a late stage or when there are several requests and the system does not allow for a streamlined coordination. A purely mandatory system benefits from legal certainty, which is the most common victim of flexibility. In any case, a preference for one or the other model (or a combination of both) would depend on how the examination is regulated. We shall briefly consider some of the most relevant parts of its regulation.

- The *appointment* of the expert that conducts the examination is one of the elements that needs to be carefully considered. Who makes the formal appointment is not as relevant as who actually selects the appointee. The formal appointor may be the court (not necessarily the judge, but, given the merely procedural nature of the act, it can be issued by order/decision of court officials), an independent third party (for example, the registrar of companies, or a notary public), or the debtor or its creditors legally empowered to do so. The first two options (court/independent third party) underpin the independence of the experts, or, at least, its objective external appearance of independence (a benefit that cannot be understated). This type of appointment is usually coupled by a random selection process, according to which the appointor follows the order of a pre-defined list of experts or simply follows a random lottery procedure.

⁶ This is the case of the Spanish system. According to art. 71 bis of the Spanish Insolvency act, the debtor or any creditor may request the appointment of an independent expert that shall issue an opinion about ‘the reasonable and feasible nature of the viability plan, about the proportionality of the collateral/guarantees provided...’, etc.

Naturally, the negative part of this type of appointment is its rigidity and the inability to select the most appropriate expert for a given case. Unless the list of experts only includes highly – and similarly – skilled professionals or entities, there is a chance that the appointee may not have enough knowledge for a big case or experience/specialisation to analyse the business plan of a business operating in a complex sector of the market. Because these risks are minimal in the case of financial distress of small businesses, the system based on random selection might seem more suited for these cases. The alternative is selection by the parties involved.⁷ The advantages of this solution are the disadvantages of the former model, and vice-versa. A proposal by the debtor may undermine the appearance of objectivity and independence of the appointee, especially in those cases where creditors have not had a say. This could generate a lack of trust and render the examination useless for creditors. The proposal by creditors may also have problems of objectivity between differently ranked classes of creditors or between creditors whose interest might not be aligned (for example, because of the different type of security rights held) and, at such early stage, may pose logistic problems (Which creditors can make proposals? Should all – relevant – creditors be allowed to weigh in? How is the decision to be taken?). However, appointment by creditors has proven successful in international experience, especially for large cases and developed jurisdictions, and is more in line with the general appointment of professionals in a market economy. The selection by the parties may trigger, if so allowed under the law, the appointment of several experts and the issuance of several reports. If this is the case, the law ought to include a rule to ensure that the debtor's estate is not unduly burdened (for example, by allocating the costs amongst the interested parties, setting a cap that should cover the expert fees of only one examination⁸).

▪ Legal systems usually include a list of grounds to exclude the appointment of professionals that may have a conflict of interest. The conflict is often deemed existing when the professional has acted

⁷ As stated in the text, selection by the parties may also be followed by their formal appointment when they are so empowered by the law, or may consist in their ability to formally propose an expert for appointment by the court (or, less frequently, by an independent third party).

⁸ This would be the rule applicable to the general examination of the plan. If it is necessary to conduct an appraisal of special assets, additional reports may be necessary.

professionally for the debtor or for its main shareholders within a reasonable period of time before the assessment. The conflict may also exist when such relationship has existed with the main creditors, although the mere existence of a previous professional link should not suffice to exclude the appointment.⁹ A much more close and permanent connection ought to be established and a case-by-case analysis considering all circumstances should be required. It must be remembered that the examination concerns the situation and prospects of rescuing the debtor, not the creditors. While we understand that a rigid rule to avoid conflict is very much a part of procedural systems in continental Europe, consideration should be given to the adoption of a different approach: one that places the weight on transparency rather than on outright prohibition. Appointed professionals would have a strong rule of disclosure concerning any activity or circumstance that may impair objective professional judgement. From then on, it would be up to the parties to avoid selecting those that would have no credibility: why select an expert whose examination is going to be ignored by the relevant stakeholders? This approach could reduce costs and would increase the information available. The solution, though, may be less convincing in smaller cases where the passivity of many stakeholders reduces the possibility of control over the appointee.

▪ A different, potential conflict may also exist in those systems where the examination takes place by a mediator or any other type of professional that is competent to carry on more tasks than just providing an opinion on the plan within the out-of-court procedure. An example would be Spain's '*mediador*' in the procedure designed for MSMEs or, in Italy, the judicial commissioner, who can then be appointed, in case of a subsequent insolvency procedure, as the bankruptcy trustee. Although there are indeed benefits to appointing the same person for the out-of-court procedure and, should the attempt fail, for the formal insolvency case as insolvency representative, the professional may be tempted to act in a way that increases the chances of extending his or her work. This problem may be tackled merely by creating adequate incentives in the out-of-court stage (e.g. increasing the fees in case a plan is approved and successfully implemented).

⁹ In some countries there are 'bright-line rules' and a general standard of independence. In Italy, for example, previous relationships with the debtor or the creditors exclude independence (Art. 67(3)(d), Bankruptcy Act).

▪ The system should include a clear rule concerning who *bears the cost* of the examination. Experience shows that, in most occasions, the costs are borne by the debtor. This is evidently the case when the examination takes place at the initiative of the debtor. However, it is quite common that the initiative by the debtor masks a previous agreement with the main creditors, who in fact select the expert (when the parties are entitled to do so, see above). In truth, there is little alternative to the treatment of the examination as a cost inherent to the procedure and, therefore, its payment out of the assets of the financially distressed business. Absent abusive practices, this seems like the correct solution: if the debtor is already insolvent, the assumption of the cost by the debtor will be more apparent than real, since it will ultimately be paid out of the moneys available for the repayment of creditors,¹⁰ and, if the debtor is merely undergoing cash flow hardships, there is no reason to impose the costs on third parties. The rule ought to be different when more than one examination is requested. Any additional reports should be paid for by those who request it. As to the amount of the fees, they should be determined by the professional market. There is no reason to create a system of predetermined fees, as is the case in some countries (for example, in Italy, Germany and Spain) for insolvency representatives. This lack of predefinition of the criteria to establish the fees should be coupled with the possibility of the relevant parties to object when the fees have been abusive (see also Chapter 4, par. 2.4, on advisor's fees).¹¹

Policy Recommendation #6.2 (Examination of the plan). Although a professional examination of the plan is not always necessary, it is advisable in most cases. Only when the debtor is a micro-entity with a basic business model, the examination may be excluded *ab initio*.

¹⁰ Indeed, in the case of an already insolvent debtor, the costs may therefore be borne by creditors (each penny paid to the expert is *ceteris paribus* a penny less for creditors as a group). This, together with the fact that the plan would allocate the value in the estate, creates the risk that the costs would be borne by minority claimants.

¹¹ There may be a problem if the debtor and appointed professional cannot agree on the fees. The debtor surely cannot block the appointment this way, whereas the professionals should not be allowed to request extortionate fees because in the end the debtor has to hire them anyway. However, a mechanism to challenge abusive fees, as mentioned in the text, is likely to solve issues when the debtor's and the expert's views are irreconcilable.

The examination report may be mandatory for all cases or be only potentially mandatory, when the debtor or creditors request it. Although both systems are acceptable, the latter adds flexibility and may limit the costs of the procedure.

Although more than one examination may be a possibility, it should not be the rule, and, more importantly, a rule should be included to allocate the cost of additional reports on those who request it.

The examiner should be a capable professional, suited to the specificities of the case and independent from the parties. Pre-existing professional relationships with creditors is not to be deemed an automatic cause for exclusion of the expert, as long as these relationships do not prevent the examiner from exercising an independent judgement. A case-by-case assessment must be made.

The examination report should be comprehensive and pay particular regard to the financial assessment concerning the viability of the business and the chances of successful implementation of the proposal.

Examination reports must be subject to control ex post.

3. Participation and plan approval

This section will briefly address the main issues encountered in our research concerning the participation of creditors in the process leading to a restructuring plan: the determination of participants, the main aspects of negotiations and some salient elements of the vote will be covered. It must be noted that several topics that would fall within the scope of this chapter are also treated elsewhere.

3.1. Participants in the restructuring procedure

In the context of formal in-court insolvency proceedings, all creditors are called to participate in the procedure.¹² No one with a

¹² This participation, however, may be very restricted, particularly in case of subordinate claims. In Germany, for example, these claims cannot be filed save for a specific request by the court (sec. 174 par. 3 InsO), and creditors holding this type of

claim – real or contingent – against the debtor may be left out. The situation may well be different in out-of-court proceedings. No doubt, purely voluntary informal out-of-court agreements do not have any mandatory rule in this regard: the debtor will freely decide who should participate in the negotiations. This poses no problem, since these proceedings stay within the strict boundaries of contract law – and hence of privity of contract – taking effect only on those who voluntarily agree to engage with the debtor, and the legal framework does not attach any special effect to the agreement. However, things are very different in *regulated out-of-court proceedings*: by ‘regulated’ we mean those proceedings that comply with certain legally established requirements as a consequence of which protection for the agreement reached against ex-post avoidance actions is granted, financing extended to the debtor is granted priority or dissenting/non-participating creditors are bound by the plan.

A review of European jurisdictions offers a very open landscape: (i) there are out-of-court proceedings where all creditors are mandatorily given the opportunity to participate; (ii) procedures according to which the debtor may select the creditors involved at its discretion; and (iii) proceedings where the restructuring is limited to only one or more types of creditors.¹³

▪ **Type (i)** proceedings (out-of-court proceedings where all creditors are mandatorily given the opportunity to participate) are the most common ones. They constitute an out-of-court replica of formal in-court insolvency proceedings. Because of this, it is essential that the design of the procedure offer incentives for their use instead of the in-court alternative. The entry gate to these proceedings must be wide and lax to allow for early use: either open or including the possibility to file based on imminent insolvency. Full out-of-court proceedings that are made available only in case of insolvency make little sense: it is often too late, and the ratio of success is much lower. It is not infrequent that such proceedings are merely an excuse to procrastinate and delay the solution to the distress. These proceedings must be ‘useful’ to the debtor, and hence a stay of actions/executions must be at least a possibility, an agreement reached ought to be protected

claims do not have voting rights outside of plan proceedings (sec. 77 par. 1 InsO); in plan proceedings, they only have voting rights if their claims are not deemed waived according to sec. 225 par. 1 InsO.

¹³ The restriction may also concern the debtor. This is typically the case where the jurisdiction creates a specific procedure for MSMEs.

against ex post avoidance, debtors should be left in possession of the business and dissenting creditors must be bound by the agreement. Without these ‘carrots’ the procedure will not be used. Another element of the utmost importance is consistency with the requirements to approve a plan in formal proceedings. It must not be more costly or lengthy out of court and, especially, the majorities should not be higher. Experience in Spain has shown that higher thresholds in ‘universal’ out-of-court proceedings drive debtors away from its use. This is particularly the case when – another clear mistake – the failure to successfully approve a plan leads straight – and inevitably – to liquidation. Again, Spain was the proof of this. Both flaws have been amended by the legislature.

- **Type (ii)** proceedings (procedures according to which the debtor may select the creditors involved at its discretion) are less frequent and also have different designs. The model’s main advantage is clearly its flexibility. The debtor – most commonly a sophisticated debtor – may tailor the restructuring to its own context, maximising the probabilities of success, both in the approval and in the plan’s implementation. But these agreements require technical skills and an adequate level of reliable information, and are not always useful absent those characteristics (as is often the case with MSMEs). Naturally, this type of agreement will only bind the participating creditors. Protection against ex post avoidance or priority for new financing should only be granted in case the plan is objectively favourable to the debtor¹⁴ or when certain majorities of the total amount of claims are reached. The contrary would externalise the risk of the agreement on non-participating creditors and other relevant stakeholders.

- **Type (iii)** agreements (workouts where the restructuring, as a matter of law, is limited to only one or more types of creditors), restricted to one or more groups of creditors, have proven successful when involving sophisticated creditors with experience in the practice of restructuring and aware that full repayment of other creditors (e.g. suppliers, workers) increases their expected returns when the business

¹⁴ Spain has included a type of refinancing agreement that is protected against avoidance actions without any majority requirement, because the content of the plan – defined by the law – is so clearly favourable to the debtor – and hence to its creditors – that it merits a safe harbour. However, the requirements concerning the content of the plan are extremely burdensome, and thus there is no evidence of it having ever been used.

is viable. These creditors are also best placed to gauge which businesses have a positive going concern value and therefore deserve further investment (or, at least, support in the form of additional time to repay). Limiting the scope of the negotiation to a few repeat players also facilitates agreements: there is a greater likelihood that creditors will behave professionally; the parties often know each other and are familiar with the environment; the rules tend to be clear (not infrequently there is not even a need for a standstill agreement when the regulated procedure does not envisage a stay); and misbehaviour is rare due to the risk of reputational damage. Moreover, having fewer people to negotiate reduces transaction costs. Banks and other professional lenders tend to have better information about the debtor than anyone else (perhaps with the exception of the tax authority), and this fact also increases the likelihood of an adequate agreement being reached. From the research conducted concerning this type of proceedings, however, two risks transpire: on the one hand, the subjective scope of the procedure must be clearly defined;¹⁵ on the other, there is an additional problem when debtors are too small, since financial creditors show little or no interest in getting involved. This latter problem ought to be tackled by means of banking supervision, codes of conduct and other rules that create incentives for financial creditors to avoid passivity. The research conducted also shows that flexibility in the definition of the subjective scope could be welcome: in some cases, large commercial creditors may be as sophisticated as banks, and share most of the characteristics that make the latter adequate restructuring counterparties. Finally, the analysis conducted in some jurisdictions reflects that excluding public claims from these agreements may undermine the system. By being left out, public claimants are given an unjustified *de facto* priority that may even deter financial creditors from agreeing to rescue an otherwise viable business (the main concern being the lack of willingness to provide new money ‘for it to end up in the pockets of the tax agency’ [sic]). This problem seems more acute in smaller businesses, which are those that tend to accumulate more public arrears.¹⁶

¹⁵ In the case of Spain, the use of the expression ‘financial creditors’ has proven too vague. For example, it is unclear what the law is when there is an assignment of claims, or if guarantees are covered by the agreement. To a more limited extent, the same problem arose in Italy.

¹⁶ The inclusion of public creditors (tax, social security) in the agreements does not in any way intend to support the possibility for distressed firms that are no longer

3.2. *The vote*

The decision on the approval of a plan may be adopted by means of a written procedure or in a meeting of creditors. There is no real difference in this point between out-of-court and in-court proceedings. The feedback received in the surveys on this topic and the analysis of the different systems shows few results. The main finding is that flexibility seems to be a very positively valued factor. Due to the alleged little efficiency and high cost of creditors' meetings, an open system, with a period to cast a vote (or adhere to the plan in any other adequate manner), seems like the preferable option. The larger the case, the clearer this preference is.

The vote should be structured in classes. Classes may be freely defined or determined *ex ante* by the law. In both cases, it is essential that the classes cluster creditors whose claims have an identical economic value.¹⁷ If the design of the classes is left to the parties, the definition of each class should ensure a sufficient level of uniformity. There seems to be a positive reaction to the inclusion of shareholders as a class, insofar as there are safeguards that ensure a sound system of priorities. The use of classes seems less relevant in proceedings concerning MSMEs, given the small number of creditors. But classes are not the only element that must be considered. It is not infrequent to experience problems in the determination of the value of collateral held by creditors (directly affecting the participation of creditors). Similarly, it might make sense to create rules that coordinate the vote in case of enterprise groups. When there are joint and several guarantees within a group, the guaranteed creditors get to vote as many times as they have guarantees, *de facto* multiplying its influence of what is actually one single restructuring process (a bank lends 200 to the parent company, and receives a guarantee from three different subsidiaries: unless a rule exists to coordinate the voting process, the bank will have a vote for 200 in each of the company's assemblies). On the other hand, this is the consequence, as for voting, of

able to obtain bank financing to finance their activities by withholding taxes or social security contributions, relying on the fact that tax authorities are not quick in reacting. This kind of distorted practice is quite common in some jurisdictions (e.g. Italy) and, when coupled with a statutory priority for tax claims, has the effect of further reducing the recovery for the other creditors.

¹⁷ On class formation and the treatment of classes, see Chapter 2.

insolvency rules providing that creditors have a claim for the full amount of their credit towards each debtor, including guarantors.¹⁸

The system of majorities must strike a balance between the need to ensure a strong support for the plan and the need to make the plan effectively possible. In general, majorities beyond 75% should be envisaged only exceptionally. Some jurisdictions tend to differentiate the thresholds depending on the content of the agreement: the more detrimental to creditors, the higher the threshold will be. It is very important to mirror the formal majorities to avoid strategic choice of restructuring tools; on the other hand, in certain circumstances it could be justified to allow for lower majorities when there is a more pervasive control and, hence, a lower risk of abuse.

Policy Recommendation #6.3 (*Participation and plan approval*). In formal insolvency proceedings, all creditors must be given the chance to participate. This is not the case for out-of-court proceedings, where different options can be considered. Where a jurisdiction includes an out-of-court procedure that concerns all creditors, special attention should be paid to creating incentives for its use and avoiding a worse treatment than the parties would get in formal in-court proceedings. Out-of-court proceedings may be regulated to allow debtors to select which creditors should participate. This adds flexibility. However, the efficacy of these plans is limited and rules must be included to safeguard the interest of non-participating creditors in case the agreements are to be protected. Out-of-court proceedings involving only some creditors may be an adequate solution, so long as:

- (i) the scope of the procedure is adequately defined,**
- (ii) the creditors involved are sophisticated, professional creditors,**
- (iii) the exclusion of other creditors is founded on adequate grounds, such as suppliers or non-adjusting**

¹⁸ This is a common rule in many jurisdictions. E.g. in Germany, sec. 43 InsO: A creditor holding claims against several persons for the whole of one single payment may file the full amount in insolvency proceedings against any debtor until it is fully satisfied if it had a claim to such full amount on the date when the insolvency proceedings were opened. See also Art. 61, Bankruptcy Act (Italy).

creditors. The exclusion of public claims creates a *de facto* priority in favour of public creditors, undermines the chances of success of the agreement, and run against best international practice.

The decision may be taken in a meeting of creditors or by allowing creditors to cast a vote during a period of time. This latter method should be preferred for larger cases. In general, the majorities required in out-of-court proceedings should not be different from those envisaged for in-court procedures.

The thresholds should only very exceptionally be higher than 75%.

4. Confirmation

4.1. Definition of the scope of the confirmation

An agreement between a debtor in financial distress with some or all of its creditors alters contractual and property rights of the latter. This alteration takes place through a collective action process, and hence there may be dissenting minority creditors. Moreover, even non-participating creditors, whose contractual or property rights suffer no direct change, will often be indirectly affected by a plan due to the fact that it commonly includes a business restructuring, thereby changing the risk profile of the debtor, and offers protection from ex post avoidance or liability to new financing and acts carried out in the implementation of the plan. As a consequence of all of the above, most systems designed to tackle business financial distress – be it out of court or in a fully formal procedure – include some sort of control over the content of the plan by an independent institution, either by a court or by a public agency. In this section we shall briefly discuss the different models and propose recommendations.

In this chapter, by ‘confirmation’ we are referring to the approval by a competent court or by the relevant administrative agency of a plan previously agreed upon by a debtor in financial distress and its creditors. The plan needs to be aimed at tackling the situation of financial distress, independently of the type of exit (be it a reorganisation agreement with the same owners, with different ones, or a liquidation of any sort). It does not concern mere business restructuring plans, with no changes envisaged for the business’s

debts. Furthermore, we understand ‘confirmation’ as including some sort of analysis of the merits by the confirming body, either a material check of the legal requirements or a more in-depth analysis of the viability of the plan. A mere formal, external control of the requirements envisaged in the law is not deemed a confirmation for the sake of this chapter (e.g. the simple notification by the debtor to a Spanish court that negotiations are being conducted with a view to reach an agreement – ex art. 5 bis IA – does not qualify as a confirmation by the court).

4.2. Pros and cons of judicial or administrative plan confirmation

There are many sound reasons to include judicial or administrative control over the content of a plan. Following are some of the most evident of these reasons:

- A restructuring plan, which may be imposed on non-participating or dissenting creditors, implies a change in the legal rights assigned ex ante to the parties, altering the normal functioning of the market and affecting the subjective/property rights of stakeholders. These ‘game-changing’ effects constitute exceptional law, and hence its application should be monitored by an independent authority.

- An indirect effect with regard to the position of creditors, also those not directly affected, is given by the protection afforded by the law against ex post avoidance actions. In such case, if, for the sake of speed and efficiency, the law of a Member State allows protection from avoidance actions even without court/administrative confirmation, then a reasonable compromise seems to require an independent expert’s opinion that the legal requirements are met and the plan is commercially reasonable in a manner that facilitates the rescue of the business in the interest of creditors as a whole, not of individual – even if majority – creditors.

- In line with the foregoing, a judicial or administrative confirmation protects legality, increases legal certainty and gives credibility to the system, fostering its use as a consequence thereof.

- A confirmation constitutes a mechanism to protect minority creditors (and, ultimately, in some cases, shareholders). Moreover, a confirmation that includes a revision of the viability of a plan serves to protect non-participating stakeholders (e.g. creditors not bound by

the plan, employees), who cannot influence the plan but whose risk will often be changed by the content of the plan.

- In the case of medium and large debtors, more likely to have cross-border connections, it facilitates international recognition and fosters the participation of foreign creditors. However, the inclusion of a mandatory confirmation of the plan does not come without costs. Essentially, there are two risks that need to be considered:

- First, the confirmation may delay the implementation of the plan: the more inefficient/underdeveloped the court system, the longer the delays. Surveys and interviews collected during the project confirm that time is of the essence in out-of-court proceedings, especially since time ‘in court’ is bound to affect the reputation of the debtor and considerably lower its chances to access affordable – interim – financing.

- Secondly, there is a risk of excessive intervention by the judge or the administrative authority. The risk, allegedly not infrequent in jurisdictions with a rigid procedural system, is that the confirming body ‘substitutes’ the will of creditors, revising the risk voluntarily accepted by the latter. Confirmation based on the objective lack of viability of the plan, following an analysis of the merits, should be exceptional and very well founded on sufficient evidence. Judges/administrative authorities are not best placed to assess the viability of a plan, and should only substitute the voluntary risk-taking of a majority of creditors when there is evidence of abuse or a very clear case of damage to minority creditors.

In light of the advantages and risks identified above, the following sections analyse the possible systems of confirmation. The recommendations that will follow the analysis shall aim to maximise the pros and to minimise the risks listed above.

4.3. Who should confirm the plan?

The body having the competence to confirm a plan must be independent of the parties and have the legal capacity to alter subjective rights of debtors, creditors and – if necessary – third parties. To be sure, such a body would normally have a public nature, since most legal systems would only assign such competences to

entities having judicial or administrative powers.¹⁹ A comparative outlook shows that the competent body would be either a court/judge (most often, the court/judge that would be competent to open a formal insolvency case) or the insolvency agency (i.e. an administrative agency, most often part of the Ministry of Justice or the Ministry of Economy/Finance), with the former model being the most common one.

In abstract, there is no reason to consider one model above the other in terms of legal knowledge and experience. In most developed countries, judges have a good technical capacity and an adequate level of specialisation, but this is not always the case (and it is hardly ever true for developing jurisdictions), and there is no reason why an administrative agency could not hire people with at least as good a command of the subject matter.²⁰ The administrative model has its advantages: the agency could be designed with an inter-disciplinary team, including experts in economic analysis, a most useful resource when assessing the viability of a plan; alternatively, these organisations tend to be more free and hence ‘nimble’ to engage expert opinions on a given plan if deemed necessary; the decision-making process is generally internal and hence not subject to strategic delays by the parties (e.g. by frivolous appeals); and, finally, these entities could be more efficient generally than courts, and have a higher degree of specialisation (at least in comparison with those judicial systems where judges not only decide insolvency – and pre-insolvency – cases).

And yet the court system has one clear advantage: in most systems, it will be considered the most appropriate body, from a technical point of view, to confirm a plan whose effect will be the alteration of subjective rights (contractual or property rights). In fact, there is little doubt that court scrutiny must be available, at least in the form of an appeal, to avoid problems of constitutionality in the vast

¹⁹ However, it is not impossible to conceive the assignment of the confirmation powers to a specialised private person/body. This private system would be similar to a mandatory legal arbitration. We are not aware of any jurisdiction with such a system. Naturally, the parties (i.e. creditors) cannot be the confirming body, since, by definition, their consent will have already been given before confirmation (and one of the main reasons for a confirmation is precisely the protection of minority creditors).

²⁰ As a matter of fact, some jurisdictions (e.g., Peru, Colombia) have successfully created specialised agencies to handle insolvency matters, precisely with a view to improve the technical level and better ensure honesty.

majority of jurisdictions. Hence, systems with a confirmation assigned to an agency (or to a private body) may incur delays due to their decisions being challenged in court.

In view of the foregoing, and keeping in mind the benefits and risks of the mandatory confirmation system, we conclude the following:

- The court is the most obvious solution, and it is also the most appropriate one, the more developed the court system of the jurisdiction. It is able to provide legal certainty. It reduces the possibility of challenging the decision to one appeal (to the upper court). However, and as our surveys have shown, time is of the essence. Hence the procedure leading to confirmation must be short, with few formalities, and challenges on procedural matters should be drastically limited. Even the most specialised and technically prepared judges may need help when assessing the viability of the plan. In this regard, a streamlined procedure should be envisaged to allow the judge to retain expert opinion, which ought to be fully independent of the parties. This procedure should be encapsulated and protected from the parties, beyond obvious cases of fraud. Resorting to an additional expert opinion, though, should be an exception whenever the case already counts on the opinion of experts issued previously in accordance with the procedure, or even at the request of the parties (insofar as the appointment of the expert has been conducted by means ensuring independence).

- The administrative agency can be an excellent alternative in countries with slow and inefficient court systems. It is especially appropriate for the smaller businesses, where the plan should be simple, the use of templates widespread, the amount and sophistication of creditors is limited and there is a low risk of ‘political’ decisions due to the small size of the cases. Often, the same agency may have also been involved in the case during the negotiation and approval of the plan, and in some jurisdictions relevant information on the debtor will be lodged in the agency itself. In the procedures involving MSMEs, the use of an administrative agency is bound to liberate the court system from the burden of many small – or very small – cases, which, due to rigid procedural schemes take many time and resources anyway. The decision of the agency to confirm or to reject the confirmation of a plan should be open to challenge by affected parties. This appeal ought to be decided by a court of justice. However, it is essential that the competent court has some degree of

specialisation in commercial matters. This may not always be evident in jurisdictions where the decision of a public agency will need to be taken to a court having administrative jurisdiction for appeal.

▪ In both cases, it is essential that the appeal against the confirmation not suspend the efficacy of the plan. Naturally, the competent judge should have the possibility to adopt cautionary measures, but the general effects of the plan should not be withheld unless there are very sound reasons for it.

4.4. Content and different types of plan confirmation

As stated above, the benefits of plan confirmation would seem to clearly outweigh its disadvantages, and, in those countries where said disadvantages are likely to pose a real problem, it is easier to take action to reduce them rather than it would be to find a substitute for the benefits of confirmation. This section therefore takes the need for some type of confirmation as a starting point, at least whenever the agreement is protected from ex post avoidance actions or it binds third parties. There are different possible models and types of confirmation. We shall briefly consider the most common scenarios.

But before laying out the different scenarios, brief consideration should be given to the scope of confirmation, which is something that affects all models. *The confirming body would need to focus on three different sets of issues that are part of the plan:*

(i) **The general formal legal requirements.** This would consist in ensuring that formalities have been met: as applicable, the issuance of mandatory expert reports, the intervention of a notary public, notifications to all relevant parties, the use of mandatory templates for MSMEs, etc. This is the most basic part of the judicial/administrative control, which in some instances can even be conducted mainly by court officials.

(ii) **The consent of creditors.** This would refer to controlling compliance with the material aspects of the formation of consent by creditors. Of course, this would include checking that the necessary majorities have been reached, but also more complicated aspects, such as the adequate formation of voting classes or even the determination of participants, when the agreement is one of a kind limited to certain creditors. The formation of classes may be predetermined by the law or, with some legal limits, it can be freely determined by the debtor

with a view to increase the chances of approval and to tailor the plan to the needs of the different groups of creditors. This last model, which adds flexibility to the system, has created problems of litigation. For example, it is noteworthy that in the UK the schemes of arrangement envisaged two court confirmations, the first one for the formation of classes. While this has proved helpful in large, complex cases (schemes of arrangement often concern this type of cases), it would seem unjustified in smaller entities and in jurisdictions with less efficient court systems. While it may increase clarity, it would be at the high cost of a lengthy delay of the process, in a situation when time is of the essence.²¹

(iii) **The material content of the plan.** By this, we refer to the control over the viability and feasibility of the plan, of its potential to be realised/implemented in practice. This is one of the most controversial aspects of confirmation, since, by definition, the **successful** implementation of a plan is uncertain and implies the assumption of a new risk, a risk that has been voluntarily accepted by a majority of creditors. The analysis of the proposal and its context by a judge or an administrative body with a view to confirm or reject its conclusion entails a substitution of the will of private parties that should be handled with care. In reality, the issue boils down to answering the following question: what degree of discretion should the court/agency have when deciding to confirm or reject a previously agreed plan? This is not the right place to have a full discussion about a classic debate of insolvency law, so this report only purports to express what has been identified as best practice, stemming from the research conducted.

The scope of this project is the analysis of several EU jurisdictions, which share with the rest of the Member States a market economy model. In this context, the decisions of stakeholders freely adopted with an adequate level of information available should, as a matter of principle, be respected. A financially distressed debtor and

²¹ As stated earlier in this chapter, certain jurisdictions have restructuring tools limited to ‘financial creditors’ (for Spain, homologated refinancing proceedings named *acreedores financieros*; for Italy, there is a special type of court-confirmed restructuring agreement limited to financial creditors, provided under Art. 182-septies of the Italian Insolvency Act). The determination of what constitutes a financial creditor has proven controversial and, particularly in Spain, has been mentioned in the context of qualitative interviews as one of the most common grounds of complaint by the stakeholders commonly involved in this sort of out-of-court procedure.

the existence of a collective procedure are not ordinary situations, which can always be left entirely to the parties (and to the law). A restructuring plan, which changes the business, produces the effect of protecting the transactions implementing the plan from the risk of ex post avoidance actions, and binds on some dissenting/non-participating creditors, can have important effects on third parties (including, especially, creditors not directly affected by the plan, and even future creditors – involuntary and non-adjusting – of the distressed debtor). This situation is tackled by the control of the court/agency, which should ensure that the process leading to the plan has been correct and compliant with legal requirements, that the content of the plan meets the requirements envisaged to protect affected and participating creditors, and that the plan is objectively ‘feasible’. It is with respect to this third type of assessment that discretion ought to be limited. A court/agency will not always be in the best position to make such assessment. And, even if it were, it would be unjustified, generally, for the judge/agency to substitute the will of the parties. Voting in favour of a plan implies – almost inevitably – a change in the risk level of creditors. This change of risk has been willingly accepted and no confirming authority can replace a decision voluntarily adopted by the ‘owners’ of their rights over the claims against the debtor. The confirmation would thus be granted to *protect those who did not participate, or those who objected by voting against* said risk-level change. But this must surely have a limit. A minority (dissenting creditors) cannot possibly impose its will on a majority, a majority that, in many countries, implies a high percentage of the outstanding liabilities.²² And creditors not bound by the plan should generally suffer no damage, since their debts will be fully repaid in case of plan implementation. Their risk is therefore limited to the damage they would suffer if the plan cannot be effectively implemented and the above-mentioned effects of the plan cannot be reversed.

Both the interests of minority participating/bound creditors and non-bound creditors deserve protection, but it must be balanced against the objective informed decision of the rest of creditors. In light

²² In some countries, a majority of 75% is required (e.g. Spain; Italy, with respect to out-of-court agreements with financial creditors); in others, a majority of 50%+1 of the amount of the claims plus a majority of heads (Germany); in others, a simple majority of 50%+1 of the amount of the claims (formal insolvency proceedings in Italy).

of this, the discretion of the confirming authority must be limited to ensuring there is no misuse of the plan. We take it to conform to the standard by which the judicial or administrative authority should override the decision of a majority of creditors, hence rejecting a plan on its merits (more precisely, based on its lack of ‘feasibility’) when it would be obvious to a market participant in the sector of activity of the debtor using a minimum basic commercial diligence that it could not be successfully implemented. Finally, it should be underlined that excessive judicial/administrative discretion would lower predictability, damage legal certainty, and undermine the use of the system.²³

The content of the plan must also be controlled concerning the treatment of affected creditors. Especially in out of court restructuring agreements, some creditors may be treated differently than similar creditors, or be asked to assume a sacrifice that could be deemed unjustified. If the judge finds this to be the case, the plan should not be confirmed. In most models, however, the control of this sort of illegality is handled ex post, by means of an ex parte appeal against the plan confirmation. From an efficiency point of view, it is arguably more reasonable to have this control ex post, since the affected parties are those who may identify the mistreatment incurring lower transaction costs. This topic will be further covered in the next section.

²³ This is consistent with the result obtained in Spain, where stakeholders showed more concern with the low predictability of the system than with the risk of abusive behaviour by the debtor and its main creditors (i.e. non-minority creditors).

The research in Spain, however, did show some concern about possible abuse by the majority creditors in very large restructurings. In particular, foreign investment funds that had acquired large packages of distressed debt but which were nevertheless minority creditors complained that Spanish banks (the majority creditors) accepted ‘objectively unfeasible’ plans for what they labelled as ‘political’ reasons (see the National Report on Spain, available at www.codire.eu). It must be said that these complaints were not supported by the courts. It is interesting to observe that financial creditors can have very different profiles and their interests are not always aligned. While distressed funds will often seek to make a quick profit, banks may want to make an effort to continue business with a repeat client. Furthermore, it seems reasonable to believe that, at least in the largest cases (*Abengoa*, *FCC*, etc.), banks valued the negative reputational consequences that expressing dissent on the plan would have created. Is this unfair? Should the system deal with this?

Finally, confirmation will also be the procedural act to consider a cram down of dissenting creditors and classes of creditors. The intricacies of this are analysed elsewhere in this report.²⁴

Taking the foregoing into consideration, the possible scenarios for a confirmation of a restructuring plan would be the following:

▪ **Scenario I. Mandatory confirmation with control ex ante.**

According to this scenario, the debtor – or, less often, creditors – would file a request for confirmation of a previously agreed-upon restructuring plan by the requisite majorities. The request for confirmation should include not only the formal petition with the plan and its annexes, but also any valuation of the plan drafted by experts (independent or *ex parte*). According to this scheme, the court/agency will conduct a full analysis of the plan. This includes: (i) checking that all formal legal requirements are met; and (ii) an analysis of the merits, including an assessment of the viability of the plan. This scenario has two possible models, depending on when dissenting parties can make allegations. In the more common model, the time between the request for confirmation and the issuance of a decision is short (e.g. 10 days for Spain), and there is no possibility for anyone to provide documents or allege arguments, a possibility which would only exist in an *ex post* appeal against the decision to confirm the plan. Alternatively, a procedure may allow the parties to provide information during the time leading to the confirmation or rejection of the plan, facilitating the decision-making process of the relevant authority (see also Art. 10(4) of the Directive, which requires a decision to be handed down in 30 days from the filing of the request).²⁵ As stated, the latter model could enrich a decision that has to be adopted on the merits, but it may also delay the procedure (if more information is available, the judge/agency may need more time to decide). In any case, either model should allow the parties to challenge the decision. The appeal, which should be made to the upper court, *should not suspend the implementation of the plan*, without prejudice to the possibility of the relevant court ordering cautionary measures. Said cautionary measures ought to be limited and affect only the part of the plan that would cause damage that could not be repaired (or that would be too costly to repair). Our

²⁴ See Chapter 2, par. 9.

²⁵ E.g., in Italy creditors have 30 days to object to confirmation and the court usually decides within a few weeks from the expiration of the deadline for objections.

research shows that long periods of suspension of the effects of the plan cause severe damage to the credibility of the system.

▪ **Scenario II. Mandatory confirmation with control ex post.** This model seeks to speed the decision-making process by including a light initial control and leaving the analysis on the merits for an ex post appeal against the plan. This type of model relies heavily on the idea that the process leading to the agreement already incorporates sufficient controls and mechanisms to ensure that participating parties are well protected, and hence that litigation (appeals against the confirmation) will be rare. Naturally, this idea will be more convincing the higher the majorities required to approve a plan and the more information is mandatorily incorporated in the process (e.g. mandatory experts' reports). According to this scenario, the debtor (or creditors) will request the confirmation of the plan that has already been agreed upon with the required majorities. The court/agency will only conduct a simple check on the merits (mere objective appearance of 'feasibility') as well as a thorough control of compliance with the legal requirements (formal requirements, majorities, etc.). Obviously the decision may be subject to appeal by non-participating or dissenting creditors. It is in the appeal that the competent judge will make a decision on the merits of the plan, including on its 'feasibility'. Creditors may also challenge any of the formal and legal requirements of the process, which had already been checked by the first instance judge or by the administrative agency. In this case, the lack of initial control of the merits of the plan advises caution with regard to the immediate implementation of the agreement. While there is still no reason to delay its full efficacy until the appeal has been resolved, the admission of the appeal for consideration could include an initial suspension of some of the parts of the plan. This ought to be decided by the competent court upon acceptance of the case.

▪ **Scenario III. Potential confirmation.** According to this scenario, confirmation would be the automatic consequence of the passage of a period of time: if no one requests a judicial/administrative control or challenges the confirmation (depending on the model), the plan would be deemed confirmed after a certain period of time has expired. This model system would have two aims: on the one hand, it would seek to reduce court intervention, streamlining the process and reducing the burden of the relevant institutional framework; on the other hand, it would seek active participation by creditors, often too passive when it comes to

restructuring proceedings, with special regard to micro and small businesses. As mentioned in Chapter 5, passivity may also be tackled by excluding non-participating creditors from the calculation of the required majorities and, in certain cases, introducing a ‘deemed consent’ rule. When the law provides for a ‘deemed consent’ rule, the legislature ought to be careful in introducing also a ‘potential confirmation’ rule; combining the two rules might be inadvisable. In any case, confirmation attained by the passage of time should also be subject to possible appeal by dissenting/non-participating creditors, possibly on more limited grounds pertaining to the fact that their rights may be prejudiced. The fact that they did not act promptly cannot be considered in all cases a sufficient argument to deprive them of *every* right to appeal.

In this case, the deciding judge would be the one competent to confirm (not the upper court), acting in first instance.²⁶ It must be noted that in some cases (especially in larger cases, where potential confirmation would seem less appropriate), new financing will be provided. In many systems, new financing is protected *ex post* by the insolvency of the debtor. This would immediately affect the risk levels of all creditors, including those that are – on paper – not to be affected by the plan. In these cases, all creditors should be allowed to request confirmation, even if for limited causes.

The effects of the confirmation of the plan are its immediate application and the substitution of any legal effects on the debtor and creditors by those foreseen in the plan (primarily, the rescheduling and/or the writing down of the claims). The rejection of the plan usually means the end of the regulated procedure and most, though not necessarily all, legal effects it may have generated,²⁷ although in

²⁶ An alternative would be to allow dissenting/non-participating creditors to request a confirmation during a period envisaged in the law. In this case, the petitioning creditor could add documents, reports and other elements of probation to the case. Naturally, even in this case – and consistent with previous scenarios – creditors could challenge the confirmation, but this time to the upper court. However, it is less evident if duly notified creditors, who were given the chance to request a confirmation and did not should be allowed to appeal against the automatic confirmation attained by the passage of time. If allowed, the law could limit the reasons for appeal.

²⁷ There are certain effects that should be preserved notwithstanding the rejection of the plan by the competent court, e.g. the protection from avoidance of interim financing extended in good faith for the purpose of making it possible for the

some cases the parties may reformulate the plan. The court's refusal to confirm the plan most often leads to the opening of formal in-court insolvency proceedings (if the debtor is insolvent) or, in some cases, to the commencement of liquidation.²⁸

4.5. Appeals against the decision to confirm or reject the confirmation of the plan

As it transpires from the previous sections, the possibility of an appeal against the decision to uphold or reject the petition for confirmation of the plan is included in most systems and it is in accordance with best practices. In fact, depriving the parties generally of the possibility to appeal may create issues of constitutionality in some jurisdictions.²⁹ In most cases, the upper court will be competent to decide on the appeal. This may, however, not be the case when there has been a confirmation following a mere control of formal requirements, or when the initial decision has been adopted by an administrative agency, when the appeal can be decided by the first instance court. Whether functional jurisdiction will be attributed to the commercial court (i.e. the civil court that would be competent to open formal insolvency proceedings over a given debtor) or to an administrative court is to be decided by the law on jurisdiction of each country. However, if the solution is the latter, it would be advisable to assign the appeal to a court that has some expertise on commercial or economic matters (or, at least, this competence should be clustered in one or very few first instance administrative courts, so that, thanks to a critical mass of cases, they can gain experience).

debtor to keep the business as a going concern while negotiating the restructuring agreement.

²⁸ The introduction of a rule providing for the automatic initiation of liquidation in case of failure of out-of-court regulated restructuring proceedings was widely regarded as having strong negative consequences in Spain. This rule was in force until 2015 for the special out-of-court procedure for MSMEs (*Acuerdo Extrajudicial de Pagos*). As a consequence of this rule, the procedure was hardly ever used, since debtors would not want to risk going straight to liquidation. The rule has been changed since then.

²⁹ Although this is not necessarily the case in every jurisdiction. According to the European Charter of Human Rights, a second instance is only strictly necessary in criminal cases.

The decision should be adopted in a quick procedure. Restructuring operations deal poorly with long periods of uncertainty: reputation is eroded, financing becomes increasingly difficult and new projects are withheld. Moreover, as a general rule it is essential for the correct operation of the system that the appeal not have the effect of suspending the implementation of the plan. In order to protect the interests of those whose rights could be damaged by the implementation of the plan, it should be sufficient to provide the court (the confirming court or the upper court, depending on the procedural system existing in the jurisdiction) with the possibility to limit the implementation to only some of the items envisaged in the plan or to apply certain cautionary measures. An overall freezing of the plan should be exceptional and based on very clear grounds.

In most systems, the plan may be challenged based on the same causes that were listed above as the topics to be reviewed by the confirming judge/agency. In those jurisdictions where the initial confirmation has been merely formal, and there has not been a thorough analysis of the content based on the merits of the ‘feasibility’ of the plan, the appeal should review this topic in detail. Absent clear cases of abuse (which, in most situations, will not have escaped the control of the first judge/agency), the review of the ‘feasibility’ need not be as thorough when the control had already been conducted in first instance (a limit in the revision of the judgement concerning the valuation of facts is consistent with many procedural systems). An appeal against the confirmation may be filed based on what the dissenting/non-participating creditor considers an unjust treatment of its contractual or proprietary right. Not uncommonly, the laws use undefined legal concepts to justify the appeal: for example, the expression ‘disproportionate sacrifice’ applicable in Spanish Law, or ‘unfair prejudice’ used by the Directive proposal. While these expressions may be dealt with appropriately in jurisdictions with a high level of judicial expertise, they may create uncertainty in others, where the judges do not have such a high technical level of expertise. In the latter cases, some legislative help in clarifying those concepts might be the better option.³⁰

³⁰ Even in jurisdictions where the technical level and the experience of the judiciary having jurisdiction over these matters is adequate, stakeholders complain about the concept being too vague and hence the resulting lack of predictability. This is the case of Spain, where – after a rather intense application of the system – there is still lack of clarity as to what constitutes a ‘disproportionate sacrifice’ of creditors.

The system should clearly regulate the effects of a ruling in favour of an appeal. There is little controversy when the confirmation is reversed due to the breach of a legal requirement, the mistaken counting of majorities or the evident, objective impossibility of implementing the plan: the implementation is cancelled, its foreseen effects disallowed and effects that had already taken place may be reversed insofar as this is still possible, without prejudice to the protection of good-faith third parties. In other words, the agreement falls for every creditor. But the scope of the effects of a successful appeal that affects only one or more litigants is less clear and may give rise to problems of uncertainty.³¹ This would be the case, for example, when the Court accepts that a creditor or a group of creditors have been inflicted a ‘disproportionate sacrifice’, as in the Spanish system, or that the best-interest of creditors test is not met with regards to one creditor or one class of creditors.

In many cases, this will call the feasibility of the whole plan into question, in particular where a major creditor or a large number of creditors are (potentially) affected. In this scenario, the entire plan should be cancelled (*rebus sic stantibus*). To avoid this consequence, the plan can provide for sufficient reserves to cope with adverse contingencies (see Chapter 4), of which challenges by creditors are an example. The law may provide³² that, in the absence of such reserves, the court has to reject or cancel the entire plan outright, or it may allow the judge the discretion to decide whether to cancel the entire plan or not, after having consulted with the participating creditors.

In case an appeal only concerns an individual stakeholder’s position under the plan and the feasibility of the plan is not called into doubt, a strict application of procedural tenets would restrict the effect of the court’s decision to the appellant (subjective scope of litigation), and the fruits of their litigation (= better treatment) would not be extended to other stakeholders in the same position. It cannot be argued validly that such a result would foster litigation (i.e. since the successful appeal only benefits the appellant, every stakeholder in the same position has an incentive to appeal), since – or rather, insofar as – basic procedural rules allow for the consolidation of identical actions, which would – should – be tried in one procedure and decided

³¹ This has been the case in Spain (see Spain’s National Report, available at www.codire.eu).

³² As it does, for example, in Germany.

in one court decision. It is true, though, that this would result in a situation of relative unfairness (identical stakeholders being treated differently), but stakeholders are free to appeal and should not be allowed to benefit from someone else's – costly – proactivity (*caveat creditor*).

Policy Recommendation #6.4 (Confirmation of the plan). A judicial or administrative confirmation of a plan is to be preferred when the law protects the agreement against avoidance actions, creates an ex post priority for new financing or binds dissenting or non-participating creditors. Confirmation may be issued by a judge or an administrative agency. Preference for one model or the other depends on the characteristics of the relevant jurisdiction. Confirmation should review (i) compliance with formal legal requirements, (ii) the adequacy of the consent from creditors leading to an approval of the plan, and (iii) the material content of the plan, including its objective viability. By approving a plan, a majority of creditors voluntarily assumes a new risk. While the judge/agency must protect minority creditors, it should refrain from assessing the adequacy of the risk assumed: only in *very clear* cases of non-viability of the plan should its confirmation be withheld. There may be different models of confirmation: mandatory confirmation with control ex ante or ex post, and even, in some cases, merely potential confirmation. The confirmation should be subject to appeal. The process to decide the appeal should be quick and simple, and the effects of the plan should not be withheld as a general rule, subject to cautionary measures when justified. In principle, a successful appeal concerning an individual stakeholder's treatment under the plan should only limit its effects to the appealing stakeholder, not to others in a similar or even identical situation. However, the court should have the possibility to cancel the plan when the new situation makes the plan no longer viable or the sacrifice demanded of the creditors is excessive.

CHAPTER VII

IMPLEMENTING AND MONITORING PLANS*

SUMMARY: 1. Introduction. – 2. Implementing the plan. – 2.1. Responsibility for implementing the plan. – 2.2. Change in board composition and retention of key employees. – 2.3. Directors and officers specifically appointed to implement the plan (CRO). – 2.4. Appointment of a professional with the task of realising assets. – 3. Monitoring the implementation of the plan. – 3.1. The importance of proper monitoring. – 3.2. Monitors. – 3.3. Monitoring devices. – 4. Reacting to non-implementation. – 4.1. Consequences of non-implementation: ‘Zombie plans’. – 4.2. Possible remedies for plans that are not fully implemented.

1. Introduction

The implementation phase follows the approval of the restructuring plan and its court confirmation, if the plan is subject to confirmation. The length and relevance of that phase is very different according to the terms of the plan: it is very compressed, indeed substantially absent, in case of restructuring plans providing an instantaneous implementation (i.e. setting forth actions to be implemented through the plan itself or just upon the plan approval/confirmation, such as the sale of the whole business to a third party identified in the plan). In other cases, the implementation and monitoring of the restructuring plan can take years, thus acquiring greater complexity.

In light of the above, the paragraphs below address the implementation and monitoring only of those plans that are

* *Although discussed in depth and shared by all the members of the Co.Di.Re. research team, paragraph 1 is authored by Diletta Lenzi, paragraph 2 is authored by Iacopo Donati (sub-paragraph 2.3 partially draws from a draft paper submitted by Annika Wolf), paragraphs 3 and 4 are authored by Andrea Zorzi.*

‘non-instantaneous’. In these cases, the law should always deal, among others, with the following issues:

(i) who is in charge of the plan implementation (e.g. person/body ordinarily in charge of running the business, the liquidator, or a chief restructuring officer);

(ii) whether the monitoring activity should be performed directly by the court or entrusted to an independent insolvency practitioner, to the creditors and/or another person/body (e.g. one or more directors, a board of statutory auditors, a professional appointed by the creditors);

(iii) who the person/body in charge of monitoring the implementation of the plan should report to (typically, to the court, to the debtor, and, when it is a company, to the board of directors, but very often also to the creditors), and what the consequences of a failure to comply with the terms of the plan are (e.g. forbearance, insolvency, or amending the plan directly by order of the court or upon the agreement of the debtor and its creditors);

(iv) what the reaction to the prolonged non-implementation of a restructuring plan should be.

Due to historical reasons, the rules concerning these issues are often not as effective as they could be. Insolvency law is generally more concerned with the debtor’s access to restructuring tools, the fairness of the procedure to obtain creditor approval and court confirmation of the plan, rather than with the implementation and monitoring phase. This phase, however, is important, and the empirical data show that significant problems emerge during the implementation phase.

In light of the above, provisions included in restructuring plans that set rules and criteria ensuring effective implementation and monitoring are to be regarded particularly favourably.¹

In any case, the provision of formal implementation and monitoring systems, either by contract or by law, should always consider the costs associated therewith. Considering this, the

¹ B. WESSELS, S. MADAUS, ‘Instrument of the European Law Institute - Rescue of Business in Insolvency Law’ (2017), p. 339. Such provisions ‘can either be contractual in nature (e.g. reporting duties under covenants) or make use of a specific statutory right to mandate the insolvency practitioner (or an independent auditor), supervise the debtor and alarm the creditors in case of wrongful actions or a negative development in order to allow them to initiate a plan modification or new (insolvency) proceedings’ (ibid.).

size of the restructured firm is a relevant aspect to be taken into account: in case of small firms, the benefits arising from an effective implementation and monitoring system may be easily outweighed by the expenses that would be incurred to put in place such systems.

2. Implementing the plan

The issue of adequate implementation of a restructuring plan is twofold:

- On the one hand, a successful implementation rests, to a large extent, on the meticulous drafting of the plan, particularly concerning the reasonableness of the measures and projections of their expected results as well as the provision of effective self-adjusting mechanisms;

- On the other hand, with respect to plans due to be executed over an extended period of time, the responsibility for their implementation must be clearly allocated.

The provisions to be included in the plan with a view to ensuring a proper implementation of the plan have been already addressed in Chapter 4, par. 5. The following paragraphs will focus on the second of the above-mentioned issues, namely the effective assignment of the responsibility for implementation.

2.1. Responsibility for implementing the plan

One of the defining features of most restructuring tools and proceedings outside formal insolvency proceedings is to leave the debtor in possession, possibly under the supervision of a judicial or administrative authority depending on the type of tool/procedure and according to the choices made by each legislature. In light of that characteristic, unless the plan is ‘instantaneously’ implemented (see par. 1), the responsibility for implementing the restructuring plan is ordinarily assigned to the person or body in charge of running the business (i.e. the entrepreneur in case of individual firms; directors and officers in case of companies).

Stakeholders, namely creditors, are clearly affected by the adequateness and timeliness of the plan’s implementation. The time and rate of their recovery is strictly dependent on the

ability to carry out the actions envisaged in the plan. However, given that the debtor is left in possession of the business while resorting to restructuring tools (cfr. Art. 5 of the draft Restructuring Directive), the creditors are not entrusted under the law with the power to directly implement the plan, possibly being granted only with monitoring rights and the possibility of triggering remedies in case of inadequate implementation (see *infra* par. 3).

In certain cases, it may be advisable to replace the members of the board of directors and the senior management and/or appoint someone specifically entrusted with the task of implementing the restructuring plan. The debtor and its creditors may always negotiate such measures in the plan, which may be deemed valuable in the perspective of those creditors required to consent to the plan (e.g. when creditors do not trust the management or the management lacks relevant skills and expertise required to implement the plan, or both).

However, imposing such measures by force of law – enacting what would unavoidably be a one-size-fits-all provision – may not be efficient, especially regarding the replacement of the debtor company’s directors and senior management that would most likely pose adverse incentives (see par. 2.2). It may instead be advisable, in certain cases, to enact legal provisions mandating the appointment of a person entrusted to realize the debtor’s assets, known as a ‘liquidator’ in some jurisdictions (see par. 2.4).

2.2. Change in board composition and retention of key employees

As mentioned, the plan may provide for changes in the board of directors and senior management of the debtor company. Such measures may be particularly beneficial in the perspective of the implementation of the restructuring plan, whenever the existing directors or managers do not have the skills or expertise required to successfully implement the plan. Even when directors and managers are skilled and experienced, it may well be the case that the creditors do not trust them anymore and thus make their consent to the restructuring plan conditional on their replacement, or they may not be in a sufficiently objective and independent position to carry out

properly what the plan requires (e.g. they may be bound by personal ties to redundant employees, they may have to fully disclose past transactions that turned out to be disadvantageous to the company).

In Italy there is empirical evidence showing that when the plan provides for the continuation of the business by the same company, the replacement of the board of directors is positively correlated with the likelihood of full implementation.² One of the possible reasons is that the appointment of new directors may contribute specific turnaround knowledge and ‘fresh eyes’ to the business, thereby facilitating the implementation of the measures envisaged in the plan. It should be noted, however, that in out-of-court restructurings, when the business is continued by the debtor (i.e. with no transfer of business), changes in the board happen quite rarely.

Although the plan provisions concerning the replacement of whole or part of the board of directors and senior management may entail the above-mentioned benefits, it appears inadvisable to mandate under the law the application of such measures for all companies’ restructurings. Such a general obligation may create adverse *ex ante* incentives for the directors and officers perceiving their dismissal as unavoidable, with the likely effect of delaying access to preventive restructuring measures.

To the contrary, it is important to retain the most skilled and knowledgeable employees in the business, who can contribute to the implementation of the restructuring plan, especially in the shorter term, when the survival of the business may depend on handling issues swiftly and neutralising threats (e.g. cash management, pending litigation, collecting receivables, preserving relationships with strategic suppliers and clients). For the purpose of retaining the company’s key employees, who are also those most likely to receive other employment offers, it is important to involve them in the plan negotiation soon and set adequate economic and moral

² In Italy, the replacement of the members of the board of directors seldom takes place, particularly with respect to MSMEs and family businesses. The replacement of whole or part of the top management is instead more common in medium-large Spanish businesses (especially the appointment of a new CFO). See the qualitative part of the Italian and Spanish empirical researches, published on the website www.codire.eu.

incentives for them to stay with the company (see Chapter 5, par. 4.2).

Policy Recommendation #7.1 (*Provisions on changes in board composition*). The law should permit restructuring plans to include provisions committing the company to carry out, as part of plan implementation, a change in the composition of the board of directors and/or the senior management team. However, there should not be any legal duty to include this sort of provisions in restructuring plans.

*2.3. Directors and officers specifically appointed to implement the plan (CRO)*³

The implementation of the restructuring plan may be delegated to a chief restructuring officer ('CRO') appointed with the specific goal of supporting the company in putting in place the measures envisaged by the restructuring plan. This officer may or may not be appointed as part of a wider change in the board composition and/or senior management team.

The appointment of a CRO yields significant benefits in a variety of circumstances. Of course the additional costs associated with the appointment of the CRO may be outweighed by the benefits of his or her activity only when the restructured business has a certain size.

The main benefits associated with the appointment of a CRO are the following.

First, the restructuring process requires significant time commitment. In certain cases, the time the management would be required to devote to the restructuring efforts could further slow down business activity and, ultimately, be the very reason for failing to implement the restructuring plan. The appointment of a CRO allows the management to remain focused on business strategy as well as the daily operations of the business, while the CRO leads the company through restructuring.

Second, even if management has time to devote to the restructuring process, it often lacks the necessary specific expertise. Therefore, hiring a CRO may be advisable when the

³ This sub-paragraph partially draws from a draft paper submitted by Annika Wolf specially for the present final report.

existing management team lacks the relevant turnaround knowledge.

Third, creditors may deem the company's directors and officers untrustworthy and not believe that they are able to undertake the restructuring with integrity and credibility. In such a circumstance, large creditors may condition their consent to the restructuring plan on the appointment of a CRO enjoying broad powers concerning the plan's implementation, thereby practically requiring the debtor company to appoint a CRO chosen by the creditors themselves.

Fourth, besides the knowledge brought by the CRO to the company, which may or may not already be part of the company's management expertise, the qualitative empirical evidence shows that one of the main benefits of hiring an external CRO is that he or she is not attached to the debtor's management team, thereby being more inclined to lead the company through whatever changes he or she deems necessary without having any emotional ties limiting his or her actions.⁴

CRO is usually a temporary position filled by a professional (most often a licensed trustee, insolvency practitioner, or a chartered insolvency and restructuring professional) retained by the debtor company, frequently upon determination by the financial creditors. Additionally, the CRO often has vast experience in accounting, finance, or law.

The CRO's compensation is determined according to the terms of his or her engagement letter with the debtor company. Compensation structures vary, and may provide for monthly salaries, hourly rates, daily fees or fees for services. Sometimes, the engagement letter may include a provision detailing a 'success fee', which is dependent on the letter's definition of 'success'. This could be based on a 'percentage of the...value of a transaction (sale or refinancing) or a portion of the

⁴ The CFO of a large Italian corporation that recently underwent a restructuring (name redacted for confidentiality) explained that although many companies may never want a CRO to step in as it signals financial difficulty, the CRO is often an invaluable resource to the debtor company for his/her 'fresh set of eyes' and expertise. The above result of our qualitative empirical research is in line with H. HENRICH, 'The Role of the CRO in Debtor/Lender Communications in Bankruptcy', (2004) 23(6) American Bankruptcy Institute Journal

improvement in financial performance the CRO is able to implement'.⁵

The role of the CRO is not defined under the law, being defined on a case-by-case basis by the parties, also through provisions included in the restructuring plan. Nevertheless, in most cases, *in the short term* the CRO is commonly required to acquire all relevant information on the company and the restructuring plan, focus on cash management, and address the organisation's current threats (e.g. closing down unprofitable business lines, handling outstanding or pending litigation). Tackling these short-term potential problems, thereby ensuring the short-term continuation of the debtor's business, is a crucial pre-condition to successfully implementing the plan. *In the medium to long term*, in light of the company's corporate goals, strengths, and weaknesses, the CRO should take formal control of the restructuring of the distressed company, particularly adopting the measures envisaged by the restructuring plan and, where needed, overcoming any resistance to internal change within the company (as may be the case when the existing management or employees, although formally complying with the restructuring plan, counteract the plan's implementation).

It is worth mentioning that the involvement of the CRO may also precede the approval (and confirmation) of the restructuring plan. A CRO may be appointed, as is commonly the case in Germany, with a mandate having a wider scope than the mere implementation of the plan, including also its conception and negotiation. In this regard, however, it is to be noted that the involvement of the CRO in the plan's drafting and negotiation may, on the one hand, be beneficial due to a greater knowledge of the company, which could help in the implementation phase; on the other hand, his or her previous involvement may sometimes interfere with his or her 'fresh view' while implementing the plan.

Guideline #7.1 (*Appointment of a CRO*). The appointment of a chief restructuring officer (CRO) in charge of implementing the restructuring plan is recommended

⁵ T. ONICH, 'The Chief Restructuring Officer: What Does He or She Do?' (2013), available at www.dailydac.com/commercialbankruptcy/alternatives/print-view/268 (accessed 24 June 2018), with reference to the possibility of granting to the CRO a compensation that is entirely success-based.

for all large business, whereas the additional costs of the appointment of a CRO may outweigh the benefits in the case of small businesses.

2.4. Appointment of a professional with the task of realising assets

When the restructuring plan provides for the sale of all or part of the debtor's assets (e.g. the sale of the entire business as a going concern), the responsibility for implementing the plan (or the part thereof envisaging the realisation of the assets) may be allocated to an insolvency practitioner or another professional acting on a specific mandate.

The appointment of a professional with this task may be either mandated by the law, which may entitle the court or the creditors to appoint him or her, or envisaged in the plan.⁶

The first approach may make sense when the plan provides for the sale of all the assets or a major part of them. If the sale of the assets is the main measure envisaged by the plan, the debtor (i.e. the person or body ordinarily in charge of running the business) would have no or limited interest in maximising value in the interest of creditors, particularly when the debtor may enjoy limited liability or a second chance. The choice of the professional to be appointed should be given primarily to creditors (possibly, with the court sanctioning their choice), and, should the creditors not exercise their power, to the court.

In all other cases, the second approach, leaving the decision on whether to appoint a professional with the specific task of realising the debtor's assets to the plan, seems superior. The appointment of such a professional entails additional costs. When there is no risk of the debtor's lack of interest in the plan's implementation, it is reasonable to leave the decision on whether his or her appointment is a value-creating measure to the bargaining between the debtor and creditors. This

⁶ Under Italian law, the court appoints a professional acting in the interest of creditors as a liquidator when the in-court restructuring plan (*'concordato preventivo'*) envisages the sale of the debtor's assets. In Germany, the implementation of an insolvency plan (*'Insolvenzplan'*) rests with the debtor; the debtor regains full control over assets not already realised by the insolvency practitioner during the (preceding) actual insolvency proceeding and, e.g., not placed in trust by the plan.

assessment is evidently strictly dependent on the market value of the assets to be sold and their marketability: The higher the market value and the lower the marketability, the more urgent the need for a professional having the specific task of realizing the debtor's assets acting in the best interest of the creditors.

Guideline #7.2 (*Appointment of a professional to realise assets*). When the restructuring plan envisages the sale of certain assets having a relevant economic value, particularly when such assets are not easily marketable, the plan should consider granting the creditors the right to appoint a professional entrusted with the task of selling the assets in the best interest of creditors.

Policy Recommendation #7.2 (*Appointment of a professional to realise assets*). The law should provide for the appointment of a professional entrusted with the task of implementing the plan concerning the sale of the debtor's assets in the best interest of creditors, when the plan is completely or prevalently based on the realisation of the debtor's assets. The creditors should have the right to choose the liquidator.

3. Monitoring the implementation of the plan

3.1. The importance of proper monitoring

Plans are often complex and include many different measures, some of which are planned to take effect immediately upon execution of the plan (or its confirmation), and others that occur later. As time goes by, the debtor and creditors may lose focus on the implementation of the plan and this may cause it to stall. Empirical evidence from some jurisdictions (Italy in particular) suggests that a strikingly high percentage of plans are not implemented in full.⁷ The degree of incompleteness is not

⁷ The data collected in Italy on judicial composition with creditors ('*concordato preventivo*') show that only a minority of confirmed plans (including purely liquidating plans) are timely implemented, and some will reach full implementation well after the envisaged implementation deadline. See the Italian empirical research, published on the website www.codire.eu.

usually registered, however, so data could capture both cases in which implementation is almost complete and cases in which it has just started, and even cases, which anecdotal evidence shows exist, where even the main planned undertaking has not been implemented. Adequate monitoring and, in some cases, reaction to such lack of implementation is very important to avoid this phenomenon (see par. 4.1 for some possible explanations and par. 4.2 for the reasons why unfulfilled plans are not commendable).

3.2. Monitors

The plan is usually implemented by the debtor and, when the debtor is a company, by its directors and officers. Besides carrying out the actions required under the plan to, the debtor is also the first monitor of the implementation of the plan. It is in the interest of the debtor to check whether the assumptions of the plan prove to be correct and the prospected events have actually taken place or appear to be taking place in due course. Thus, managing directors and officers of the debtor certainly have a duty towards the debtor to monitor the implementation of the plan. Such duty may also lie with auditors or independent directors, depending on the governance system adopted by the debtor.

While directors and officers have an interest in continued and attentive monitoring, however, they have no interest in sharing this information with the creditors, or at least they may want to be selective in disclosing the degree of implementation and possible critical issues. In some cases, for example, some problem in implementation, even involuntary, may be a breach of a covenant, and debtors may not want to reveal this to creditors because they fear that creditors may not want to waive the breach.

Auditors and independent directors may have better incentives to take steps *vis-à-vis* problems in plan implementation. However, all these gatekeepers face the well-known issues of, for example, lack of independence, or lack of immediate information, etc., issues which are here enhanced by the fact that the main disciplining factor towards creditors may be liability, whereas appointment rights still lie with the debtor or its shareholders.

Therefore, in order to adequately protect the interests of creditors it is important to include them in the monitoring process. Of course, direct monitoring by the individual creditor, although possible, faces significant hurdles (time, costs, access to information) and is subject to ‘classical’ collective action problems, insofar as each monitoring creditor bears the full cost but only partially seizes the benefits. It is therefore assumed that some form of ‘collectivised’ monitoring is efficient, at least to the end of the generation of adequate information (for possible reaction measures, see par. 4.2).

There are various ways to involve and protect creditors in the monitoring of the implementation of the plan.

The main instrument for creditor monitoring could be the appointment of an *ad hoc* creditor committee or a creditor representative monitoring the implementation, providing timely information to creditors, and interacting with the debtor on behalf of the creditors.⁸ This form of ‘direct’ monitoring requires that there are sufficient incentives to perform this task, which will largely depend on the size of the debtor’s business.

A voluntary system based on provisions of, and appointments in, the plan may work very well when the plan only affects consenting creditors. However, the same system may prove deficient when the plan has been crammed down on some creditors. Since non-consenting creditors did not participate in the appointment of the monitors, they cannot trust them to assert their interests, exactly as creditors in general cannot trust the debtor in the monitoring of the plan.

Therefore, when the plan has an effect on non-consenting creditors, a fully independent monitor should be appointed. The monitor could be an independent expert appointed by the court or by an administrative authority or, perhaps and depending on the case, an organisation of experts or similar. Monitors should be experts, such as insolvency practitioners, in order to understand not only the business developments, but also the insolvency law implications of possible issues in implementation.

⁸ The empirical research conducted in Spain shows that the appointment of a steering committee (a body comprised of representatives from the financial creditors entrusted with the role of controlling the fulfilment of the agreement, among other functions) is extremely rare (less than 3% of the approved refinancing agreements).

Since many national laws already provide for the protection of transactions carried out to further the implementation of a restructuring plan (see also Art. 17 of the draft Restructuring Directive) and for new financing, including exemption from civil, administrative and criminal liability (Art. 16 of the draft Restructuring Directive), one could argue that, in all cases in which there are non-consenting creditors, even if the plan provides for their full repayment, these could have an interest in adequate monitoring. The consequence is that a creditor-appointed committee could never be sufficiently independent, even if there was no cram down, because the plan also has effects that go beyond cram down (the mentioned safe harbours).

It is reasonable, however, to distinguish between direct effects on creditors' rights (cram down on dissenting creditors) and indirect effects that occur as a consequence of the protection afforded to certain transactions. The draft Restructuring Directive itself shows there is a difference between measures that directly affect creditors (cram down and stay on enforcement actions) and measures that only indirectly affect them (all the other measures) when it provides that an insolvency practitioner must be appointed when there is a stay or cross-class cram down (Art. 5) and plans must be confirmed by the court or an administrative authority when the plan affects the interests of dissenting creditors or provides for new financing (Art. 10). As a general rule, therefore, one could argue that an independent monitor should be appointed when the plan directly affects dissenting creditors' claims.

Guideline #7.3 (Monitoring in case of plans affecting only consenting creditors). Plans should provide for proper creditor monitoring, with a view to triggering the actions and remedies that the plan or the applicable law envisage in case of non-performance.

Guideline #7.4 (Monitoring in case of plans affecting non-consenting creditors). When the plan has an effect on dissenting creditors' rights and the law does not provide for appropriate monitoring devices [see Policy Recommendation #7.3], the plan should provide for proper independent monitoring.

Policy Recommendation #7.3 (Monitoring in case of plans affecting non-consenting creditors). The law should provide for proper monitoring, at least with regard to plans that affect the rights of dissenting creditors, to ensure that non-performance does not go undetected due to the lack of incentives or means for creditors to monitor the implementation of the plan.

3.3. Monitoring devices

Monitoring implementation requires, first of all, an independent (and expert) monitor (see par. 3.2). Monitoring can be made easier in various ways, such as by setting milestones and thresholds. In some cases, however, the issue is not only to detect implementation issues, but to make sure that the debtor takes adequate steps to get back on track when the plan is lagging behind. Not always is it possible to rely on creditors' reaction, both because of collective action problems (see par. 4.2) and because creditors could have no interest in reacting, although there may be a public interest in not leaving plans unimplemented (see par. 3.1); and the debtor may not be a proper monitor of its own plan – at least with regard to third parties' interests.

Therefore, a case may be made for providing for a default mechanism that shifts the burden of action from the creditors (or the monitor) to the debtor. The plan or, more likely, the law could set a specific term to implement the plan and require the debtor or any other interested party to file for an extension in order to avoid the plan coming to a halt. The law could provide increasing requirements for the extension of the plan, at least when the request comes from the debtor. This kind of mechanism is common and is used also by the draft Restructuring Directive for extensions of the stay on enforcement actions (see Art. 6 par. 4-6).

4. Reacting to non-implementation

4.1. Consequences of non-implementation: 'Zombie plans'

The empirical data show that a significant part of restructuring plans does not perform as expected, as mentioned above.⁹ In some cases it is only a matter of delay, in others it is a matter of results, in many cases it is both, i.e. plans are not implemented within the projected timeframe *and* do not yield the expected results.

This may lead to different consequences. First, the plan may have built-in mechanisms to deal with non-performance, i.e. the plan is to a certain extent self-adjusting. For instance, the plan may contain contractual clauses by which creditors have accepted *ex ante* the result of a best-effort liquidation of specific assets, whatever such results are, or clauses by which creditors' claims are automatically reduced if for objective reasons the business performs worse than expected. These mechanisms are typical of well-drafted and high-quality plans (see Chapter 4), and, being the product of the negotiation between the debtor and the creditors, they must in principle be observed.

Second, the debtor or the creditors may take the initiative to renegotiate the plan to cope with the circumstances at hand. Repeated restructuring is frequent, particularly in Italy. On the one hand, this phenomenon appears to be the product of optimism and reluctance to fully acknowledge the extent of the losses incurred or of the impossibility to obtain the proper write-offs from creditors (see Chapter 4, par. 4.5, on the importance of realistic cash flow projections). On the other hand, renegotiation is facilitated by the fact that the parties involved have acquired significant information and, especially for the debtor, have acquired skills that debtors rarely possess in normal circumstances. However, there might be a problem of distrust in the new plan if the management does not change. In case of renegotiation, a new plan will have to be drafted, agreed-upon and confirmed, according to the rules that are applicable in the new setting (e.g. a fully consensual plan may end up in a plan that requires judicial confirmation). If this happens, the non-performance will be cured. Given the fact that

⁹ See footnote *supra* 7.

renegotiating a plan entails costs, legislators may consider giving the court or an independent monitor, at least for minor failures to comply with the plan terms, the power to amend the plan according to what appears to be in the best interest of creditors.¹⁰

Third, the plan may – whether automatically by law or by a court order *ex officio* or at creditors’ request – be terminated and the creditors’ original claims reinstated, usually forcing the debtor into insolvency.¹¹

However, it does happen that plans simply linger in a non-implementation stage, with no initiative taken to amend or terminate them, or, if applicable, convert the cases into proper insolvency proceedings (‘zombie plans’). This may happen due to the cost that individual creditors must bear to acquire information on the debtor and the prospects of the plan being implemented, or to the awareness that proper insolvency proceedings cannot always lead to a better result for creditors. This is the very reason why it is advisable to provide for proper and effective monitoring of the plan implementation with a view to reduce the costs that creditors must bear in order to make informed decisions (see par. 3.2). Having said that, even

¹⁰ Only a few Member States provide for simplified modifications of the plan: see B. WESSELS, S. MADAUS, ‘Instrument of the European Law Institute - Rescue of Business in Insolvency Law’ (2017), p. 326: ‘In France and Poland, for instance, the court may adapt the plan to new circumstances upon request. In Greece, a plan cannot be amended after its judicial ratification in principle except that in recovery proceedings the agreement can be amended by the bankruptcy court, but only once, based on a subsequent agreement concluded by all the contracting parties and as long as specific conditions are met’.

Art. L626-26 of the French Commercial Code states: ‘Substantial modifications of the goals or means of the plan may be made only by the court, on motion of the debtor and based on the report of the plan performance supervisor. When the situation of the debtor permits a substantial modification of the plan to the advantage of creditors, the motion to the court may be filed by the plan performance supervisor... The court shall rule upon the case after having received the opinion of the Public prosecutor and after hearing or duly summoning the debtor, the plan performance supervisor, the controllers and representatives of the works council or, in the absence of a works council, the employee delegates and any interested party’.

¹¹ In Germany, an original claim is automatically reinstated by law if its creditor is not paid on time or with only a minor delay according to the terms provided under the plan (which in most cases is no more than two weeks from the moment when the debtor received a notice from the relevant creditor) or if a further insolvency proceeding is initiated. See sec. 255 InsO.

fully informed creditors may decide to remain passive for various reasons and tolerate a zombie plan.

Policy Recommendation #7.4 (*Amending and curing the plan during implementation*). The law should empower the court or the independent insolvency practitioner appointed to monitor the implementation of the plan with the authority to amend the plan, curing minor failures in its implementation in line with what appears to be the best interest of creditors. Such power should be exercised by the court or the independent insolvency practitioner after having acquired sufficient information from the parties.

4.2. Possible remedies for plans that are not fully implemented

One might wonder whether the law should be concerned with zombie plans at all: If creditors do not react to non-implementation, why should anyone else? Although this is true in principle, a well-designed law should also be concerned with the reliability of the system, in the sense that a large number of plans that do not perform as expected may undermine public confidence in the restructuring process, therefore inducing creditors, *ex ante*, to be more sceptical even towards good candidates for restructuring.¹² Of course this is particularly relevant for repeat players, typically financial creditors, and less so for other kinds of creditors, such as trade creditors. However, the relevance for financial creditors is indeed enough to be very careful not to undermine the credibility of the debtors' commitment in restructuring frameworks. Many trade creditors, on the other hand, may not be *per se* repeat players, but they may have resorted to credit insurance, factoring, etc., thus transferring their credit management to repeat players.

¹² Out of concern for the problem of 'zombie plans', for instance, the Italian Court of Cassation ruled in 2017 that the debtor that has obtained confirmation of a *concordato preventivo* can be subjected to insolvency proceedings (on demand of the public prosecutor) without any previous court decision to terminate the plan (that requires a specific demand by a creditor) when the implementation of the plan has ceased or appears manifestly inadequate to satisfy the creditors (Court of Cassation, 11 December 2017, No. 29632).

Second, resources of the participants in the plan may remain tied up uselessly for a long time instead of being reinvested in other ventures. For example, one can imagine a restructuring process in which non-core assets are to be sold. If the liquidation part of the plan never materialises, these assets, while not going to the benefit of creditors, are not even available to the debtor.

Third, it should be noted that monitoring is important in the perspective of liability: continuing with the implementation of a plan that is no longer suitable to achieve the restructuring goals that were initially set may result in liability for the debtor and its directors and officers.

Further, the prolonged formal execution of the implementation phase, while no measures or initiatives are carried out, may nevertheless require some activities and generate costs (e.g. fulfilling reporting duties) that are not justified with respect to plans whose implementation will never take place.

As mentioned, there are historical reasons that explain why insolvency law tends to overlook the implementation and monitoring phase, while being very concerned about the debtor's access to restructuring tools, the fairness of the procedure to obtain creditor approval and court confirmation of the plan. Therefore, it should be appreciated that the plan provides for the right of the monitor, or of a creditors' representative, to initiate the termination of the plan, thereby fully reinstating creditors' rights, or anyway to take those actions that appear appropriate in the interests of the creditors. For instance, the plan may provide for the mandatory substitution of the board or the managers in case of significant differences between the plan and the actual results.

When there is a collective action problem, provisions along these lines might also be inserted in the law to ensure that the restructuring package that is negotiated by the parties is complete also with respect to the implementation phase. For example, the law could entrust the monitor or supervisor with the power to initiate remedies (including, as the case may be, the power to file for the insolvency of the debtor). Moreover, the legislators may consider whether its continuation should be conditional upon the determination expressed by the interested parties after a proper period of time without the complete implementation of the plan.

However, the law should avoid overkill. A mandatory provision that allows a creditor ‘representative’ such as an insolvency practitioner to file for debtor insolvency, etc. makes sense only once it is ascertained that creditors are not doing so themselves because they lack the incentive. When their passivity is rational also on a collective level, there must be a very strong case to allow an independent monitor (e.g. court-appointed insolvency practitioner) to file for insolvency when creditors have not.

Policy Recommendation #7.5 (*Power to initiate remedies*).

The law should give the monitor/supervisor the power to initiate remedies (including, as the case may be, the powers to move for the termination of the plan or to file for the insolvency of the debtor) or to provide for the automatic discontinuation of the plan after an appropriate period of non-implementation, unless an interested party moves for an extension.

Draft of 20 September 2018

CHAPTER VIII

SPECIAL CONSIDERATIONS FOR MICRO, SMALL, AND MEDIUM ENTERPRISES*

SUMMARY: 1. Introduction. – 1.1. The importance of the topic. – 1.2. The conclusions of the research concerning MSMEs. – 2. The need to implement a bespoke system for MSMEs. – 3. The main elements of the reform: a comprehensive approach aimed at introducing a cost-effective, flexible procedure. – 4. The procedural structure. – 4.1. The ‘core’ procedural solutions. – 4.2. The options available to the debtor. – 4.3. The options available to creditors. – 5. Encouraging timely use of the MSME regime. – 6. Measures concerning creditors.

1. Introduction

1.1. The importance of the topic

This report would not be complete without a specific reference to the financial and economic distress of micro, small, and the smaller medium enterprises (together referred to here as ‘MSMEs’). It is impossible to exaggerate the importance of MSMEs, which the European Commission describes as ‘the backbone of Europe’s economy’.¹ MSMEs represent over 99% of all businesses in the EU, provide two-thirds of all private sector employment, and in the five years to 2018 were responsible for 85% of all new jobs. Although several European

* *Although discussed in depth and shared by all the members of the Co.Di.Re. research team, this Chapter is authored by Ignacio Tirado, with help by Riz Mokal.*

¹ See https://ec.europa.eu/growth/smes_en (accessed 10 September 2018). The data included in the text in the remainder of this paragraph are from the same webpage. While the references on the webpage regard small and medium enterprises (‘SMEs’), the exclusion of micro businesses is probably erroneous and the point holds for MSMEs as a whole.

initiatives have focused on their particular needs, and even though the draft Restructuring Directive seems to underline their importance, neither previous legislative action nor the draft Restructuring Directive as it currently stands would provide adequate measures to tackle what arguably constitutes Europe's main problem in the realm of pre-insolvency and insolvency law.

1.2. The conclusions of the research concerning MSMEs

The research conducted in the different jurisdictions showed similar trends and led to comparable results. The main findings are the following:

- Micro and small entities rarely use formal insolvency proceedings voluntarily, and when they do it is almost inevitably too late to preserve value. This statement can be broken up into the following components: *(i)* the percentage of formal insolvency cases triggered by the filing of creditors is higher in case of micro and small businesses than in medium and large enterprises; *(ii)* when insolvency proceedings are commenced, the percentage of cases ending in liquidation is considerably higher for micro and small businesses than for the rest of businesses (well above 90%); and *(iii)* amongst those businesses ending in liquidation, the percentage of going concern sales tends to be very low for the smallest businesses. In other words, the vast majority of the entrepreneurs in the jurisdictions analysed use formal proceedings too late and end in value-destructive liquidation.

- The main reasons thought to explain the fact that small businesses do not use formal insolvency proceedings or use them very late in the spiral of distress and insolvency include the following: *(i)* in the vast majority of cases, micro and small debtors have very little knowledge of their legal position, seek legal advice too late, and, not infrequently, the advice received from legal and financial advisors is poor (arguably since debtors can only afford to pay very small fees they often retain inexperienced/technically unprepared professionals, or the latter have little incentive to prepare the case; or else the debtor resorts to its pre-distress accountants or other advisors who may not possess distress-specific expertise); *(ii)* financial information available is often poor, hindering early awareness

of the financial distress; (iii) the lack of adequate financial information also affects the ability of creditors to monitor the debtor; (iv) creditors may behave passively towards smaller debtors and/or may resort to individualistic debt collection rather than collective insolvency processes; and perhaps the most important factors that explain the late or lack of use of formal insolvency proceedings is that (v) most small businesses are family-run and family-based, constitute the family's only source of income, and the reputational stigma associated with formal insolvency proceedings remains significant.²

- Financial information often is poor, document keeping is weak, and hence the use of out-of-court workouts and bilateral refinancing agreements seeking to preserve the going concern value of a sound business is scarce. Sufficient, reliable information is key to solve problems early and informally, and its absence is a serious hindrance.³

- Frequently, the largest creditors of micro and small businesses are financial institutions and public creditors. The behaviour and legal position of these creditors have proven to be a problem in some of the jurisdictions. The following are the main reasons:

- *Financial institutions.* In most cases there are only one or two financial institutions involved. Although there is no unanimity in the responses collected in the different jurisdictions, the main problems caused by the behaviour of financial lenders with regard to micro and small businesses are: (i) some jurisdictions report a lack of proactivity by banks, that refuse – or at least delay the moment of – negotiating with their smaller debtors. However, other responses point in the opposite direction and report a tendency of banks to reschedule almost automatically, without a previous analysis of the viability of the business (creating the risk of ‘evergreening’); (ii) banks that do sit down to negotiate tend to limit the scope of the negotiation

² The results of the quantitative and qualitative research performed in the four jurisdictions (Germany, Italy, Spain, UK) provide extensive evidence of the fact that small businesses – family-run and/or family-based – do not use formal insolvency proceedings or use them very late. See the results of the empirical research, published on the website www.codire.eu. The reasons for this phenomenon were described in Chapter 1.

³ Smaller businesses often have an inadequate reporting system that hinders early detection of distress. The data emerge from several interviews of professionals assisting debtors and creditors. See the empirical research published on the website www.codire.eu.

to a rescheduling of the debt (write-downs are not an option), and request additional security rights or personal guarantees (Hobson's choice), without a previous assessment of the business's viability (this entails the loss of an initial moment where the bank may play the socially beneficial role of filtering and separating viable businesses from those that ought to be liquidated at a relatively early stage); (iii) not infrequently in some jurisdictions, banks have a slow decision-making process, and the internal allocation of tasks sometimes does not give the right incentives to restructure viable businesses.

– *Public creditors.* Public creditors are the largest creditor for many micro and small businesses, because the largest taxes are due annually (as opposed to the shorter term maturity of bank instalments or of supplies), debtors do not want to jeopardise the relationship with their commercial creditors, they try to avoid the triggering of security rights, and, most commonly, not paying the wages of the few employees is not considered an option unless absolutely necessary. Given this situation, public creditors tend to behave starkly, seizing assets and refusing to negotiate. In some jurisdictions, the negotiation – when existing – is legally limited to a refinancing of the debt (with a write down only permissible within formal insolvency proceedings). It has been found that it is often precisely a seizure by public creditors that pushes debtors to seek professional advice.⁴

▪ Somewhat surprisingly, a high number of interviewees in the different jurisdictions allege poor knowledge of the existence of out-of-court alternatives to formal insolvency proceedings in the micro and small business community. The lack of awareness of these alternatives drives debtors to procrastinate and ‘bargain for resurrection’.

⁴ In Spain, a jurisdiction where there is a specific out-of-court procedure for MSMEs, the privileged legal position of public creditors constitutes the main reason for the system's failure. Public creditors are left out of the automatic stay during the out-of-court negotiation period, which is a procedural privilege that allows them to seize assets of the debtor when other creditors cannot, often undermining any chance of success for the restructuring negotiations (since financial creditors refuse to provide new financing ‘to pay the taxes’ of the debtor).

In Italy, tax authorities seem to be cooperative in negotiations with large debtors, but not with smaller businesses. See the Italian empirical research, published on the website www.codire.eu.

2. The need to implement a bespoke system for MSMEs

The quantitative and qualitative importance of micro and small businesses in particular, as well as the negative scenario portrayed by the research conducted in the current insolvency and pre-insolvency systems, indicate the need for legislative and institutional action. The action would cover both out-of-court and in-court solutions, given the strong likelihood – higher than in larger businesses – that most micro entrepreneurs require a speedy and efficient liquidation, with very little going-concern value to rescue. The reform would also need to take into consideration the differences between legal entities and individual entrepreneurs, and address the issue of cross-over of business and personal insolvency.

The legislative action ought to be aimed at achieving cost-effective and timely proceedings to tackle the financial and economic distress of micro and small entrepreneurs. The following are good reasons to pursue a reform with these characteristics: *(i)* a quick procedure that allows for an efficient liquidation and a discharge would encourage early action by entrepreneurs and facilitate the exit of inefficient firms, freeing resources that can be put to better use in the market; *(ii)* the second chance provided to small debtors would enhance entrepreneurial activity, increasing the creation of businesses and allowing the return of – now, more experienced – entrepreneurs to the market; *(iii)* since many micro-businesses are run by sole entrepreneurs or by families, the new start would free public resources otherwise used for social purposes; *(iv)* financial creditors would have the opportunity to clean up their balance sheets and stop squandering resources on pursuing unrecoverable debts; *(v)* the market would generally benefit from an increase in transparency and a strengthening of legal certainty; *(vi)* in most cases – and this is one of the tenets of the reform – the new system would produce a greater return to creditors; and *(vii)*, not least important, a well-functioning system of MSME insolvency would help unclog court systems, freeing them from a large backlog of unresolved files.

Legislative action ought to follow a number of tenets and a basic common design, but it ought to be bespoke, adapted to the circumstances of each jurisdiction. While we have identified common elements in all jurisdictions concerning the problems of micro and small businesses in crisis, the legal and

institutional differences are paramount in some cases. Certainly, one size does not fit all in this matter. Disparate legal traditions, different types of security rights, diverse behaviour of financial and public creditors, the situation of the court infrastructure and the technical capabilities of judges and professionals should have an influence on the type of reform adopted by each jurisdiction.

Policy Recommendation #8.1 (*Specialised MSME regime*).

Each jurisdiction should promulgate a distress resolution and insolvency regime tailored to the particular needs of micro, small, and medium enterprises. Such a regime would respond to common characteristics of MSME businesses in distress including, in particular, (i) the lack of knowledge and understanding of the law by entrepreneurs who run such businesses; (ii) such entrepreneurs' undiversified investments, including non-market ones, in their business; (iii) the late commencement of insolvency processes; (iv) the paucity of resources in the business to pay for legal and financial advice; (v) weak recordkeeping and inadequate information; (vi) creditors with an insufficient individual stake in the business to justify monitoring of or constructive engagement with the business, or active participation in an insolvency process; and (vii) secured creditors' preference for individualistic debt enforcement over collective insolvency processes.

Policy Recommendation #8.2 (*Financial creditors' incentives*).

The regulatory and supervisory regimes applicable to institutional financial lenders should encourage lenders to engage constructively and timeously with MSME borrowers, to undertake proportionate and good faith analyses of the viability of distressed borrowers, and, where appropriate according to the circumstances, to enter into restructuring agreements that allow viable distressed borrowers to shed non-repayable liabilities and a chance to trade out of distress without weakening financial discipline or engendering moral hazard.

Policy Recommendation #8.3 (*Public creditors' powers and incentives*). Tax authorities and other public sector creditors should have the power and the incentives to participate in good faith restructuring efforts where they consider a distressed MSME borrower to be viable.

3. The main elements of the reform: a comprehensive approach aimed at introducing a cost-effective, flexible procedure

Traditional in-court insolvency proceedings are not designed with MSMEs in mind; at best, limited exceptions are envisaged for these debtors (shorter terms, smaller fees, etc.), but – as the survey shows – such *ad hoc* solutions do not seem to work. Systems are underused, too expensive, excessively rigid, and generally inefficient. The functioning of the institutional framework tends to be cumbersome when applied to the smallest debtors, frequently with very little value left: the ‘overhead’ costs of ordinary insolvency proceedings are too high to justify their use by MSMEs. Because of this, the treatment of MSME financial and economic distress needs *systematic reconsideration* with a view optimally to achieving the core objectives of all insolvency proceedings: maximisation of the value of the business and its assets, a fair distribution of the proceeds, accountability for wrongdoing of debtors/directors/shareholders, and the attainment of a discharge for honest debtors.

In order to achieve an efficient reform, we propose a new type of system for consideration, one that goes beyond the traditional division between in-court and out-of-court proceedings. *Flexibility* is the driving principle underlying the system proposed. Hence, the process may be fully out of court, or partially or fully in court depending on the decision of the parties in the given distress scenario (that is, the entrepreneur of a particular distressed MSME and that MSME’s creditors and other stakeholders) and a number of legal circumstances. Drawing from the lessons learned in a rich pool of different existing proceedings in the jurisdictions covered by the project and beyond, the bottom-up approach of the research has made it possible to identify the main and most effective procedural

elements. The proposal is to *unpack* those main elements traditionally available in restructuring and liquidation proceedings, leaving a core, default process. The parties in each case will then have the possibility to select any combination of the unpacked elements that adapts to the specific case, given the nature and type of debtor and assets, the causes of distress, and the perceived prospects for viability and rehabilitation of the business.⁵

In order for a reform that includes this approach to be effective, the following principles must be respected:

- *Party autonomy.* – The essential tenet underlying the system is that parties to a particular insolvency case are best placed to select the tools appropriate to that case. By making certain procedural measures and material legal effects of the procedure merely optional, the institutional burden is reduced and otherwise costly measures will be limited to situations where they are really necessary. Naturally, the application of this tenet entails the adoption of measures to improve the information available to the parties as well as some incentives for the parties to act (see below).

- *Proportionate institutional involvement.* – As mentioned above, the costs inherent in the use of the court system are usually too high in micro and small business insolvency. Similarly, the professional services of insolvency practitioners, mediators or professional counsellors bear a cost that will not infrequently outweigh the benefits generated by their involvement. In light of this, the reform should try to minimise institutional involvement to the extent possible: the court (or an administrative agency) should be regarded as a potential resource, to be used only when the parties so request and/or there may be concerns of protection of property and fundamental procedural rights. In line with this, private professionals are to be involved in a case when the parties expressly request it, and there are sufficient funds to cover their fees and expenses.

⁵ This scheme has been labelled the ‘Modular Approach’, with each of the different options as ‘modules’ to be selected by the parties. A thorough explanation of this approach can be found here: R. DAVIES, S. MADAUS, A. MAZZONI, I. MEVORACH, R. MOKAL, B. ROMAINE, J. SARRA, I. TIRADO, ‘Micro, Small and Medium Enterprise Insolvency. A Modular Approach’, Oxford, OUP, 2018. This chapter draws extensively from this work.

▪ *A holistic approach.* – The main deficiencies observed in MSME insolvency systems across Europe and beyond are wide-ranging. A reform that merely tackles the procedural issues of in-court proceedings would by no means be enough to solve the problem. The financial and/or economic distress of small businesses does not only constitute a collective action problem (like the insolvency of any other business), but also the clearest case of a market failure, where informational, organisational and social elements often fail. In EU jurisdictions it has been possible to identify problems of late action by the parties, creditor passivity, lack of adequate financial information, a shortage of interim and post-commencement financing and insufficient accountability of directors, only to mention some relevant aspects. All of them should be specifically addressed in the reform, if it is to be successful. Because of this, express measures affecting debtors, creditors and even professional lenders are proposed in the general package of reform.

Policy Recommendation #8.4 (*Principles guiding the specialised MSME regime*). The specialised MSME regime should respect the following principles:

(i) *party autonomy* – the parties to a given distress scenario together have the best information about the causes of the distress, whether the distressed debtor remains viable, and how best to address the distress;

(ii) *proportionate institutional involvement* – the consumption of resources and of time associated with the involvement of courts and other institutions and of legal and other professionals may not always be justified in MSME cases, and such involvement should occur if and to the extent that the parties to a particular case consider it to be justified; and,

(iii) *a holistic approach* – the MSME regime should address the particular needs of MSMEs in distress not only within but also beyond insolvency law in a systematic and holistic manner.

The following sections will first explain the proposed general procedural structure and then will list the main effects suggested for debtors (and directors) and creditors (including financial creditors) as well as measures concerning third parties.

4. The procedural structure

As stated above, a dual structure is proposed, composed by a core procedure with two possible outcomes (it may lead to liquidation or to a restructuring) and a number of optional measures, also differentiating between those available for debtors and those available for creditors. The flexibility does not only concern the options or mechanisms selected by the parties, but it also concerns legislators of the Member States: based on the specific characteristics of each jurisdiction, legislators may choose to leave out one or more of the options proposed below. The options are basic and should work in any Member State of the European Union, although choosing not to include in the reform the option for one or more mechanisms would not necessarily undermine the final outcome.

4.1 The 'core' procedural solutions

The core procedural solutions are (i) an expedient, in some cases automatic, *liquidation*, and (ii) *restructuring* proceedings, mainly with a debtor in possession.

(i) *Liquidation*. – The liquidation of the business is the default solution. This is easy to explain, looking at the numbers of the jurisdictions analysed, where piece-meal liquidations constitute the vast majority of cases. Arguably, the same would apply to every EU jurisdiction. The reform should aim to create an efficient, cost-effective liquidation procedure for non-viable micro and small businesses. The procedure ought to end in a discharge of the – honest – debtor, making it therefore attractive for entrepreneurs who seek a fresh start. Naturally, the liquidation may consist of a transfer of the business as a going concern (preferred solution), although this is likely to occur only in a few cases. Automatic liquidation will happen whenever the debtor is insolvent (although there is no need to prove insolvency upon petitioning for liquidation) and either no restructuring plan is presented by the debtor or one or more creditors, or a proposed plan is not approved by a sufficient majority. The opening of liquidation proceedings does not *per se* entail a stay of the creditors' remedies. It should be a possibility, only awarded whenever there is the appearance (with objective likelihood) of a possible going-concern sale of

the business, and it ought to be very limited in time. Having a general stay as a default, automatic, rule makes no sense in most insolvencies of micro-businesses where there are hardly any unencumbered assets. Making the stay only an option would likely reduce the time and the cost of proceedings in most jurisdictions and free the court system of many unnecessary cases. In line with this, a filing of claims would only be initiated if a distribution to one or more classes of creditors beyond secured creditors is probable. This relatively informal, ‘unpacked’, procedure may in some cases be abused by the debtor (or, more rarely, by creditors). Because of this, the system should include mechanisms to protect the basic rights of the parties involved (especially property rights and the – often constitutional – right to a fair trial). In particular, the reform ought to, first, include a cost-effective, proportional and efficacious system of notification to creditors. For this, email notification, the use of online platforms and other cost-free mechanisms should be explored. Furthermore, the parties should have the possibility to resort to the court for the protection of their property rights. This proposed system is based on the presumption that an honest entrepreneur that cooperates actively with the liquidation procedure will be automatically discharged from liabilities following the lapse of a relatively short period of time (for example, one year from the beginning of the liquidation procedure). This reform may – and we think should – provide for said automatic discharge without the need for judicial intervention. Where such automatic discharge would be unconstitutional or undesirable from a policy standpoint, the entrepreneur may, on the conclusion of the stipulated period, apply to the court for a discharge. The discharge should in any case be granted unless the court is convinced that the entrepreneur has committed fraud, acted in bad faith, has negligently or wilfully made incomplete disclosure, or has been uncooperative in the procedure.

(ii) *Restructuring*. – Entrepreneurs who want to continue the business may want to try to agree on a restructuring plan with their creditors. This path is designed only for viable businesses, and it can be triggered both by the debtor and – if the respective legislator so chooses (see Chapter 1, par. 4) – by its creditors. Proof of insolvency is, *a fortiori*, also not required to start this procedure. The default rule – and one of the main rules of this path – is that the debtor retains control of the

business and continues to run the day-to-day activity (which should not stop, if liquidation is to be avoided). This measure is especially justified in cases involving micro and small enterprises, as it stems from the results of our interviews with relevant stakeholders: keeping control is a very powerful incentive to foster the voluntary use of the system by debtors at an early stage (most micro and small entities are family-based, and, psychologically, entrepreneurs would not want to risk losing their – all too often – only source of income for the family); precisely because of the nature of micro and small businesses, commonly with a strong subjective *goodwill*, the value of the business will be linked to the continued involvement of the previous owners (i.e. decisionmakers); and, finally, not infrequently, there will be very few assets left in the business by the time the debtor takes action, and hence very little money to pay an insolvency practitioner tasked with the direct management of the business. The plan, which can be proposed by both the debtor and its creditors, may include a restructuring of the business and/or of the debt. The content, which should not have limits beyond those applicable to ordinary insolvency proceedings, will in most cases be simple, not requiring special supervision or expert analysis. Its drafting should be facilitated by templates provided at no cost by the local authorities. Generally, measures are to be implemented to lower commencement and participation costs of the parties. The process is designed to minimise complexity, and vest discretion in decisionmakers only where it contributes to maximising certainty. The process may be initiated and continued online, for example, through voting on a proposed plan; and strict and brief timelines should be enforced.

As with liquidation proceedings, the basic procedural rights and the property rights of creditors have to be protected, by implementing efficient means of notice of the plan procedure and its main stages as well as by granting the parties access to the court. While a consensual plan would not generally need to be sanctioned by a court, objections by creditors or other stakeholders would create the need for court review.

Policy Recommendation #8.5 (Core procedures of MSME regime). The specialised MSME regime should provide for the following ‘core’ procedures:

(i) Liquidation – The process should enable the business or its constituent assets to be sold off promptly, without need for court involvement and without any unnecessary procedural hurdle, subject only to cost-effective notification to all creditors and other stakeholders and the right of any party to invoke judicial or other independent oversight of the process. The process should culminate in the discharge from personal indebtedness of the entrepreneur, unless there are grounds to suspect fraud, dishonesty, inadequate disclosure of relevant information or assets, or the entrepreneur has been incooperative in the procedure.

(ii) Restructuring – The process should be available, without the need to demonstrate insolvency, to the debtor itself and may also be made available to creditors. The entrepreneur should presumptively remain in control of the business throughout the process. Pro forma restructuring plan templates should be made available that may be adapted to the specifics of the particular case with minimal input from the parties.

4.2. The options available to the debtor⁶

The different measures and options available to the debtor, which would be added to the core processes described in the previous section, would be:

(i) Creditor action moratorium. – As stated above in case of liquidation (applicable, *a fortiori*, in the plan restructuring alternative), a stay of the procedural remedies of creditors is not an automatic consequence of the opening of proceedings: the debtor must request it, by ticking the appropriate box in the template, stating the desired length and scope of the stay. The moratorium may have important costs (e.g. the provision of an adverse signal about the debtor's status and prospects, the impairment of the debtor's relationships with stayed creditors,

⁶ For a detailed explanation of this section and the next, see R. DAVIES, S. MADAUS, A. MAZZONI, I. MEVORACH, R. MOKAL, B. ROMAINE, J. SARRA, I. TIRADO, 'Micro, Small and Medium Enterprise Insolvency. A Modular Approach', Oxford, OUP, 2018, at Chapter 4.

or the potential for entrepreneur abuse and thus of value destruction). That is why it is proposed as an option that may not be desirable or necessary in all cases. The stay should be available for a limited time only, for example, the period required to cast votes and sanction the plan, or, in addition, cover the short period granted to the debtor to come up with a plan. In any case, the stay should be lifted if the plan fails or on request, if an affected creditor proves that its rights are insufficiently protected.

(ii) *Mediation.* – With a view to facilitate a restructuring agreement, the entrepreneur could apply for the appointment of a mediator. The reform could envisage that the good faith use of this option suspends temporarily certain procedural terms (e.g. those leading to a plan proposal). The costs of the mediator should be borne by the estate or by the parties, but, in any case, a majority of creditors should be able to block this additional expenditure.

4.3. *The options available to creditors*

In the proposed reform, as it could not be otherwise, creditors play the most important role and their interests are the ones to protect primarily. If the entrepreneur is insolvent, creditors are the residual owners of the business; and in case of solvent but cash-flow distressed entrepreneurs, creditors as a whole have the incentive to maximise the value of the business to enhance their chances of repayment. Furthermore, creditors tend to possess the highest level of information about the business (after the debtor and its members), and are often best placed to adopt a decision about its viability. Because of this, creditors should be awarded the control over the procedure, by providing them with options that may restrict the actions of the debtor or even cause an immediate opening of insolvency proceedings at any stage. In light of this, the main proposed options available for creditors are:

(i) *Mediation.* – This option mirrors the one provided to the debtor explained above. Creditors representing a pre-defined percentage of the total claims may, at any time during the proceedings, request the appointment of a mediator, which could have a general mandate, or one restricted to specific tasks, e.g. the drafting of a plan, the drafting of a list of claims

or any other where there seems to be a dispute between the parties. The failure of mediation should not have adverse consequences, and the mediator should only be appointed if all disputing parties agree and the costs are covered.

(ii) *Debtor action moratorium.* – As stated in the previous section, the debtor will normally continue to operate the business and manage its assets, especially in the process potentially leading to a restructuring plan. However, creditors may consider that this situation entails a high risk of damage to the estate or of the misappropriation of the value resulting from the management of the estate. Thus, a number of creditors representing a pre-defined percentage of the total amount of claims may request the total or partial removal of the entrepreneur's ability to manage the business and/or its assets, or to incur further liabilities. Provided that the necessary threshold is reached, the option should be implemented automatically upon the petition. Since this measure may interfere with the continuation of the business (especially in cases where the value of the business is directly linked with the personality of the entrepreneur), this option should be used with care. The debtor may appeal against this measure, which will be disallowed when it is proved that it was unjustified or detrimental to the value of the estate.

(iii) *Appointment of an insolvency practitioner.* – Directly linked with the previous option, creditors representing a pre-defined percentage of the total amount of claims could request the appointment of an insolvency practitioner. The template should reflect the different tasks requested from the practitioner: they could be appointed to supervise or manage all or part of the estate. The practitioner may also be commissioned to investigate the affairs of the debtor and its behaviour prior to the commencement of proceedings. The existence of sufficient funds in the estate, or an assumption of the payment of the fees by the parties, should be a requirement.

(iv) *Doomed to fail.* – This option is aimed at staving off the risk of a debtor artificially keeping alive a business that has no real, objective prospect of rescue. It creates a fast way for creditors to thwart any attempt to reach a restructuring agreement when liquidation is the only exit. It could be requested at any time of the procedure and its success would entail the automatic opening of liquidation proceedings. In any case success should be granted when the petitioners represent a

percentage of claims sufficient to make any continuation plan fail.

Policy recommendation #8.6 (Optional modules available to parties). The specialised MSME regime should enable the entrepreneur and/or creditors in each distress scenario to bring into play the key tools they consider necessary in the case, including the following: (i) creditor action moratorium; (ii) debtor action moratorium; (iii) mediation; (iv) appointment of insolvency practitioner; and (v) termination of a debtor-initiated restructuring on the basis that it is ‘doomed-to-fail’.

5. Encouraging timely use of the MSME regime

As stated earlier in this chapter, our research concludes that businesses generally tend to use pre-insolvency and insolvency systems too late, when there is little value to rescue. This problem, which is present in varying degrees in every jurisdiction analysed, becomes even more serious in relation to MSMEs. The reasons are clear: (i) informality is higher, creditor supervision less intense and entrepreneurs often lack sophistication, all of which contributes to a delayed awareness of financial problems; (ii) the micro business is frequently the only source of income, and it has a strong family component, and debtors are reluctant to take any action that may endanger the control – let alone the survival – of the activity; and (iii) linked with the previous point, a tendency for entrepreneurs to form overly optimistic judgements about the viability of their businesses seems to be widespread in some jurisdictions. All the above underpin the importance of adopting specific measures to ensure the timely and adequate use of the pre-insolvency and insolvency system. In this chapter, we briefly propose a few measures especially suited to the circumstances of smaller businesses. However, other measures proposed in different chapters of this report (i.e. see the proposal on directors’ liability or on early action) should also be applicable to this case, *mutatis mutandis*.

The reform should consider including a mix of incentives and sanctions (a ‘stick and carrot’ approach). Briefly:

▪ *Retaining management.* – The main incentive has already been partially referred to in the description of the procedural framework: as a general rule, the debtor that voluntarily starts a procedure should be allowed to continue managing the business. Only when creditors request a removal or a partial divestment of management powers should entrepreneurs lose their ability to guide the business through the proceedings. This will naturally happen more often in liquidation proceedings, when the debtor may have lost all incentives to preserve any remaining value.

▪ *Addressing the behaviour of the entrepreneur on the verge of insolvency.* – Given the peculiar circumstances of micro and small enterprises, effective, balanced, and effectively enforceable regulation of the behaviour of the debtor in the period approaching insolvency is especially important. The system ought to aim for early action, fostering an adequate behaviour when the business is near or in financial distress, but neither unable to pay its debts already nor – *a fortiori* – balance sheet insolvent. While this is a rule generally applicable to all debtors, it is in the case of the smaller entrepreneur that an effort needs to be made to ensure that out-of-court rescue options are considered early, making entrepreneurs liable for externalising the risk or, directly, the damage to creditors. When approaching insolvency, the entrepreneur should manage the business in the interests of the general body of stakeholders, and actively attempt to avoid insolvency or minimise its effect to the extent objectively possible.

The regime needs to be balanced not to hinder entrepreneurship or unduly restrict proper market risk-taking. It has been found that in some jurisdictions there are concerns about the level of formality and knowledge of the financial and legal context applicable to small businesses. Hence, it is paramount to create a programme that provides guidance about the obligations of entrepreneurs and the positive consequences of acting early. Following best international practice (as envisaged in the UNCITRAL Legislative Guide⁷), we suggest a regime that conforms with a wrongful trading system, adapted to the peculiarities of small businesses, with simple steps to comply with and eliminating certain measures and expected

⁷ See Part IV of the Legislative Guide, which is available online at www.uncitral.org.

actions that would not be necessary or expedient in the context of MSMEs (for example, requiring the debtor to engage sophisticated and costly professional advice; or, given the common absence of separation between management and ownership, the need to convene board or shareholders meetings, seeking advice from auditors, etc.).

Similarly, as in the most common definition of wrongful trading, entrepreneurs should take action when they know or ought reasonably to have known that the business is in a situation of imminent insolvency (defined as the inability to pay its debts as they fall due). When this moment arises, the debtor is expected to take active measures to minimise damage to creditors and other relevant stakeholders. Unlike in the general system, the obligation would be discharged through an active consideration of the alternative solutions provided in the procedural system hereby proposed, e.g. mediation, commencement of liquidation proceedings, supervised continuation process. The option selected would need to be adequate given the financial situation of the debtor in order for the duty to be deemed complied with. The debtor ought to also make sure that economic, financial and legal information about the business is available and accurate; and, especially, the debtor should ensure that the resources of the micro or small business are not used in a way that is detrimental for the general body of stakeholders.

The importance of keeping proper financial information cannot be overstated. Without it, the chances of reaching out-of-court solutions are dramatically reduced, and abuse may become widespread. While this may cause additional costs to the operation of start-ups and small businesses, the gain should outweigh such expenses and generate improved corporate governance practices and generally bolster legal certainty in the market. Member States should consider actively supporting this informational requirement through the provision of supportive services and through proper campaigns about means to address micro and small businesses in financial straits.

The consequence of the breach to act as described in the previous paragraphs should be the duty to compensate the damages caused to creditors – and, possibly, other stakeholders – by the lack/delay of the required action. It is essential that this consequence be stated clearly in the reform, and that institutional action be taken to ensure that the owners/directors

of small incorporated debtors are aware that limited liability could be removed in case of breach. Furthermore, additional civil sanctions may be imposed on the entrepreneur, such as, typically, disqualification from taking directorship roles in the future, restrictions on borrowing and inclusion of negative information by credit history agencies.

The foregoing reflections might not fully apply in all jurisdictions. The general insolvency legislation of some Member States already includes mechanisms to address the behaviour of the debtor on the verge of insolvency through a *duty to file* rule. While, as stated, we consider a wrongful trading system to be generally preferable, in some cases a duty to file may be more effective. This might be the case where the level of formality of small businesses is low or very low, where entrepreneurs are very unsophisticated and, especially, where the judicial system lacks the ability to conduct a proper assessment of the actions that ought to have been taken through hindsight analysis. The more underdeveloped the system, the more likely it is that a duty to file rule might work as well or even better. The reason for the distinction is that in such contexts entrepreneurs – and judges – might be better off with a rule that is relatively more clear-cut, easier to understand and simpler to apply that signals only one way to act. The duty should be triggered by a situation of imminent insolvency, and it ought to also be linked with the adequacy of the procedural options chosen. Legislators should take an honest, candid view of their national circumstances to choose one instrument or the other. In any case, it would be advisable to have a modified duty to file system, according to which the breach of the duty would only create a presumption that the delay has caused and/or aggravated the financial distress, a presumption that can be rebutted by the debtor through the ordinary means of proof available in the jurisdiction.

- *Addressing the behaviour of the entrepreneur over the course of the insolvency process.* While the specialised MSME regime should presumptively allow the entrepreneur to steer the business through the insolvency process, it should do so subject to strong incentives for the entrepreneur to act responsibly, competently, and honestly. Two key measures are of particular utility in accomplishing this objective. First, creditors, acting by stipulated proportion (say, creditors together holding at least 20% of the value of the debtor's total unsecured liabilities)

should be able to remove the entrepreneur from the helm of the business, and should also be able to override the entrepreneur's preferred course for the proceeding (say, by forcing the business towards liquidation by invoking the 'doomed-to-fail' option). And second, the regime should permit creditors to request a court or other designated authority to deny the entrepreneur discharge from personal liabilities associated with the business. These measures are likely to provide strong incentives for the entrepreneur to act in a way that earns and retains the confidence of creditors.

Policy recommendation #8.7 (*Timely use of the regime*). The

MSME regime should provide an appropriate mix of negative and positive incentives ('sticks and carrots') to incentivise the entrepreneur and other parties to act in a timely manner.

(i) Positive incentives include, amongst others, retaining the entrepreneur in control of the business through the legal process, unless another party seeks their removal.

(ii) Negative incentives include a wrongful trading rule that would make the entrepreneur personally liable for the MSME's debts if and to the extent that those debts would not have been incurred if the entrepreneur had maintained adequate records, kept the creditors reasonably well informed about the business and its prospects, and had taken appropriate steps in a timely manner upon anticipating that the MSME was or would become unable to meet its obligations as they fell due. However, in some jurisdictions with relatively immature markets, unsophisticated operators, and a high level of business informality, a duty to file may be more appropriate than a wrongful trading rule.

Policy recommendation #8.8 (*Encouraging the entrepreneur*

***to behave competently and responsibly during insolvency process*). The regime should permit a stipulated proportion of creditors to remove the entrepreneur from control of the business during the insolvency process, to override the entrepreneur's choices as to the course of the process, and to seek to deny the entrepreneur discharge from personal liability for business debts.**

6. Measures concerning creditors

The specialist MSME regime should also tackle the problems caused by rational creditor passivity, which, as our research indicates, undermines the efficacy of insolvency processes in certain jurisdictions. The following procedural measures should be considered:

- The '*scream or die*' rule. The rights of creditors in the proceedings leading to a continuation plan will be determined by the way their claims are considered and classified, and how they are treated if the plan is approved and implemented. It is hereby proposed that the reform provides a period of time for creditors to allege or oppose their treatment in the plan, after which their rights will be deemed fixed and their ability to challenge the plan legally waived. This would affect those creditors who have been listed but disagree with the way they are being treated as well as those that, having been duly notified, are not included in the final list of participating creditors. Hence, 'scream' refers to the creditors' opportunity to object, and 'die' is the loss of the ability to later complain if creditors do not object within the time period specified.

- The '*deemed approval*' rule. We have found out that too frequently creditors do not bother to participate in votes of the micro and small enterprises' insolvency proceedings. This type of creditor apathy – which has not been found in every jurisdiction – may be highly detrimental and value destructive, procrastinating the procedure or sentencing a viable debtor to a piecemeal liquidation. In some jurisdictions (e.g. Spain), the problem was so important that legislators included a rule subordinating creditors that ignored notifications and did not cast a vote. While we consider this solution to be unnecessarily harsh and intrusive, it does seem reasonable to create a rule that fosters active creditor participation, even if it is to force a liquidation. In light of this, it is here proposed for national legislators to consider including a rule that treats passivity as a positive vote: creditors – and possibly shareholders – will be deemed to have voted in favour of a plan regarding a micro and small enterprise when they failed to vote within a certain time. As stated elsewhere in this report, when a majority vote has been obtained through the deemed approval rule, a court – or an agency – should confirm the plan.

Policy recommendation #8.9 (*Responding to creditor passivity.*) The MSME regime should ensure that the insolvency process does not stall because of the lack of involvement by creditors. In particular, consideration should be given to establishing that duly notified creditors (i) who do not object to particular steps in the insolvency process should be regarded as having waived the right to object to those steps ('scream or die'), and (ii) who do not vote on a plan should be deemed to have voted in its favour ('deemed approval').

APPENDIX

GUIDELINES & POLICY RECOMMENDATIONS

The present appendix collects all the ‘Guidelines’ addressed to key players in the restructuring process (in-court and out-of-court procedures and measures) and the ‘Recommendations’ addressed to policymakers at the European and national level, included in the preceding Chapters of this Final Report.

The Guidelines and the Policy recommendations have been developed on the basis of the results of the empirical analysis carried out in four EU jurisdictions (Germany, Italy, Spain, and the UK).

I. GUIDELINES

Chapter I – Timely Identifying and Addressing the Crisis

Guideline #1.1 – *Voluntary early warning systems*

Even in the absence of legal duties or recognised standards, debtors should install adequate early warning systems monitoring the business for indicators of a crisis / ‘crisis events’. They should instruct and direct employees to recognise such indicators and promptly alert management.

Guideline #1.2 – *Access to current and accurate information for advisors*

Professional advisors hired by the debtor should be given access to current and accurate information and tasked to assess it also for signs of a crisis and advise management accordingly.

Guideline #1.3 – *Banks’ assessment of debtor’s financial condition*

Financial institutions and other institutional creditors with privileged access to financial information regarding the debtor

should assess it for clear indications of a potential crisis. In appropriate cases, loan and financing agreements should contain financial covenants providing for regular as well as – in case of certain events – ad-hoc reporting by the debtor.

Guideline #1.4 – *Discussion of financial condition of the debtor on the initiative of a creditor or other party*

If a creditor (or shareholder) gains knowledge of sufficiently strong indicators of a debtor's crisis, they should contact the debtor with the prospect of openly discussing the situation and the options to address it.

Guideline #1.5 – *Debtor should address crisis in a timely manner*

Debtors should address a crisis in a timely fashion by properly assessing it and, given the business's viability, taking action to avert it with a view of minimising the risks to creditors as a whole by, for example and as appropriate, making operational changes and/or initiating negotiations with key creditors, customers, suppliers or potential investors.

Chapter II - Fairness

There are no Guidelines in this Chapter. See Policy Recommendations below.

Chapter III - The Goals, Contents, and Structure of the Plan

Guideline #3.1 – *Operational and financial restructuring*

The party proposing the plan should consider whether the assets side of the debtor's balance sheet, and not merely the liabilities side, requires restructuring in order to provide the debtor with the best chance of restoring its viability.

Guideline #3.2 – *Assets-side measures*

The party proposing a plan should consider whether operational changes such as sale of assets or of the business or reduction in the labour costs are necessary in order to afford the debtor the best chance of restoring its viability.

Guideline #3.3 – *Valuation methods*

When a valuation of the business is required, use should be made of one or more well-established valuation techniques. Relevant parameters should be chosen in a transparent manner, if possible in consultation with stakeholders. It should also be assessed which individual should perform the valuation and, in particular, if an expert is required in case of valuation on the debtor's side.

Guideline #3.4 – *Content of the plan*

The plan and the explanatory documents should include all necessary information, accompanied by relevant documents, for stakeholders to assess and decide whether or not to support the plan. At a minimum, the plan should address (1) the context of the restructuring, (2) the consequences of the failure to implement the restructuring; (3) an overview of existing indebtedness; (4) the timeline of the plan; (5) financial projections and a feasibility analysis; (6) the valuation and allocation of the value amongst claimants; (7) legal pre-conditions for restructuring; (8) actions to be taken by affected stakeholders; (9) objections to the proposed plan arisen in negotiations; (10) provisions to address contingencies; (11) the treatment of intercompany claims; (12) a discussion on the position of directors and senior management and of the corporate governance of the debtor entity; (13) tax issues; (14) professional costs associated with plan formulation and approval; (15) jurisdiction.

Chapter IV - Drafting High-Quality Plans and the Role of Professionals

Guideline #4.1 – *Professional qualification and experience of the advisors*

It is advisable for the debtor to quickly acquire the clearest possible representation of the situation of the distressed business and of the general context in which the restructuring is expected to take place. Such representation should guide the selection of the advisors and be shared with them at the earliest stage, requiring the hired advisors to state in writing that they have the required expertise and resources.

Guideline #4.2 – Independence of the advisors

The quality and effectiveness of a restructuring plan, both from an ex ante and an ex post standpoint, is positively affected by the capability of the advisors to preserve a detached and dispassionate perspective, thereby being able to draft a fair restructuring plan based on accurate assessments and realistic predictions. In general, it is appropriate to hire advisors that have not been counselling the debtor in the ordinary course of business, possibly in addition to previous consultants.

Guideline #4.3 – Review of financial and economic data

Advisors should draft the restructuring plan on the basis of data that have been subject to a thorough review by the same advisors or by other professionals specifically hired with a view to restructuring the distressed business. Internal data or data resulting from reports unrelated to the business restructuring should be used only exceptionally, provided that they are considered accurate and that the advisors expressly state that they have relied on unverified data.

Guideline #4.4 – Focus on judicial reviewability

The restructuring plan should be drafted with a view to facilitating ex-ante and ex-post judicial review. Therefore, the plan should be clear, unambiguous and concise to the extent possible.

Guideline #4.5 – Summary and description of main actions

The restructuring plan should include a summary and brief description of the main actions that must be implemented to pursue the strategy chosen in the plan.

Guideline #4.6 – Transparency regarding the causes of the distress

The restructuring plan should identify the specific causes that have led to the distress of the enterprise, with a view to (i) facilitate the creditors' assessment on whether the plan adequately deals with such causes and prevents them from arising again, and (ii) allow creditors to make an informed decision on the proposal.

Guideline #4.7 – *Assessing and stating the economic viability of the distressed business*

The economic viability of the distressed business needs to be accurately ascertained by the advisors drafting the plan. It is advisable to make explicit in the plan the positive assessment on the economic viability of the business so as to allow an informed assessment on the plan by the creditors and, if applicable, by the court.

Guideline #4.8 – *Preparing accurate cash flow forecasts*

The success of a restructuring plan may be jeopardised by inaccurate cash flow forecasts that, setting the rescued enterprise in the position of being unable to satisfy claims as they fall due, often leads to insolvent liquidation of the business. Therefore, the plan should include accurate cash flow forecasts, which should be comprehensively illustrated in the restructuring plan so as to allow an informed assessment on the plan by the creditors and, if applicable, by the court.

Guideline #4.9 – *Time frame of the plan*

The restructuring plan should pursue the goal of rescuing the distressed business through a set of actions and measures due to take place within a period of time not exceeding 3-5 years. Unless justified on the basis of specific circumstances, a longer implementation period is not advisable due to the increasing risk of unforeseeable events.

Guideline #4.10 – *Reduction of the indebtedness to a sustainable level*

The restructuring plan should illustrate the level of debt that the debtor may serve in the ordinary course of business and how the debtor will achieve such level. Particular attention should be devoted to plans in which a significant part of the debt is merely rescheduled and left payable at a certain future date.

Guideline #4.11 – *Distinction between conditions for the success of the plan and preconditions for its implementation*

The restructuring plan should clearly distinguish between events that, although subject to uncertainty, are considered more likely than not to occur and therefore do not preclude the plan

from being implemented, and events that are proper conditions precedent and thus must occur for the plan to come into effect.

Guideline #4.12 – *Description of acts to be implemented on the basis of the plan*

The plan should describe the acts to be carried out in a detailed manner. The level of detail should be proportional to the importance of the act to be carried out.

Guideline #4.13 – *Assumptions and the effect of their variations*

In order for third parties to be able to check and assess its robustness, the plan should clearly state the assumptions and include tests that describe the effects of their variation.

Guideline #4.14 – *Divergence between forecasts and reality*

When a significant divergence between forecasts and reality occurs, the plan cannot be further implemented as originally intended and its protective effects no longer apply with respect to subsequent acts. All the acts implemented prior to the deviation are unprejudiced.

Guideline # 4.15 – *Provisions for adverse contingencies*

The plan should include provisions for adverse contingencies, including alternate routes to achieve the goal of restructuring.

<i>Chapter V - Negotiating on Plans</i>

Guideline #5.1 – *Requesting a stay on creditors*

The debtor should request a stay only when there is a going concern value to preserve. The degree of certainty with regard to the existence of going concern value should be stronger when the requested stay has a long duration, has been extended after a previous request, or when the procedure to lift the stay is burdensome for creditors.

Guideline #5.2 – *Projecting cash flows during the stay*

Before requesting a stay, the debtor must draw a cash-flow projection showing in detail what the cash-flow inflows and outflows will be during the period creditors are stayed. Such projection must take into account the likelihood of harsher

commercial terms by suppliers (possibly, dealing with the debtor only if paid upfront) and, if available, interim financing.

Guideline# 5.3 – *Avoiding a harmful stay on creditors*

If the projected short-term cash outflows exceed inflows and no interim financing is reasonably available, the debtor should abstain from requesting a stay and should quickly resort to the best available option to preserve the business value, either as a going concern or as a gone concern.

Guideline #5.4 – *Existence of the conditions for interim financing*

Interim financing should be sought only when the debtor assesses, on the basis of sound data and, if possible, expert advice, that this is the best interest of creditors, especially to preserve the business's value.

Guideline #5.5 – *Relationships with creditors during the negotiations*

Especially when the restructuring plan that the debtor plans to submit to creditors requires the creditors' individual consent, from the outset of negotiations the debtor should provide the creditors involved with adequate and updated information about the crisis and its possible solutions. Information should be provided concerning the causes of the crisis, a description of the plan and its key elements and assumptions, financial information both past and prospective.

Guideline #5.6 – *Awareness of the regulatory constraints specific to the banks involved in the restructuring. Cooperative approach between banks and debtors*

Debtors should promptly gain awareness of the regulatory considerations their lenders would make from a regulatory point of view, including in connection with elements of their NPL strategy and operational plan that under given circumstances may materially affect their approach to workout.

To achieve such awareness, a debtor should promptly approach its lenders and share with them, under appropriate confidentiality arrangements, any relevant information that might adversely affect the soundness of its business or the value of collateral and require, in turn, to be promptly informed, at the outset of any negotiation and to the extent possible, of elements

of the lender's NPL strategy and other general constraints that might influence the willingness of the latter to make concessions, or certain types of concessions, in a given crisis scenario.

Banks should not exploit the information they receive from debtors to ameliorate their position at the expense of other creditors, thereby making restructuring more difficult or impossible

Guideline #5.7 – *Internal financial assessments conducted by the bank on the debtor*

Banks should share with interested debtors (upon reasoned request from the debtor and to the extent possible) any results of internal financial assessments, including industry analyses, conducted on the debtor's situation or on the status of a specific loan segment, which might foster a better understanding by the debtor of the seriousness of the crisis and a reasoned identification of its possible remedies.

Guideline #5.8 – *Minimum duration of expected regular performance under the plan*

When negotiating concessions with banks, debtors should consider the feasibility of the proposed distress resolution actions in light of their predictable effects for lenders in terms of exposure classification and reporting requirements.

For this purpose, any restructuring measure proposed by the debtor should be conceived under credible terms and on the basis of a sound assessment as to the ability of the measure to restore and maintain the debtor's financial soundness and ability to perform in the long run and, in any case, for a time horizon of at least three years.

Guideline #5.9 – *Early start of restructuring negotiations*

Negotiations of restructuring plans should start as soon as the first signals of distress emerge and, if possible, before credit exposures are classified as non-performing. The plan should be designed so as to ensure that any concession is agreed and brought into effect no later than one year before the moment when the bank is expected to ensure full provisioning.

Guideline #5.10 – *Dealing with workers during negotiations*

The debtor should devote particular attention to dealing with workers during restructuring negotiations, possibly providing incentive mechanisms and, in any case, dealing with them in a transparent way with a view to preserving or gaining their trust.

Guideline #5.11 – *Opinion on the restructuring plan by an independent professional appointed on a voluntary basis*

When an independent professional is appointed on a voluntary basis by interested parties to assess the viability of a restructuring plan, the independent professional's opinion should (a) concisely and clearly express whether the restructuring plan is in the creditors' best interest; (b) be made promptly and easily available to all creditors; (c) avoid any disclaimer or other expression having the effect of making it equivocal.

Chapter VI - Examining and Confirming Plans

There are no Guidelines in this Chapter. See Policy Recommendations below.

Chapter VII - Implementing and Monitoring Plans

Guideline #7.1 – *Appointment of a CRO*

The appointment of a chief restructuring officer (CRO) in charge of implementing the restructuring plan is recommended for all large business, whereas the additional costs of the appointment of a CRO may outbalance the benefits in the case of small businesses.

Guideline #7.2 – *Appointment of a professional to realize assets*

When the restructuring plan envisages the sale of certain assets having a relevant economic value, particularly when such assets are not easily marketable, the plan should consider granting the creditors the right to appoint a professional entrusted with the task of selling the assets in the best interest of creditors.

Guideline #7.3 – *Monitoring in case of plans affecting only consenting creditors*

Plans should provide for proper creditor monitoring, with a view to triggering the actions and remedies that the plan envisages in case of non-performance.

Guideline # 7.4 – *Monitoring in case of plans affecting non-consenting creditors*

When the plan has an effect on dissenting creditors' rights and the law does not provide for appropriate monitoring devices [see Policy Recommendation #7.3], the plan should provide for proper independent monitoring.

Chapter VIII – Special Considerations for Micro, Small and, Medium Enterprises

There are no Guidelines in this Chapter. See Policy Recommendations below.

II. POLICY RECOMMENDATIONS

Chapter I - Timely Identifying and Addressing the Crisis

Policy Recommendation #1.1 – *Requirements to begin restructuring proceedings*

Restructuring proceedings started by the debtor should be accessible without any threshold, such as crisis or likelihood of insolvency. Such requirements should be introduced only for specific tools or measures directly affecting stakeholders' rights and (if provided for) for proceedings initiated by creditors. On an application by a creditor quorum, an authority should ascertain whether a proceeding has been started abusively and, if so, terminate it.

Policy Recommendation #1.2 – *Early warning systems*

The law should provide for universal early warning systems and obligations of management to constantly monitor and have monitored the business's affairs for indications of a crisis. This should apply – with possibly additional

requirements for big and/or public companies – to all businesses, regardless of legal status or size.

Policy Recommendation #1.3 – *Duty to define crisis events*

The law should define general ‘crisis events’ and provide for a duty of the management to define specific ‘crisis events’ that trigger warnings by employees and professionals, e.g. auditors, accountants and consultants. A particularly important general ‘crisis event’ shall be any default of the debtor.

Policy Recommendation #1.4 – *Role of management with regard to early warning*

All warnings are to be addressed to the management that shall generally have to consider how to best safeguard the interests of creditors as a whole and decide, at its discretion, whether to involve third parties (shareholders, creditors, courts, other authorities). Such discretion may be limited by laws to protect, e.g., the market or the employees, by contractual obligations or by the management’s general duty towards the shareholders.

Policy Recommendation #1.5 – *Affordable counselling for MSMEs to prevent and address crisis*

Public or professional bodies, such as the chambers of commerce and trade, should look into offering free or affordable advice to MSMEs in setting up early warning systems and in assessing a crisis and the appropriate reaction.

Policy Recommendation #1.6 – *Basic training on accounting, business and finance*

Entrepreneurs and directors should have access to training on accounting, finance and business basics and their legal obligations.

Policy Recommendation #1.7 – *Incentives to prevent and address crisis*

The law should create both positive and negative incentives for directors to safeguard their creditors’ and other stakeholders’ interests by monitoring the business, assessing its viability in a crisis, and take appropriate steps (e.g. restructuring or liquidation).

Policy Recommendation #1.8 – *Disincentives to creditors’ cooperation and overly harsh avoidance regimes*

Creditors and other stakeholders must not be discouraged by the law and its application from monitoring the debtor’s financial situation and engaging in communication and negotiations with the debtor regarding a crisis and its resolution. Avoidance regimes and lenders’ liability, in particular, should be appropriately curtailed and – outside of the debtor’s material insolvency – restricted to cases of abuse and collusion.

Policy Recommendation #1.9 – *Restructuring-friendly legal environment*

Legislators should take steps to create a generally restructuring-friendly legal environment by creating sensible privileges for worthwhile restructuring attempts (whether merely contractually and out-of-court or in the form of a restructuring proceeding), e.g. priorities for interim and new financing, by facilitating going-concern sales and by abolishing or curtailing existing obstacles.

<i>Chapter II - Fairness</i>

Policy Recommendation #2.1 – *Creditors’ support as a requirement for the confirmation of a plan.*

A plan should only be confirmed if it receives requisite support from creditors whose rights are to be affected

Policy Recommendation #2.2 – *Notice to creditors*

Intended parties to a restructuring should be provided with adequate notice of steps in the plan formulation, approval and confirmation process. Two to four weeks of notice should be provided unless the court approves an abbreviated or extended period.

Policy Recommendation #2.3 – *Electronic or online notice*

The notification may be provided electronically and/or online where this is the usual mode of communication with the relevant stakeholder group.

Policy Recommendation #2.4 – *Individual notification*

Each affected stakeholder must be provided with individual notification unless the court is persuaded that such notification is not reasonably practicable and that all reasonably practicable steps have been taken to notify the stakeholders in question.

Policy Recommendation #2.5 – *Adequate information to be provided to stakeholders*

Stakeholders whose vote is sought should be provided with sufficient information about the effect of the plan, the allocation amongst stakeholder groups of benefits and burdens under it, any collateral benefits offered or provided to some but not all stakeholders, the intended treatment of management. The information should be up to date, and if necessary, should be updated.

Policy Recommendation #2.6 – *Information on the no-plan scenario*

The plan should provide information about the debtor's prospects and the stakeholders' likely returns in the event that the plan is not approved. As appropriate in the circumstances of the particular case, this may require information in the event of the debtor's entry into insolvent liquidation or other proceedings or else the debtor's continuation in business with no modification of its obligations. If the correct comparator is insolvent liquidation, the plan should explain whether the debtor's business would be subject to a going concern sale or a piecemeal sale. In each of these scenarios, the plan should explain why it is in the affected stakeholders' interests to approve it.

Policy Recommendation #2.7 – *Competing plans*

Any creditor or a group of creditors should be permitted to formulate their own plan and to place it before relevant stakeholders for their consideration and vote.

Policy Recommendation #2.8 – *Classification of stakeholders for voting purposes*

The party proposing the plan should also propose how stakeholders are to be classified for voting purposes.

Policy Recommendation #2.9 – *Class formation: commonality of interest*

Stakeholders should be placed in the same class if their legal rights both prior to and as amended if the proposed plan were to be implemented, are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

Policy Recommendation #2.10 – *Class formation: relevance of legal rights, not private interests*

What matters for classification purposes are the parties' legal rights against the debtor. Their private interests, and any rights they might hold against third parties (such as guarantors) should generally be irrelevant to classification, though it may be taken into account by the court in considering whether their vote should be discounted.

Policy Recommendation #2.11 – *Value of claim for voting purposes*

Creditors should be entitled to vote the face value of their claim.

Policy Recommendation #2.12 – *Voting procedures not requiring a physical meeting*

The law should permit voting by proxy and virtual meetings at which to vote on a plan. The means of communication, preferably digital, used to allow the creditors to vote on the plan should ensure certainty on the capacity as creditors of those taking part to the virtual meeting.

Policy Recommendation #2.13 – *Presumption of properness of stakeholders' meeting*

There should be a rebuttable presumption that the meeting at which stakeholders voted was conducted properly and that the parties voted in a valid manner. The paucity of a debate at the meeting should not be a basis for rebutting this presumption.

Policy Recommendation #2.14 – *Conditions for confirmation of a plan that has been approved by each affected class of stakeholders.*

The court should confirm a plan that has been approved by each affected class of stakeholders if satisfied that:

1) adequate information was provided to affected stakeholders, taking into account their level of sophistication;

2) majorities in each approving class were acting in a bona fide manner in the class's interest, there being a rebuttable presumption that they were;

3) there are no issues impairing the appropriateness of the plan in the circumstances in which the plan was formulated, proposed, voted on, or proposed to be implemented;

4) the plan is not manifestly non-viable; and,

5) the plan is in the best interests of dissenting creditors or equity holders, in that it provides them with at least as much as they would receive if the plan were not approved

Policy Recommendation #2.15 – *Conditions imposed by the court*

The court should be allowed to impose conditions on its approval of the plan.

Policy Recommendation #2.16 – *Conditions for confirmation of a plan that has not been approved by each affected class of stakeholders*

The court should confirm a plan that has not received adequate support of the members of one or more affected classes of creditors or equity holders ('cross-class cram down') if, in addition to the conditions in Policy Recommendation #2.14, it is satisfied that:

1) at least one class of creditors whose rights are to be impaired under the plan has approved it by the requisite majority; and,

2) the relative priority rule is observed, in that

(i) each dissenting class is to receive treatment at least as favourable as other classes with the same rank;

(ii) no class of a lower rank is to be given equivalent or better treatment than it; and

(iii) higher ranking classes must receive no more than the full present economic value of their claims.

Chapter III - The Goals, Contents, and Structure of the Plan

Policy Recommendation #3.1 – *Scope of plan*

A plan should be capable of binding the full range of capital providers, including secured and preferential creditors, tax authorities, and equity claimants.

Policy Recommendation #3.2 – *Applicability to claimant subset*

The law should permit the plan to bind only a subset of any given category of claimants. For example, it may only affect financial lenders, leaving all other claimants out of its scope, not bound by it and therefore with the benefit of their existing rights.

Policy Recommendation #3.3 – *Sale of business as going concern*

The law should permit the sale of the debtor's business in whole or part as part of the restructuring process.

Policy Recommendation #3.4 – *Changes in workforce*

The law should provide for specific measures by which the debtor's workforce may be reduced as part of a restructuring process.

Policy Recommendation #3.5 – *Allocation of new funding*

The law should permit any new funding obtained by or promised to the debtor to be allocated outside the application of ranking of existing claims.

Policy Recommendation #3.6 – *Debt-for-equity swaps*

The law should permit the restructuring plan to effect an exchange of debt for equity claims.

Policy Recommendation #3.7 – *Preferred equity and convertible debt*

The law should permit the restructuring plan to provide for (i) different classes of equity claims, and (ii) creditors to exchange debt claims for equity claims at a future date upon the materialisation of a contingency stipulated in the plan.

Policy Recommendation #3.8 – *Non-subordination of loans of claimants who swap debt claims for equity*

Claimants who give up debt claims in return for equity should not be subject to any rule requiring the subordination of loans provided by equity holders.

Policy Recommendation #3.9 – *New financing*

The law should exempt new financing from avoidance and provide for priority over unsecured creditors under court

control, when new financing is necessary for the success of the plan. In some circumstances, applicable law may permit priority over existing secured creditors, if such creditors consent or else if the court can be satisfied that the interests of such creditors are adequately protected. The lender should be exempted from the associated risk of liability, provided that the new financing falls within the scope of one of the exemptions and is extended in good faith.

Policy Recommendation #3.10 – *Director liability and its effect on the plan*

The law or the courts should not bar plans which provide for a waiver of directors' liability on these sole grounds, as long as there is appropriate disclosure and there is no impropriety in seeking the stakeholders' consent.

Policy Recommendation #3.11 – *Taxation in restructuring*

Write-downs and other debt relief should not be considered a taxable benefit to the debtor. Creditors should be permitted to use such relief as a deductible loss.

Chapter IV - Drafting High-Quality Plans and the Role of Professionals

Policy Recommendation #4.1 – *Professional qualification and experience of the advisors*

It is advisable for the debtor to quickly acquire the clearest possible representation of the situation of the distressed business and of the general context in which the restructuring is expected to take place. Such representation should guide the selection of the advisors and be shared with them at the earliest stage, requiring the hired advisors to state in writing that they have the required expertise and resources.

Policy Recommendation #4.2 – *Independence of the advisors*

The quality and effectiveness of a restructuring plan, both from an ex ante and an ex post standpoint, is positively affected by the capability of the advisors to preserve a detached and dispassionate perspective, thereby being able to draft a fair restructuring plan based on accurate assessments and realistic predictions. In general, it is appropriate to hire advisors that

have not been counselling the debtor in the ordinary course of business, possibly in addition to previous consultants.

Chapter V - Negotiating on Plans

Policy Recommendation #5.1 – *Stay on creditors*

The law should provide for a court to have the power, at the debtor's request, to grant a stay on creditors to facilitate restructuring efforts and negotiations. The initial order of the stay, the court's decision not to terminate the stay despite creditors' motions, and any extension of the stay should depend on the assessment that the stay is beneficial to the creditors as a whole.

Policy Recommendation #5.2 – *Protection from avoidance and unenforceability*

The law should provide protection from the risk of avoidance and/or unenforceability of reasonable transactions carried out during negotiations and aimed at making restructuring negotiations possible, by either providing exemptions or designing the requirements for avoidance and/or unenforceability accordingly.

Policy Recommendation #5.3 – *Exemption from the one-year cure period after forbearance*

For the purpose of incentivising banks' participation in the negotiation of restructuring plans, regulatory provisions or standards for the exit of credit exposures from non-performing status should not apply when concessions are made within the context of a restructuring plan confirmed by the court, in which an independent professional appointed by the court or otherwise designated within the framework of the procedure has confirmed the financial soundness of the debtor post-confirmation, as well as the future capability of the plan to ensure the timely and full repayment of the debt (in its original or modified terms).

Policy Recommendation #5.4 – *Prudential effects of exposures' ageing*

Provisioning requirements should be calibrated around the real level of risks underlying credit exposures, as continuously

verified and assessed by banks on the basis of reliable and objective parameters.

After any forbearance measure taken in connection with a restructuring plan under which payment of the original or modified amount is envisaged, ageing counting should be suspended once the forbearance measure is granted and should be resumed only if the exposure is still non-performing at the end of a reasonable period needed to carry out a successful turnaround (e.g., after three years).

In any case, full provisioning should be required only if and to the extent that risk assessments pursuant to objective and reliable parameters show that no residual prospect of recovery within a reasonable time exists.

Policy Recommendation #5.5 – *Restructuring limited to financial creditors*

The law should provide for restructuring procedures or measures producing effects exclusively on financial creditors, without affecting non-consenting non-financial creditors.

Policy Recommendation #5.6 – *Adoption of codes of conduct by banks*

Banks should be encouraged to adopt codes of conduct to foster coordination among lenders, independent verification of information and fairness during negotiations.

Policy Recommendation #5.7 – *Effective negotiation with tax authorities*

The debtor should be able to negotiate the restructuring with the least possible number of tax authorities, possibly just one, the negotiation should be aimed at maximising the interest of tax authorities as a whole in the long term. The responsible employees of tax authorities should be able to make an objective decision on whether reducing or waiving certain tax claims would pursue the above-mentioned goal. To this purpose, responsible employees should be made exempt from any risks, possibly upon receiving confirmation of their assessment by an independent professional.

Policy Recommendation #5.8 – *Appointment of an insolvency mediator. Duty of confidentiality*

Whenever the law mandates or allows the appointment of a mediator, the latter should hold those qualifications and skills specifically required to act as a mediator, in addition to being competent in restructuring and insolvency matters.

In order to facilitate the creation of an adequate set of information at an early stage, thereby avoiding delays, the parties should be able to share with the mediator all the information relying on a strict duty of confidentiality. If the mediator deems that certain information would better be shared among the parties in order to advance negotiations, (s)he should require the party revealing the relevant information to waive the confidentiality. If no waiver is expressly granted, the mediator must not disclose the information under any circumstances.

Policy Recommendation #5.9 – *Opinion on the restructuring plan by an independent professional appointed as examiner*

The law should provide that when an independent professional is appointed as examiner to assess the viability of a restructuring plan, the examiner's opinion should (a) concisely and clearly express whether the restructuring plan is in the creditors' best interest; (b) be made promptly and easily available to all creditors; (c) avoid any disclaimer or other expression having the effect of making it equivocal.

Policy Recommendation #5.10 – *Exclusion of non-participating creditors from the calculation of the required majorities*

The majorities required for the adoption of a restructuring plan should be determined without taking into account those creditors that, although duly informed, have not voted on the restructuring proposal.

Policy Recommendation #5.11 – *Provisions mitigating the adverse effects of a deemed consent rule*

When abstentions of creditors are deemed consent, the law should provide for a more thorough judicial or administrative scrutiny of restructuring plans that would not have been adopted, but for the application of the deemed consent rule.

Chapter VI- Examining and Confirming Plans

Policy Recommendation #6.1 – *Examination and confirmation of the plan*

Examination and confirmation of the plan are essentially complementary and it is good practice to include both in the same out-of-court regulated procedure. Under particular circumstances, one of the two may be formally excluded. Never both.

Policy Recommendation #6.2 – *Examination of the plan*

Although a professional examination of the plan is not always necessary, it is advisable in most cases. Only when the debtor is a micro-entity with a basic business model, the examination may be excluded ab initio.

The examination report may be mandatory for all cases or be only potentially mandatory, when the debtor or creditors request it. Although both systems are acceptable, the latter adds flexibility and may limit the costs of the procedure.

Although more than one examination may be a possibility, it should not be the rule, and, more importantly, a rule should be included to allocate the cost of additional reports on those who request it.

The examiner should be a capable professional, suited to the specificities of the case and independent from the parties. Pre-existing professional relationships with creditors is not to be deemed an automatic cause for exclusion of the expert, as long as these relationships do not prevent the examiner from exercising an independent judgement. A case-by-case assessment must be made.

The examination report should be comprehensive and pay particular regard to the financial assessment concerning the viability of the business and the chances of successful implementation of the proposal.

Policy Recommendation #6.3 – *Participation and plan approval*

In formal insolvency proceedings, all creditors must be given the possibility to participate. This is not the case for out-of-court proceedings, where different options can be considered.

Where a jurisdiction includes an out-of-court procedure which concerns all creditors, special attention should be paid to creating incentives for its use and avoiding a worse treatment than the parties would get in formal in court proceedings.

Out-of-court proceedings may be regulated to allow debtors to select which creditors should participate. This adds flexibility. However, the efficacy of these plans is limited and rules must be included to safeguard the interest of non-participating creditors in case the agreements are to be protected.

Out-of-court proceedings involving only some creditors may be an adequate solution, so long as:

- (i) the scope of the procedure is adequately defined,
- (ii) the creditors involved are sophisticated, professional creditors,
- (iii) the exclusion of other creditors is founded on adequate grounds, such as suppliers or non-adjusting creditors. The exclusion of public claims creates a de facto priority in favour of public creditors, undermines the chances of success of the agreement and run against best international practice.

The decision may be taken in a meeting of creditors or by allowing creditors to cast a vote during a period of time. This latter method should be favoured for larger cases.

The majorities required in out-of-court proceedings should, in general, not be different to those foreseen for in court procedures.

The thresholds should only very exceptionally be higher than 75%.

Policy Recommendation #6.4 – Confirmation of the plan

A judicial or administrative confirmation of a plan is to be preferred when the law protects the agreement against avoidance actions, creates an ex-post priority for new financing or binds dissenting or non-participating creditors.

Confirmation may be issued by a judge or an administrative agency. Preference for one model or the other depends on the characteristics of the relevant jurisdiction.

Confirmation should review (i) compliance with formal legal requirements, (ii) the adequacy of the consent from creditors leading to an approval of the plan, and (iii) the material content of the plan, including its objective viability.

By approving a plan, a majority of creditors voluntarily assumes a new risk. While the judge/agency must protect minority creditors, it should refrain from assessing the adequacy of the risk assumed: only in very clear cases of non-viability of the plan should its confirmation be withheld.

There may be different models of confirmation: mandatory confirmation with control *ex ante* or *ex post*, and even, in some cases, merely potential confirmation.

The confirmation should be subject to appeal. The process to decide the appeal should be quick and simple, and the effects of the plan should not be withheld as a general rule, subject to cautionary measures when justified.

In principle, a successful appeal concerning an individual stakeholder's treatment under the plan should only limit its effects to the appealing stakeholder, not to others in a similar or even identical situation. However, the court should have the possibility to cancel the plan when the new situation makes the plan no longer viable or the sacrifice demanded of the creditors is excessive.

Chapter VII - Implementing and Monitoring Plans

Policy Recommendation #7.1 – Provisions on changes in board composition

The law should permit restructuring plans to include provisions committing the company to carry out, as part of the plan implementation, a change in the composition of the board of directors and/or the senior management team. However, there should not be any legal duty to include this sort of provision in restructuring plans.

Policy Recommendation #7.2 – Appointment of a professional to realise assets

The law should provide for the appointment of a professional entrusted with the task of implementing the plan concerning the sale of the debtor's assets in the best interest of creditors, when the plan is completely or prevalently based on the realisation of the debtor's assets. The creditors should have the right to choose the liquidator.

Policy Recommendation #7.3 – *Monitoring in case of plans affecting non-consenting creditors*

The law should provide for proper monitoring, at least with regard to plans that affect the rights of dissenting creditors, to ensure that non-performance does not go undetected due to the lack of incentives or means for creditors to monitor the implementation of the plan.

Policy Recommendation #7.4 – *Amending and curing the plan during implementation*

The law should empower the court or the independent insolvency practitioner appointed to monitor the implementation of the plan with the authority to amend the plan, curing minor failures in its implementation in line with what appears to be the best interest of creditors. Such power should be exercised by the court or the independent insolvency practitioner after having acquired sufficient information from the parties.

Policy Recommendation #7.5 – *Power to initiate remedies*

The law should give the monitor/supervisor the power to initiate remedies (including, as the case may be, the powers to move for the termination of the plan or to file for the insolvency of the debtor) or to provide for the automatic discontinuation of the plan after an appropriate period of non-implementation, unless an interested party moves for an extension.

Chapter VIII - Special Considerations for Micro, Small, and Medium Enterprises

Policy Recommendation #8.1 – *Specialised MSME regime*

Each jurisdiction should promulgate a distress resolution and insolvency regime tailored to the particular needs of micro, small, and medium enterprises. Such a regime would respond to common characteristics of MSME businesses in distress including, in particular, (i) the lack of knowledge and understanding of the law by entrepreneurs who run such businesses; (ii) such entrepreneurs' undiversified investments, including non-market ones, in their business; (iii) the late commencement of insolvency processes; (iv) the paucity of resources in the business to pay for legal and financial advice;

(v) weak recordkeeping and inadequate information; (vi) creditors with an insufficient individual stake in the business to justify monitoring of or constructive engagement with the business, or active participation in an insolvency process; and, (vii) secured creditors' preference for individualistic debt enforcement over collective insolvency processes.

Policy Recommendation #8.2 – *Financial creditors' incentives*

The regulatory and supervisory regimes applicable to institutional financial lenders should encourage lenders to engage constructively and timeously with MSME borrowers, to undertake proportionate and good faith analyses of the viability of distressed borrowers, and, where appropriate according to the circumstances, to enter into restructuring agreements that allow viable distressed borrowers to shed non-repayable liabilities and a chance to trade out of distress without weakening financial discipline or engendering moral hazard.

Policy Recommendation #8.3 – *Public creditors' powers and incentives*

Tax authorities and other public sector creditors should have the power and the incentives to participate in good faith restructuring efforts where they consider a distressed MSME borrower to be viable.

Policy Recommendation #8.4 – *Principles guiding the specialized MSME regime*

The specialised MSME regime should respect the following principles:

(i) party autonomy – the parties to a given distress scenario together have the best information about the causes of the distress, whether the distressed debtor remains viable, and how best to address the distress;

(ii) proportionate institutional involvement – the consumption of resources and of time associated with the involvement of courts and other institutions and of legal and other professionals may not always be justified in MSME cases, and such involvement should occur if and to the extent that the parties to a particular case consider it to be justified; and,

(iii) a holistic approach– the MSME regime should address the particular needs of MSMEs in distress not only within but also beyond insolvency law in a systematic and holistic manner.

Policy Recommendation #8.5 – Core procedures of MSME regime

The specialised MSME regime should provide for the following ‘core’ procedures:

(i) Liquidation – The process should enable the business or its constituent assets to be sold off promptly, without need for court involvement and without any unnecessary procedural hurdle, subject only to cost-effective notification to all creditors and other stakeholders and the right of any party to invoke judicial or other independent oversight of the process. The process should culminate in the discharge from personal indebtedness of the entrepreneur, unless there are grounds to suspect fraud, dishonesty, inadequate disclosure of relevant information or assets, or the entrepreneur has been incooperative in the procedure.

(ii) Restructuring – The process should be available, without the need to demonstrate insolvency, to the debtor itself and may also be made available to creditors. The entrepreneur should presumptively remain in control of the business throughout the process. Pro forma restructuring plan templates should be made available that may be adapted to the specifics of the particular case with minimal input from the parties.

Policy recommendation #8.6 – Optional modules available to parties

The specialised MSME regime should enable the entrepreneur and/or creditors in each distress scenario to bring into play the key tools they consider necessary in the case, including the following: (i) creditor action moratorium; (ii) debtor action moratorium; (iii) mediation; (iv) appointment of insolvency practitioner; and (v) termination of a debtor-initiated restructuring on the basis that it is ‘doomed-to-fail’.

Policy recommendation #8.7 – Timely use of the regime

The MSME regime should provide an appropriate mix of negative and positive incentives (‘sticks and carrots’) to incentivise the entrepreneur and other parties to act in a timely manner.

(i) Positive incentives include, amongst others, retaining the entrepreneur in control of the business through the legal process, unless another party seeks their removal.

(ii) Negative incentives include a wrongful trading rule that would make the entrepreneur personally liable for the MSME's debts if and to the extent that those debts would not have been incurred if the entrepreneur had maintained adequate records, kept the creditors reasonably well informed about the business and its prospects, and had taken appropriate steps in a timely manner upon anticipating that the MSME was or would become unable to meet its obligations as they fell due. However, in some jurisdictions with relatively immature markets, unsophisticated operators, and a high level of business informality, a duty to file may be more appropriate than a wrongful trading rule.

Policy recommendation #8.8 – *Encouraging the entrepreneur to behave competently and responsibly during insolvency process*

The regime should permit a stipulated proportion of creditors to remove the entrepreneur from control of the business during the insolvency process, to override the entrepreneur's choices as to the course of the process, and to seek to deny the entrepreneur discharge from personal liability for business debts.

Policy recommendation #8.9 – *Responding to creditor passivity*

The MSME regime should ensure that the insolvency process does not stall because of the lack of involvement by creditors. In particular, consideration should be given to establishing that duly notified creditors (i) who do not object to particular steps in the insolvency process should be regarded as having waived the right to object to those steps ('scream or die'), and (ii) who do not vote on a plan should be deemed to have voted in its favour ('deemed approval').