Insights from theory into restructuring and phoenixing activity

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Debt Restructuring and Notions of Fairness
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This article examines concern for fairness in the way in which loss is distributed when a company or financial institution facing financial difficulties is restructured. It shows how this concern is often grounded in loose notions of fairness, or generalisations from one situation to another, rather than in detailed analysis. Adopting an interdisciplinary approach, it builds an analytical frame for the fairness debate in debt restructuring. It shows why rigour is important in identifying fairness concerns, in weighing them against other considerations, and in applying concerns which arise in one scenario to another, and illustrates the types of policy mistake or policy incoherence which can arise if this is not done.

We think of fairness as an intuitive concept, confident that as the colloquial expression goes “we will know it when we see it”. Substantive unfairness is usually associated with some sort of imbalance: between how one person is treated compared with another; between effort put in and reward gained; between what we legitimately expect and what we get; between how losses fall on the weak and upon the strong. Procedural unfairness, too, reflects this sense of an uneven playing field: between the rights which different parties have to participate in a process or between how favoured and unfavoured parties are treated or between the rights of those in a powerful bargaining position and the rights of everyone else. But not every case of imbalance will be unfair, and many factors may vindicate the situation. Closer examination reveals a slippery concept, which eludes a single definition applicable to all contexts and which suffers from various levels of abstraction unless it is applied to a real situation.

Indeed, if we rely on our intuition we face three risks. First, we risk generalising from one situation to another when the situations ought properly to be differentiated from each other. Secondly, to the extent that we suggest reform to address a fairness concern, that reform may be only weakly related to the real fairness issues in the particular context. Finally, when we weigh fairness concerns against other considerations, we may have a poorly defined idea of what it is that we are putting in the balance. This article argues that our repeated failure to identify systematically our fairness concerns in different types of debt restructuring in English law has led us into all three of these traps. Drawing broadly on scholarship from diverse fields such as moral and political philosophy, biological sciences, psychology, organisation theory, group theory and economics, the article seeks to unpack the principles and the procedural demands which are bound up in some measure in our intuitive sense of what is fair, and to apply them in a rigorous way to three different types of debt restructuring: a restructuring of a small or medium sized enterprise (SME), a restructuring of a large corporate, and a restructuring of a financial institution in English law. In each case, a fairly typical scenario is described to ground the analysis, which reveals repeated failure to distinguish one type of restructuring case from another, to identify accurately where the fairness concerns are lurking, and to decide what we are putting in the fairness bucket of the trade-off scales. In short, it reveals the policy mistakes which may arise if we give “our

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1 See also L. Kaplow and S. Shavell, Fairness versus Welfare (2006), 79 fn 121 and accompanying text (discussing whether a mode of analysis arguably appropriate in one context should be applied without alteration in another).
unscrutinised instincts an unconditional final say". ²

The analysis concentrates exclusively on fairness. It does not consider the trade-off between fairness and other objectives (such as sustaining the putatively unfair situation because another, fairer outcome would cost more than the benefits it would deliver or would provide the wrong incentives for some of the stakeholders), or utilitarian objections (because a situation which differentiates between classes of stakeholder in its approach to the fairness of the case would make the stakeholders worse off overall), or with arguments that what we might consider to be questions of fairness should properly be reinterpreted as economic questions. In short, its objective is not to argue that fairness per se should prevail over other considerations, but rather to explore, as an initial question, the quality of fairness in each of the situations with which it is concerned. In each case the analysis has been divided between what are termed “principles of fairness”, which are the principles we apply to a given outcome to determine whether the result is fair, and procedural fairness which attempts to identify the factors which determine whether the process by which the outcome was arrived at was itself fair. This division proved no easier to handle than the fairness notion itself, and the reader may on occasion take issue with the allocation of principles between procedure and substance, but given the law’s commitment to procedure some attempt to identify a line between outcome and procedure seemed essential.

Finally, the extent to which notions of fairness can properly be said to be contingent upon history, geography and culture is controversial, but many scholars would argue that there are significant and important national value differences as to what is fair.³ As this article focuses on English law debt restructuring, an in-depth cross-cultural analysis is not attempted and the literature which is drawn upon focuses principally on England and the US. Further research might usefully consider how the analysis maps onto other debt restructuring regimes, but that is for another day.

SME Restructuring

In a typical (controversial) English law debt restructuring of a financially distressed SME, the owner/managers of the company launch an auction process to sell the business and assets as a going concern. They line up a licensed insolvency practitioner (chosen by, or with the agreement of, the bank which finances the company) to act as administrator should the bidding process fail to attract sufficient interest to meet all of the company’s debts in full, so that the company needs to be placed in an insolvency process. The owner/managers subscribe for all of the shares in a new company (bidco). Bidco bids in the auction at a price slightly above the amount outstanding to the seller’s fully secured bank, but below the amount sufficient to repay all of the company’s existing creditors. The auction process attracts only low bids, so that bidco is successful.

Bidco then negotiates a sale and purchase agreement with the seller’s administrator-in-waiting, financing the purchase price by borrowing a fully secured loan from the seller’s bank. Once the loan agreement has been agreed with the bank and the sale and purchase agreement has been agreed with the seller, the directors of the seller appoint the administrator and place the company into administration. In English law this appointment can be made out-of-court.⁴ The sale and purchase agreement is immediately signed by the administrator and bidco, and the purchase price

³ See, for example, J. Elster, Local Justice: How Institutions Allocate Scarce Goods and Necessary Burdens (1992), 149.
⁴ Paragraph 22 of Schedule B1 to the Insolvency Act 1986.
is paid to the seller. Together with the owner/managers, the bank agrees with the administrator that the seller has five suppliers who should be paid in full for all invoices outstanding at the date of the administration. Many other small suppliers have substantial outstanding debts with the company at the administration date but these debts are not paid in full; apart from payments to the five selected suppliers, certain amounts due to employees and a small deduction which is legally required to be divided amongst all the unsecured creditors, the purchase price is distributed to the bank as the seller's secured creditor. After the transaction is completed and the economy has begun to recover, bidco raises a new, cheaper loan from alternative lenders and repays the bank in full. The owner/managers continue to own all of the shares in the newly restructured business.

For some time there has been a sense of moral outrage with this pre-packaged administration solution, troubling government and prompting a series of reviews. These reviews have tended to concentrate on the question of whether, in our example, the bid vehicle is purchasing the business and assets at below market price. Yet, as we shall see, when we examine our intuitive reaction to this pre-packaged restructuring scenario other circumstances of the case implicate notions of fairness.

The SME Restructuring and Principles of Fairness

Fairness, when used in the context of the distribution of money or goods, is strongly associated with treating identically situated persons equally or, if there is not enough to go around, at least proportionately, sometimes referred to as the principle of “horizontal equity”. Of course, in a real world situation we need to decide the criteria by which we will determine whether creditors are “identically situated” or not. In other words, some differences will go to the question of differentiating the party's claim and others will not. In an institutional setting we typically develop well-defined criteria by which we decide whether or not one party is equal with another. Sometimes these concepts are codified in rules or laws and sometimes they are simply widely understood.

When a company is in administration, the broadest differentiating criterion in English law is whether a party has security or not. After that, English law chooses to treat some of the claims of employees before the claims of other creditors, makes a relatively small proportion of the realisations of certain secured creditors available to unsecured creditors, and elevates the claims of creditors who deal with the administrator after appointment above those of creditors who have dealt with her before. Adopting Walzer’s terminology, these rules mark out the principle of equal treatment in English insolvency law, and its boundaries. The first way in which the SME

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5 So that, in effect, the bank’s existing loan to the seller is replaced by a fully secured loan to bidco, which now owns all of the seller’s assets.
7 Aristotle The Politics edited and translated by E Baker (New York: Oxford University Press 1946), Book III Chpt XII [1282b].
10 Zajac, n 8 above, 106.
11 To some extent secured creditors stand outside the administration, realising their security and only claiming the balance of their debt after deducting the amount they have realised; see rule 2.83 of the Insolvency Rules 1986
restructuring situation makes us uncomfortable is that, as Walzer puts it, "something roundabout or even clandestine" seems to be happening which crosses these boundaries. The owner/managers and the bank make their determination as to which unsecured creditors to pay in full and, as this deviation from the principle of equal treatment happens in a way which is largely subjective and unobservable, we have a strong sense of unfairness. A number of justifications can be advanced; crucially, that the suppliers who are paid in full are objectively different because they are more critical to the business than the other suppliers and that English insolvency law permits payment in full to so-called "ransom creditors" in marking out the principle of equal treatment. Yet no reasons are given to explain why these creditors are critical, and the unpaid trade suppliers have no straightforward right of appeal. We will return to this issue later when we consider the concern for procedural fairness.

It may be possible to justify deviation from the principle of equal treatment on the basis that one person is more deserving than another or, on the other hand, to explain our intuitive sense that a situation is unfair by concluding that someone has not got what they deserve. In order to explore either claim it is necessary to somehow rank or order what we count as deserving for the purposes of reward, and this is further complicated by the fact that the "dueness condition" has both an objective and a subjective quality (getting what one believes to be one's due). In his examination of our biological instinct for what is fair, Sun describes it as a requirement that rewards should be proportional to the contribution which a participant has made to the overall endeavour. He explains that this principle should apply equally in the downside scenario. In other words, those who benefit when things are going well should bear a greater proportional loss when things go badly. Arneson attributes weight not only to objective considerations, but also to how hard an individual has tried, given the particular circumstances in which she finds herself and her particular condition. This idea of prioritising deserviveness based on effort also has a long history, familiar in the depression-era concept of the "deserving poor" who struggled with poor background conditions but with maximum determination and commitment when compared with the "idle rich". It stands in contrast to modern, competitive individualistic doctrine, in which inequalities can be justified "because they are perceived to be rewards for unequal achievement, talent, rationality and merit".

Whilst the bank may be convinced of the merit-based fairness of the case, there is long run

16 The analysis is moderately complex but relies, amongst other things, on the fact that a party is not prohibited by the moratorium which arises on administration from terminating a contract for the insolvency of its counterparty, potentially giving a critical supplier a "ransom" position by insisting on full payment as a condition of continued supply (Re Olympia & York Canary Wharf Ltd [1993] BCC 154), on paragraph 66 of Schedule B1 to the Insolvency Act 1986 which permits an administrator to make a payment other than in accordance with the normal rules of distribution where "he thinks it is likely to assist the achievement of the purpose of the administration", and on paragraph 13 of Schedule 1 to the Insolvency Act 1986 which empowers the administrator to make "any payment which is necessary or incidental to the performance of his functions".
17 Note, in particular, the ability of the administrator to make the payment if he "thinks" it is likely to assist the achievement of the purpose of the administration – essentially a rationality standard (see also fn 56 below and accompanying text).
20 Sun n 19 above, 63.
Evidence in social history of a tendency for wider society to be unimpressed by the "mere" contribution of finance. David Kynaston's four volume history of the City of London provides a rich treasure trove of examples, and the debate over the social usefulness of much of what the finance industry does has been reignited with passion and vigour after the financial crisis by, amongst many others, Thomas Piketty, John Kay and Atif Mian and Amir Sufi. Banking in the UK has been a virtual oligopoly for almost two centuries and there is a sense (heightened after the financial crisis) that the banking community wields significant political power, influencing the making of insolvency laws which serve to protect its interests and producing outcomes which are unfair. In our example, the stranded trade supplier has contributed not just money but also commercial effort to the endeavour, but appears to have been inadequately rewarded, whilst the bank's position is entirely protected and the owner/managers retain their equity. Related research in the field of group psychology provides further insight. This research suggests that we tend to deny the deservingness of groups to which we do not belong, whilst valuing too highly the rights of our own group. As the distribution to the fully-paid trade creditors relies on the discretionary assessment of the owner/managers, the bank and "their" administrator, social psychology would suggest that a narrative of "us" and "them" could rapidly be constructed, and that the trade supplier will develop an in-group identity with all the other unpaid trade suppliers, and contrast it with the outcome for the other groups.

One plausible response to these concerns in the context of a market exchange is that the trade suppliers negotiated their supply contracts in the shadow of English restructuring law, and thus consented to the position in which they now find themselves. Many scholars have identified the idea of consent as legitimising market exchange, so that questions of fairness do not arise, or at least not explicitly. In Robert Nozick's work, a market exchange is always voluntary, notwithstanding practical considerations which effectively limit choice, provided those exercising rights which result in the practical constraints do so legitimately. Thus, the fact that a small supplier is forced to transact as a practical matter on terms which he may not have chosen if he had occupied a stronger bargaining position is not sufficient to render his decision-making involuntary. Consent is also strongly linked to the broader concept of responsibility: a party should be held responsible for choices freely made (see, for example, the examination of the subject by Fleurbaey), or even for Dworkin's complex idea of "option luck" (accepting an isolated risk such as bankruptcy of a counter party which an individual should have anticipated and might have declined) as distinct from "brute luck" (situations which were not in any sense a deliberate gamble).

Yet in the real world of the SME none of these concepts of consent, responsibility or luck takes us as far as it might. We are all aware that under certain conditions, "the free market is not all that

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25 Walzer n 15 above, 121.
29 Nozick n 28 above, 262. See also an excellent discussion of this point in M Allingham, *Distributive Justice* (2014), 76-78.
and of the superior bargaining position and expertise which the bank had in negotiating a fully secured loan agreement, compared with the position of the weaker trade creditor in the market. We suspect that, even if she had wanted to, the small trade creditor could not have adjusted the price of the contract to reflect fully her risk on default nor, in many cases, have insured against it, and we are familiar with the idea that conditions agreed in the market may be suspect as a result of inequality of bargaining power. Nozick’s work is admirable as a dazzling intellectual exercise but nonetheless struggles as a theory which we can relate to our own experience of the real world. We assume that the bank had a team of professional advisers to assist it in reaching the best possible deal, and inside knowledge of the situation as it unfolded. In other words, we are dubious about the quality of consent, responsibility or bargained for bad luck. As Sandel puts it, “Consent matters, even if it is not all there is to justice. But it is less decisive than we sometimes think”. Ultimately, the unpaid, unsecured trade creditor is suspected of lacking any market power to ensure that the risks which she takes are connected to her actual effort and initiative.

Linked to, but somewhat different from, the concept of “just deserts” (and consent) is the idea of legitimate expectation. In other words, when the parties engage in a venture according to defined rules they expect all others who have submitted to the same rules to deliver their side of the bargain. Thus, in dealing with the counter party, the unsecured trade creditor expects her contract to be observed to the fullest extent of the counter party’s ability, and feels a sense of outrage when she concludes that the counter party has not done so. Of course, we might argue that the contract was concluded in the shadow of restructuring law, so that the weak trade supplier consented to the outcome. We have dealt with that point above, and the arguments made there are not repeated here. Instead, the point is made that the stranded trade supplier may object to the SME situation on the basis that her legitimate expectation that she would be paid in full or, if not in full, to the maximum extent that the company is able to afford, has not been met whilst the equivalent expectations of the bank and the family have been met. In other words, there is a discrepancy between the outcomes which we think ought to prevail and those which have.

The mirror of “just desert” and legitimate expectation for the wronged party is a desire to see those who are responsible for loss suffer for the harm which they have inflicted, what Mark Warren calls a “pathological form of fairness”. Sun has shown how hidden elements of our reasoning process lead us to the ignoble emotion of spite. Fleurbaey carefully analyses what he calls the “sour grapes” effect and demonstrates that, whilst a consequentialist analysis (with which this article is not concerned) might mitigate against a fresh start for those who have caused the harm, there should not be “a principled opposition to it”. Nonetheless, as Sandel puts it “outrage is the special kind of anger you feel when you believe that people are getting things they don’t deserve”. In the SME situation, the owner/managers who have brought about the trade

33 B. Barry, Justice as Impartiality (1996), 51.
34 Sandel n 32 above, 144.
35 Walzer n 15 above, 118.
36 Barry n 33 above, 33.
37 Zajac n 8 above, 106.
38 Sun n 19 above, 132.
40 Ibid., 138.
41 Fleurbaey n 30 above, 181-182.
42 Sandel n 32 above, 7.
creditor’s ruin retain all of the equity in the business. The stranded trade creditor may simply want to make them pay.

This brings us to our last, important principle of fairness in the distribution of money or goods: that loss should not fall on those least able to bear it. In John Rawls’s search for a theory of the ideally fair institutions of a sovereign state, the lot of the worst off in society assumes central importance in the so-called difference principle – the idea that inequalities can be admitted where, and to the extent that, they improve the lot of those worst off in society. Work in the biological sciences has shown how powerful our compassion for the weak is. What is implicated here is a sense of “vertical equity”, comparing the position between classes of stakeholder rather than simply the position within a class. It also finds expression in the responsibility debate, “What must be done ... is to determine who in each circumstance class (i.e., a subpopulation of individuals with identical circumstances) is worst-off, compare them across classes, and give priority to the worst-off among them”.

In the SME case, the weakest trade creditors bear the brunt of the loss.

The SME Restructuring and Procedural fairness

When we think about fairness we think not only about fairness of outcome, but also the fairness of the procedure by which the outcome is reached. Indeed, some scholars would argue that provided the procedure is accepted, the result can never be impugned. This leaves open the possibility that a party who does not like the result claims not to accept the procedure, so that what may matter is not whether everyone has agreed to the procedure, but rather whether they would agree to it if they were behaving reasonably.

For the moment the point is made that the procedure may be fair if a stakeholder acting reasonably would accept it, even if a stakeholder acting unreasonably in the real world rejects it.

For many scholars an important aspect of procedural fairness is the number of voices which are heard. This may be drawn very widely (because, although the relevant actor is disinterested in the particular situation, her voice may have an important and interesting perspective), or may be limited to anyone whose interests are involved. Research in the fields of social psychology and organisation theory suggest that the ability for someone affected by the procedure to be heard within it impacts their view of how fairly they have been treated, even if there is no or very limited capacity to influence decision making. Moreover, a so-called voice system provides feedback to those running the procedure. Thus plurality of voice is an important requirement for bankruptcy scholars who subscribe to the “forum” view of insolvency; the widest number of perspectives on the situation ought to be offered so that no opportunity is overlooked which might otherwise be aired. This directly impacts on the third reason for voice within the insolvency procedure, in that it provides the opportunity to correct a course of action which has been settled on, or to make changes going forward.

44 Sun n 19 above, 27.
45 Zajac n 8 above, 120.
46 Fleurbaey n 30 above, 83.
47 Barry n 33 above, 150.
48 Woodruff n 18 above, 111.
49 Lind and Tyler n 19 above, 5, 9, 49-51, 59, 170-172, 176-177.
50 Sen n 2 above, 44.
51 Sheppard, Lewicki and Minton n 18 above, 140-141.
Whatever view one takes of "voice", and of procedural fairness, in the SME case a limited number of stakeholders has the chance actively to participate: the owner/managers, the bank, and an administrator chosen by them (with whom we might assume the bank has a pre-existing relationship). An administrator is required to hold a meeting of creditors to discuss her proposals for the administration, but not where the company is so insolvent that no return to unsecured creditors is anticipated (other than a legislatively fixed small return).\(^{53}\) Moreover, case law has established that, even where English insolvency law does require a meeting to be held, when an administration sale is "pre-packaged" the administrator is not required to hold the meeting before the sale is completed,\(^{54}\) so that creditors are effectively presented with a \textit{fait accompli}. Challenging the administrator's decision to pursue the sale transaction rather than, for example, a different debt restructuring transaction is also fraught with difficulty, so that the unpaid suppliers lack an effective right to appeal. Crucially the administrator is entitled to move to a sale transaction if he "thinks" it would achieve a better result for creditors as a whole,\(^{55}\) (essentially a rationality standard),\(^{56}\) and the courts are extremely reluctant to interfere in the administrator's commercial decision making.\(^{57}\) Indeed, recent cases have shown just how difficult it is to unwind a certain pre-packaged administration sale in order to pursue a different, uncertain debt restructuring.\(^{58}\)

Of course, building "voice" into the system also gives rise to consequentialist concerns, particularly the question of whether the cost of doing so outweighs the benefit. Indeed, the Small Business, Enterprise and Employment Act 2015 will abolish a number of creditor meetings within the insolvency process, apparently as a result of this concern.\(^{59}\) Yet work in organisation theory suggests a number of ways in which voice can be built into a procedure efficiently.\(^{60}\) This work in organisation theory does, though, give us pause for thought on another issue. It identifies that a significant reason for adopting a voice system is "fundamentally to preserve and protect the power of those who currently govern the organisation".\(^{61}\) This leads directly to our next concern: eliminating bias and partiality from the system.

Adam Smith employed the idea of the "impartial spectator" in his ethical scheme to examine our conduct, and to consider whether that conduct can objectively be regarded as fair.\(^{62}\) This idea of a lack of bias, or of impartiality, links both to the question of whether any unequal treatment can be supported, and the quality of the procedure by which the unequal outcome is arrived at.\(^ {63}\) Thus John Rawls, in his search for how the fairness ideal should be embedded within political institutions, employed the thought experiment of a hypothetical agreement by members of society in the original position behind a thick veil of ignorance. In other words, Rawls strives for an objective or impartial assessment of the fairness condition by stripping his imagined actors of any knowledge of the attributes which they will have, and the conditions which they will be in, in a real

\(^{54}\) Re T&D Industries plc (in administration) [2000], WLR 646; Re Transbus International Ltd [2004] 1 WLR 2654 interpreting para 68 of Sch B1 to the Insolvency Act 1986.  
\(^{55}\) Para 3(1)(b) of Sch B1 to the Insolvency Act 1986.  
\(^{58}\) Case Management Conference In the Matter of Coniston Hotel [2014] EWHC 397; Hockin and others v Matsden and another [2014] EWHC 763 (Ch); Holgate and another v Reid and another [2013] EWHC 4630 (Ch).  
\(^{60}\) Sheppard, Lewicki and Minton n 18 above, 148-155.  
\(^{61}\) Ibid., 154.  
\(^{63}\) Rescher n 9 above, 23; C. L. Carr, \textit{On Fairness} (2000), 16; Sen n 2 above, 54.
world setting.\textsuperscript{64}

Once we consider the demand to avoid bias as a “foundational idea” of fairness,\textsuperscript{65} the SME case makes us still more uneasy. First, the choices between which suppliers to pay and which to leave unpaid are reached by parties who are clearly insiders, and who have strong, vested interests to influence their decision making. Moreover, the appointment of the administrator out of court means that judges who are screened for, and subjected to rules to remove, concerns of bias so that they can preside over disputes where questions of fairness of outcome and of process might arise are not involved in the decision making.\textsuperscript{66} The administrator has been selected and paid for by the owner/managers and the bank. The administrator is a repeat player, and likely to be influenced by the bank’s wishes,\textsuperscript{67} so that she is not in fact the disinterested gatekeeper which we might like her to be. This problem with identifying a truly neutral gatekeeper is a familiar one: it has been identified in the work of Enriques and Macey on independent valuers in share transactions,\textsuperscript{68} in work on ombudsmen in organisation theory,\textsuperscript{69} in post financial crisis literature on the role of the rating agencies,\textsuperscript{70} and explicitly in the literature on administration.\textsuperscript{71} It is an explicit policy objective of the US Chapter 11 process to eliminate bias by providing a central role for the court, whilst the court has a minimal role in an English administration. Once again efficiency concerns outside the scope of this article come into play, but once again our examination of the meta-fairness of the case helps us to identify the issues with which we are concerned. Ultimately, we suspect that the decision which was reached did not put questions of power aside, and thus did not arrive at an impartial decision.

The idea of protection against abuse of power is also fundamental to our sense of fairness. Often, when we refer to an unfair outcome or process we mean that one of the participants has exploited their position of power so as to be able to bend the rules of the game to their own advantage, and in a way which is inappropriate to the nature of the activity which they are participating in.\textsuperscript{72} Thus Rawls’s thick veil of ignorance strips the parties of the ability to gain bargaining advantage over one another.\textsuperscript{73} This leads to difficult questions about delineating the point at which it ceases to be morally legitimate to use bargaining strength to improve one’s position.\textsuperscript{74} But the ideal is that the system should control abuses in such a way that no-one in a position of power is able to gain an advantage which she does not deserve merely through the exercise of that power. The SME situation gives us cause for concern that the vulnerable trade creditors have not been protected from the power of the bank, part of the financial elite, by the appointment of an administrator

\textsuperscript{64} J. Rawls, \textit{A Theory of Justice} (1971), 17.
\textsuperscript{65} Sen n 2 above, 54.
\textsuperscript{66} Sun n 19 above, 83.
\textsuperscript{69} Sheppard, Lewicki and Minton n 18 above, 155.
\textsuperscript{70} B. Eichengreen, \textit{Hall of Mirrors: The Great Depression, the Great Recession and the Uses – and Misuses – of History} (2015), 79.
\textsuperscript{72} Carr n 63 above, 9.
\textsuperscript{73} Taylor n 22 above, 34 as he puts it, “by situating OP parties symmetrically with respect to one another, it [the veil of ignorance] assures that the terms of cooperation that arise will be fair ones, reflecting norms of reciprocity instead of replicating preexisting inequalities”.
chosen by them. Moreover, the family are clearly powerful insiders in the case and have better information which they are able to exploit in reaching their desired outcome.

In sum, whilst other considerations may make the SME scenario the best policy solution, it nonetheless triggers many concerns which are bundled in different combinations in our own concept of what is fair. Importantly, these concerns go beyond the policy focus on the price at which the sale transaction is completed. It is tempting to hold that the analysis is the same in any corporate restructuring where some creditors are excluded, but as we shall see the analysis needs to be revisited where only financial creditors are implicated, or where we are concerned with the special situation of a financial institution. Fairness considerations in debt restructuring are not generisable because they are intrinsically related to the circumstances of the case.

Large Corporate Restructuring

Many private equity sponsors finance acquisitions of large corporates through a small amount of equity and significant amounts of debt (so that the loans are known as "leveraged loans"). The debt is often divided into a senior secured loan, and a loan or loans which are also secured but which rank behind (or junior) to the senior loan in insolvency (and which consequently attract higher pricing).

Of course, one of the consequences of carrying a significant amount of debt is that the company has a relatively high interest bill to pay. Furthermore, before the financial crisis, most European leveraged loan agreements contained financial covenants which tested, on an ongoing basis or periodically, whether the borrower’s financial health was being maintained (for example, by testing that the ratio of financial indebtedness to earnings remained within prescribed levels). If these financial covenant ratios were breached, the lenders became entitled to accelerate the loan and demand that it was immediately repaid, so that if the loan could not be refinanced the company would become insolvent. Many private equity transactions faced debt service or financial covenant compliance problems during the financial crisis, and the market value of the companies at the time was often significantly less than their debt. In these circumstances, one common approach was to seek to swap some or all of the company’s senior loans into equity but (after 5-10% of the equity had been reserved for management to incentivise them) to offer nothing or only a very small amount for the junior lenders. If there was disagreement about the debt-for-equity swap amongst the senior lenders it was common to take advantage of England’s scheme of arrangement procedure which enabled the transaction to be imposed on the senior lenders with a lower threshold than the unanimous consent mandated in the loan agreement. If the junior lenders sought to challenge the transaction (or threatened to do so), the scheme of arrangement could be “twinned” with a pre-packaged administration pursuant to which the company’s business and assets were sold to a new vehicle owned by the converting lenders in return for a release of their debt (which, remember, usually exceeded the current market value of the business and assets), leaving the junior creditors stranded in the "old" company which had been stripped bare. During the restructuring negotiations, it was common for the debt to trade widely, so that the creditors who eventually entered into the restructuring had often acquired their interest at a discount. In the years after the worst of the crisis, in an improved macroeconomic environment, it was often possible to sell or list the shares in the newly restructured company for a substantial profit.

75 For an explanation of why the private equity industry favours this model, see L. Gullifer and J. Payne, Principles of Corporate Finance (2015), 776.
76 A. McKnight, The Law of International Finance (2008), 149-151.
English law clearly marks the boundaries of the principle of equal treatment in a scheme of arrangement first, by requiring a determination as to whether creditors can vote as a single class, or should be divided into separate classes for voting purposes, and secondly, by mandating that the scheme can only proceed if creditors in each separate class accounting for a majority in number and 75% in value of the claims present and voting in that class vote in favour of the scheme. A body of case law has developed which indicates that the crucial question for the purposes of determining who is to be placed in each class is the rights which the members of the class have before, and the rights which they will receive in, the scheme, so that in the large corporate scenario it is likely that the senior lenders will vote as a single class. At first sight, therefore, no particular concern for "horizontal equity" arises.

However, matters are not quite so straightforward. It is possible, for example, that some of the senior lenders voting on the scheme have entered into lock-up agreements in which they commit to support the scheme before it is proposed, have received consent fees in return for voting in support of the scheme, hold an interest in another part of the company's capital structure which may influence their overall assessment of the restructuring or are content to support the scheme only because of the discount at which they acquired their interest. As a result, after voting on the scheme, a second court hearing is held at which the court decides whether to sanction the scheme. At sanction the court will be alert to the possibility that "... any group of creditors even in properly constituted classes have been unfairly coerced by the majority within their class in terms of having been corralled by people whose rights appear similar but whose objectives and interests were poles apart." 

Furthermore, if the junior creditors are not offered anything, and the scheme is to be twinned with a pre-packaged administration sale in order to strand them in an empty shell company, the junior creditors will have no vote in the scheme because, strictly, they are not being asked to vote on a change in their rights. In other words, the company is entitled to leave them out of the scheme of arrangement. However, a party who is left outside the scheme can appear at the sanction hearing to argue that the scheme is unfair because the class of creditor of which she is a member should properly have been offered something within it. The English court will address this question by determining whether the creditors who have been left out of the scheme retain an economic interest in the company so that they should have been offered some consideration in it. 

In determining whether the creditors have such an economic interest, the English court puts particular weight on the position the creditors would be in if the scheme of arrangement were not sanctioned. Where the company is financially distressed, this typically leads to an inquiry into whether the price which an administrator would receive in a market sale of the business and assets at the time of the restructuring would be sufficient to make a distribution to the creditors excluded from the scheme. However, asset prices may be generally depressed if there has been a slowdown in the business or finance cycle. This means that even though the current market price may indicate that the excluded creditors have no economic interest in the company, if the

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77 Practice statement [2002] I WLR 1345.
78 S. 899(1) of the Companies Act 2006.
79 See, for example, Re Hawk Insurance Co Ltd [2001] 2 BCLC 480 at [23].
80 Primacom Holding GmbH v A Group of the Senior Lenders & Credit Agricole [2011] EWHC 3746 (Ch) at [57].
82 MyTravel [2004] EWCA Civ 1734; Re Bluebrook Ltd [2009] EWHC 2114 (Ch).
other creditors receive all of the equity in the company in exchange for their debt in the scheme of arrangement they may make a significant profit when asset prices recover.

To address this concern, US bankruptcy law adopts a valuation standard based on professional valuation opinions, rather than current market price established through an auction process.\footnote{The author has written extensively about this elsewhere. See Paterson n 67 above, 348-356 and S. Paterson, ‘Rethinking Corporate Bankruptcy Theory in the Twenty-First Century’ (2015) Oxford Journal of Legal Studies available at http://ojls.oxfordjournals.org/cgi/content/full/gqv038?ijkey=ESvFGKwAj6fTLDz&keytype=ref.} Thus it does not decide who should receive an equity allocation in the debt restructuring based on the current price in the market, but rather adopts traditional valuation techniques such as discounted cash flow, comparable transaction and private equity valuations in an attempt to give more credit for the prospect of a post-restructuring recovery in the price of the business and assets than a purchaser in the distressed market at the time of the sale might be willing to give. The very existence of this alternative is significant, because research into how we perceive unfairness has shown that it is in part determined by our ability to think about alternatives.\footnote{R Folger, ‘Reformulating the Preconditions of Resentment: A Referent Cognition Model’ In: JC Masters and WP Smith (eds) Social Comparison, Social Justice and Relative Deprivation: Theoretical Empirical and Policy Perspectives (1987) 183-215 cited in Sheppard, Lewicki and Minton n 18 above, 50.} It has given rise to lively debate amongst judges, scholars and practitioners as to whether senior creditors in an English restructuring receive “too good a deal”,\footnote{Re Bluebrook Ltd n 82 above at [49].} and whether England should move towards the US approach.\footnote{M. Crystal and R. Mokal, ‘The Valuation of Distressed Companies: A Conceptual Framework Part 1’ (2006) International Corporate Rescue 63; N Segal, ‘Schemes of Arrangement and Junior Creditors – Does the US Approach to Valuations Provide the Answer?’ (2007) 20 Insolvency Intelligence 49; AFME and Weil, Potential Economic Gains from Reforming Insolvency Law in Europe February 2016, 17-18 available at www.afme.eu.} In addressing the fairness aspect of this question, and leaving aside the broader advantages and disadvantages of the US approach,\footnote{For discussion of these broader advantages and disadvantages see Paterson n 67 above.} we must remember the socio-historical context in which the valuation approach in Chapter 11 was adopted. It is tempting to see it as what Sen has called a “transcendental framework”,\footnote{Sen n 2 bove, 15-18.} in other words an objective standard of what is fair in a debt restructuring formulated and developed by the brilliant academics who designed Chapter 11 independently of the action and behaviour in bankruptcy which they saw at the time. If this were the case, then the normative distributional concerns of Chapter 11 would remain constant over time. However, it is suggested that there is considerable “historical conditioning” in the theory,\footnote{This term is borrowed from Maurice Dobbs, see M Dobb Theories of Value and Distribution Since Adam Smith (1973), 16.} and that it was very much a product of what the academics saw of the actual operation of debt restructuring. In particular, in the 1970s when Chapter 11 was developed, it was usual to compromise trade creditors in a large, corporate debt restructuring as well as in an SME restructuring. In other words, there would have been fewer contextual differences between the SME restructuring and a large corporate restructuring. Thus we must be very cautious about how we apply “inherited ideas and concepts”\footnote{Ibid., 17.} to the new situation with which we are faced, conscious that “ideas have a genealogy of their own”.\footnote{Ibid.}

We should, therefore, pause to ask ourselves what we mean by “too good a deal” in this scenario. We do not mean that the quality of what the parties has contributed, or the effort they have dedicated to supporting the endeavour, is somehow different. Each has contributed money, and it
is likely that none of them played a particularly active role in monitoring the financial health of the company, or acting as a “whistle blower”, as might once have been the case.\textsuperscript{93} Crucially, the junior debt will have attracted higher pricing than the senior debt to reflect its increased riskiness on default, recalling Sun’s requirement that the quality of receiving what one deserves applies in the downside as well as the upside.\textsuperscript{94} We might argue, therefore, that provided the legal consequences were known in advance, in this scenario concepts of “deservedness” are of considerably reduced significance. We might also despatch the requirement for satisfaction of “legitimate expectations” in the same way.

The principle of free exchange in which the junior creditors consented to, are responsible for and took calculated chances on the situation in which they now find themselves is also more compelling in this scenario than in the SME scenario. These are financial creditors who have the full gamut of investment opportunities available to them. They are likely to be properly advised, and to understand the risks which they are taking. We do not have the same sense of a sophisticated insider of the financial elite pitched against a rookie. To the extent that the financial creditor represents a pension fund seeking the high risk, high return investment necessary to meet the requirements of an ageing population, we might argue that the pension fund has no more choice in investment selection than the weaker trade creditor, and no better ability to adjust price in competitive market conditions. We might be sceptical about the ability of investment managers accurately to predict and price for risk of and return on default, so that a US approach to valuation becomes crucial to protect pension investments for wider society, or conversely we might be confident that investors can predict and price risk and return on default, so that we fear the traditional English approach has an impact on the availability of credit. Or we might fear that unless we move to a system more recognisable to US creditors, they will not be willing to undertake the necessary learning process to feel happy to invest in businesses in the UK at a time when we are keen to attract direct foreign investment.\textsuperscript{95} These are vast issues and for another day. For the moment, the point is made once again that the argument is not that current corporate restructuring practice meets the paradigmatic trade-off between fairness and other considerations. Rather it is that the extent to which the situation falls short of our notions of fairness is not as extreme as it is in the SME case where a classic battle is fought between the weak and the strong. In the same way, whilst the argument that loss should not fall on those least able to bear it resonated in the context of weak trade creditors ranked against powerful financial creditors, it has less salience when we are considering financial creditor pitched against financial creditor.

One of the criticisms of financial markets after the financial crisis is the apparent absence of cultural or ethical norms to control bad behaviour.\textsuperscript{96} This is most commonly ascribed to globalisation and diversification of the market: it is well documented that cultural norms are seeded and thrive best in relatively homogenous groups.\textsuperscript{97} Yet this belies a fundamental shift in ideas. Modern markets do not look to the era of gentlemanly codes of conduct with misty-eyed nostalgia.\textsuperscript{98} There is a well-documented dark-side to homogenous groups with strong codes of

\textsuperscript{93} For the role of banks as monitor and whistle blower in the days of so-called relationship banking see J Armour and S Frisby, ‘Rethinking Receivership’ (2001) 21 Oxford Journal of Legal Studies 73-102.
\textsuperscript{94} Sun n 19 above and accompanying text.
\textsuperscript{97} See, for example, F Fukyama, Trust: the Social Virtues and the Creation of Prosperity (1995), 277.
\textsuperscript{98} For this period see, for example, D. Kynaston, The City of London: A Club No More 1945-2000 (2002); P. Augar The
behaviour: the codes which develop to keep members in the group may equally well be used to keep others out. Indeed, well-known work in the 1950s lamented the complacent and sluggish state of American capitalism and the apparent stifling of entrepreneurialism. In contrast, Piketty has described the “meritocratic extremism” of modern markets, and modern finance markets are more likely to judge a situation solely by an economic calculus. Of course, this raises issues too extensive to investigate here. But one benefit of a market bonded by an economic calculus is its “hyper-rationality”, in other words, its reluctance to allow emotional responses, such as spite, to play any role in determining the economically rational response. Thus it is arguably less likely that there will be a sense of a need for retributive justice when the creditors who have suffered the harm are sophisticated economic actors.

The Large Corporate Restructuring and Procedural Fairness

We may still have some concerns for procedural fairness because it is likely that the administrator is appointed by management together with the senior creditors, and we may remain concerned that the “voice” of the junior creditors is not adequately heard. Moreover, although in our example the pre-packaged administration is "twinned" with a scheme of arrangement providing a forum for objections, in another case where the senior creditors are ad idem the pre-packaged administration may be used alone to strand the junior financial creditors much as it was used in the SME case to strand trade creditors. However, it is still likely that the junior lenders are sophisticated financial creditors who are aware how a transaction of this type is likely to play out. They have the financial wherewithal to employ professional advisers to put their legal and economic arguments, and are unlikely to be wholly excluded from the process, or to be surprised by it. Whereas it will have been a key part of the strategy of the SME case to keep the transaction from as many trade creditors as possible, precisely to ensure that they continue to deal with the company in the shadow of the pre-packaged administration, no such concerns arise in speaking to the junior creditors. This is because it is likely that the junior creditors will be prohibited by the terms of the inter-creditor agreement from taking action against the company in the negotiation period. These creditors do not require a formal voice system in order to access decision makers – they are perfectly capable of doing so themselves.

Moreover, whilst the investment bank’s valuation (and any marketing process which supports it) is crucial to the outcome, and we may have concerns about the independence of management in producing the business plan on which the valuation will depend (particularly given the equity which they stand to gain in the transaction ranking behind a much reduced debt burden), the quality of the bias problem is arguably different from the SME situation. First, as noted above there is significantly less selection between equally situated creditors. Secondly, although the administrator in this scenario is likely to have been retained by those leading the transaction, she is also likely to have worked in other situations in which creditors who are currently in the junior


99 Fukuyama n 97 above, 314.
100 See, for example, D. Riesman The Lonely Crowd (1961) and W.H. Whyte The Organisation Man (1956).
101 T. Piketty n 24 above, 334.
102 For this argument in the case law see Re Bluebrook Ltd n 82 above at [63].
104 For a detailed discussion of this point and possible solutions to it see S. Paterson, ‘The Paradox of Alignment: Agency Problems and Debt Restructuring’ forthcoming European Business Organisation Review.
debt held the fulcrum securities. In other words, whereas in the SME transaction she is likely to have overriding loyalty for the single player whose patronage is crucial for future appointments, her long-run loyalties are less clear in this situation. We may have concerns that the situation is not as free from bias as we might ideally like, but it stands at a shorter distance from that position than the SME case. We have thus already trailed, and can dispatch relatively quickly, discussion of protection against abuse of power. In the large corporate restructuring scenario we have painted we are dealing with the “high hats” of the financial elite. We have already examined the reduced patronage concerns in the appointment of the administrator. We have also touched on the advisory team available to the junior creditor, and their implicit understanding of the situation.

In sum, the argument is not that the large corporate debt restructuring represents the paradigmatic marriage of fairness and efficiency. There may be other, fairer outcomes which are supportable or good arguments (outside the scope of this article) for preferring another solution on the basis that it will, for example, improve ex ante investment incentives which will encourage the raising of capital, or create better incentives ex post for the directors, or protect pension funds for wider society. Instead, the point is made that the large corporate situation is not as far away from what we might regard as the ideally fair solution as that of the SME restructuring. In other words, we need to adjust how we think about fairness in the new circumstances of the case. As we shall see, this need critically to assess our mode of thinking about notions of fairness comes into stark relief in the context of financial institutions.

Financial Institution Restructuring

Before the crisis many US financial institutions had issued bonds backed by residential mortgage loans to low income families in the United States (so-called sub-prime mortgages). Often the purchase of these residential mortgages had been funded through the short term money markets, and the mortgages were subsequently packaged together (or securitised) to support highly rated bonds. This proved a very attractive line of business, but eventually the funding market, and the market which traded in the securities, began to doubt the quality of the mortgages in the portfolios. Funding liquidity in the money market and the interbank market abruptly dried up. This meant that European financial institutions which had relied heavily on these markets for funding were no longer able to access them. At the same time, many of these institutions had also invested heavily in the US sub-prime securitisations, so that the asset side of their balance sheets took a heavy hit. During the financial crisis, European governments dealt with this by using taxpayers’ money to recapitalise the banks’ balance sheets and to provide them with funding liquidity; in other words, the banks were bailed out. After the financial crisis the "bail-in" tool has been developed, enabling the authorities forcibly to convert certain liabilities of distressed financial institutions into equity, recapitalising the relevant institution’s balance sheet and rebuilding confidence in it. Insofar as the fairness analysis is concerned, many of the same considerations apply to bail-in as in the large corporate debt-for-equity swap scenario. But there are certain crucial distinctions introduced into the fairness analysis by the fact that the entity to be restructured is a regulated financial institution.

The Financial Institution Restructuring and Principles of Fairness

105 The fulcrum securities are those which are likely to receive some consideration in the restructuring, but not to be repaid in full, which often provides their holders with effective control of the case.
106 See fn 71 above and accompanying text.
107 The term “high hats” is borrowed from D.M. Kennedy, Freedom from Fear: The American People in Depression and War (1999), 237.
In the era before the Great Depression bank runs were a common feature of the US business cycle. Often it was not clear what sparked the loss of confidence in an institution, but once the psychological fear gripped depositors, the bank could fail with frightening speed. Depositors rushed to withdraw their cash, and the bank, in a desperate attempt to stave off financial collapse, began to liquidate assets at fire-sale prices. It was all too easy for the situation to spread to other financial institutions. In the Depression era it became clear that mechanisms were needed to improve depositor confidence. This led to a number of reforms, including the introduction of deposit insurance, and legislation to ring fence deposit-taking business from other business so that depositors could have confidence that their deposits were not being used to fund other, risky activities. After these steps were implemented the rate and volume of bank failure slowed dramatically in the US, and US and UK finance markets entered an extended period of relative stability which came to be known as the Great Moderation.

Deposit insurance, however, creates a risk of “moral hazard”: bank executives inured against the risk of having insufficient assets to meet deposit obligations (because the deposit insurer is standing by to meet the liability, should it arise) take ever riskier action. At the same time, before the crisis deposit insurance was capped at a relatively low level in the UK so that it did not provide much comfort to modern depositors, and it did not cover (and so did not reassure) the money and interbank funding markets. Ring fencing of operations never arrived in the UK and was lifted there in the US 1999. The structure of the finance market changed, with increasingly complex financial arrangements of the type described above (the effects of which were not entirely understood), and a growth in the so-called shadow banking system outside the regulated sector. Assumptions that the post-Depression era reforms, sound central bank policy and a better understanding of the business cycle meant there would never again be a bust in the financial system proved to be groundless. Nonetheless, the financial crisis revealed an economic imperative to rescue financial institutions because of a fear that collapse would threaten the fabric of the financial system of the country. Scholars studying the Great Depression had criticised the response of the US Federal Reserve (the central bank) and Government, holding them partly responsible for the depth of the crisis in the 1930s by, amongst other things, failing to respond with rapid injections of sufficient liquidity for the struggling financial sector. Many of the policy actors in the financial crisis had studied the response to the Depression and had learnt these lessons. As a result, the UK Government stepped in, using taxpayers’ money to restore banks’ balance sheets, and in doing so revealed that before the crisis banks had been able to raise debt very cheaply because lenders had anticipated precisely this result. In the post-mortem this has been seen as intolerable to public opinion, and the political imperative that it should never be allowed to happen again is at the heart of the post-crisis legal and regulatory response.

110 Eichengreen n 70 above, 66.
111 Eichengreen n 70 above, 3.
113 Eichengreen n 70 above, 172, 180.
114 Admati and Hellwig n 109 above, 46; Eichengreen n 70 above, 11, 70, 99.
115 Eichengreen n 70 above, 73-75.
116 Eichengreen n 70 above, 72.
117 Eichengreen n 70 above, 115, 119.
118 Eichengreen n 70 above, 378.
119 Admati and Hellwig n 109 above, 89; CM Reinhart and KS Rogoff This Time is Different: Eight Centuries of Financial Folly (2011), 145.
A significant development has been the incorporation of the so-called bail-in tool in the Bank Recovery and Resolution Directive (henceforth the BRRD), implemented in the UK through amendments to the Banking Act 2009. The bail-in tool effectively enables the regulator to compel holders of certain debt instruments issued by the bank to swap them for equity. This will immediately reduce pressure on the bank's balance sheet and, it is hoped, restore confidence in it. It is also designed to remove the implicit government subsidy for banks by making it more realistic for regulators to restructure a distressed financial institution rather than bailing it out. As a result, bail-in risk should henceforth be priced into the cost of bank debt. However, in order to adjust the price of lending to reflect bail-in risk, a creditor needs reasonable transparency as to how the bail-in will occur. To this end, the European Banking Authority has issued a series of regulatory mandates, designed to ensure a reasonably uniform approach between member states on the treatment of capital in bail-in. At the time of writing the regulatory mandates remain in draft form, but the relevant ones for the purposes of allocating consideration (and, therefore, losses) in a restructuring are the Draft Guidelines on the Rate of Conversion of Debt to Equity in Bail-in, Draft Guidelines on Treatment of Liabilities in Bail-in, Draft Guidelines on Treatment of Shareholders First in Bail-in and Draft Technical Standards on Valuation in Bail-in.

The draft guidelines reveal a somewhat Byzantine structure for the valuation exercise. One valuation is carried out by an independent valuer in order to determine the rate of conversion of the debt and allocation of equity amongst debt holders. This is done by valuing the bank as a going concern after it has been successfully restructured, broadly similar to the use of valuation opinions for large corporate restructurings in US bankruptcy described above. A second valuation is carried out (both before and after bail-in) to determine the treatment which creditors would have received if the financial institution had been placed into an insolvency proceeding rather than being restructured using the bail-in tool. As in the traditional English approach in a large corporate restructuring, this valuation is likely to be done using current prices for the bank’s assets if they were sold in the market at the time of the restructuring. If a creditor is able to show that she is in a worse position after bail-in than she would have been in if the financial institution had been placed in an insolvency process and its assets realised and the proceeds distributed, she may bring a claim under the “no creditor worse off” principle enshrined in the BRRD. But this may be challenging if the bank is facing distress at a low point in the finance cycle when there may be a general lack of funding for banks in the market, so that many banks may be trying to sell assets at the same time to raise funds and there will be few buyers. As more banks seek to sell assets, prices become increasingly depressed, further weakening banks' balance sheets and thus requiring more asset sales to raise funds. This may mean that prices for the bank's assets are particularly depressed at the time of the bail-in. It would therefore seem to be more promising for a creditor to argue for a greater allocation of equity in the bail-in based on the post-restructuring value of the bank. However, it is not at all clear what a creditor can do if she disagrees with the going concern assessment for the purposes of the second valuation, as the only explicit right of appeal in the BRRD is the no creditor worse off principle based on the insolvency valuation.

To the extent that the valuation standards are intended to enable the market to reach a firm view on the position on default, both in deciding to lend and in pricing the lending decision, so that the treatment of the capital in bail-in is legitimised by consent, responsibility and luck, we might have expected clearer standards and clearer rights. This would also address the now familiar charge

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120 2014/59/EU, Articles 43 and 44.
121 Available at http://www.eba.europa.eu/.
122 Article 73.
123 Adler n 83 above, 16-17.
that creditors have not received what is due to them because, once again, it is suggested that provided the operation of the valuation standards is clear no principled fairness concern arises in the context of bail-in of sophisticated market actors investing in complex debt.\(^\text{124}\) To the extent that we are concerned with “deservedness” we may simply limit ourselves to clear and transparent rules. As before, this should ensure that the legitimate expectations of powerful market actors are met.

This analysis is reinforced in the unique situation of financial institution restructuring when we consider the fairness principle that loss should not fall on those least able to bear it. Whilst this was not a tremendously meaningful concept when we considered allocation of losses amongst financial creditors in the large corporate scenario, in the context of a financial institution, it is an explicit policy objective that losses should not fall on the taxpayer. Thus, as explained at the beginning, much of the post crisis response has been about ensuring that the system can absorb failure without implicating taxpayers’ money. There are many aspects to this, but in the context of bail-in of bank capital it is a clear plank of the valuation standards. It is also explicable in the limited legal right to complain based on the “no creditor worse off” principle. Yet the role of the going concern valuation is not clear, and whilst it seems unlikely that it will positively impact ex ante lending behaviour (because of its very uncertain role and the lack of clearly enforceable rights which relate to it) it does seem to open up the possibility of litigation ex post with all of the attendant costs for the taxpayer. The question then arises as to whether concern for procedural fairness motivated the complex valuation structure.

The Financial Institution Restructuring and Procedural fairness

The financial institution bail-in solution can be imposed on the creditors in a UK financial institution by the Bank of England.\(^\text{125}\) Thus concerns about procedural fairness in this case may reflect concerns about controlling regulatory behaviour, particularly the exorbitant exercise of regulatory discretion.\(^\text{126}\) Put shortly the concern emerges that regulators who have been provided with extensive regulatory tools will have an overwhelming desire to exercise them, and a new vein of literature relating to regulatory accountability is implicated. However, it is important that we identify this as the new concern in assessing the fairness of the procedure because, whilst the control of regulators has some parallels with the control of market actors explored in the other two situations, it also raises different issues around public interest. It also leads directly to a concern with protection against abuse of regulatory power.

This concern appears to manifest itself in the BRRD with the extension of valuation to going concern value as well as liquidation value. However, given that the only clear legal right is that provided by the no creditor worse off principle, we might ask to what extent that ambition is met. If we are genuinely concerned with abuse of regulatory power, we might wish to provide stronger enforcement rights for creditors who feel that they should have received a greater allocation on a post bail-in going concern basis. An alternative possibility is that the real benefit of the going concern valuation step comes from making the regulatory process seem, rather than be, fair.\(^\text{127}\) As

\(^{124}\) As before, we may conclude that other considerations (such as the need to encourage investment in the regulatory capital of financial institutions or to protect investment made by professional investment managers of pension funds for wider society) militate against a more brutal allocation of value. But if this were the motivation, we would expect to see clearer rights accompanying the post-restructuring going concern standard.

\(^{125}\) Section 12AA of the Banking Act 2009.

\(^{126}\) Kaplow and Shavell n 1 above, 406.

\(^{127}\) For this distinction between “seeming” and “being” see Jonathan Glover’s distinction between seeming and being moral in his work *Humanity: A Moral History of the Twentieth Century* (London 2001), 20.
discussed in the SME situation, work in the field of organisation theory suggests that acceptance of a system may be reinforced by an aura of fairness, even if the changes to the system do not render it fairer in any substantive sense, and notwithstanding that the effect of such a system is to reinforce the acceptance, and therefore the power, of those in control of it rather than to level the playing field. It may be, therefore, that the going concern valuation exists to provide what we might call surface fairness rather than a deep convergence towards a fairness standard. Or it may be that it has arisen from the debate around valuation standards in large corporate debt restructuring and that that is why the overall system lacks clear policy coherence. In other words, it is not clear to what extent the policy prescription has arisen from a clear analysis of the meta-fairness of the case.

Conclusion

Ultimately, there seems to be a lack of clear thinking about the normative concerns for fairness in the evolving valuation standards for the BRRD, the current debate around valuation standards in large corporate debt restructuring and the reform efforts around connected party SME pre-packaged administrations. Each scenario examined neatly illustrates the point which we started with. Not only do we always need to be mindful of other considerations which ought to prevail over our notions of fairness when determining policy responses in restructuring, we must also be clear what the normative concerns for fairness are which we are weighing in the balance. In other words, we must be mindful not simply to rely on intuitions or instincts but rather must critically examine the elements of our loose notions of fairness. Most importantly of all, we should be especially careful not simply to translate notions of fairness from one circumstance to another, without assessing whether some adjustment is required. Policy missteps are inevitable if this is not done.
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Commencement of Corporate Reorganisations in China

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Abstract:

This article is to investigate the commencement of corporate reorganisations in China from 2007 to 2014; specifically, it is focused on four questions surrounding these issues. The first question is to ask how many corporate reorganisation cases are entered during this eight-year period. The second question is to ask how Chinese courts conduct reorganisation entry tests when deliberating whether a reorganisation petition could be accepted. The third question is asking which parties are, in practice, liable to file reorganisation in Chinese courts, and the fourth question is to untangle the court jurisdictions over Chinese corporate reorganisations. Each answer is accompanied with a comparative analysis with the corporate reorganisation theories and practice in the USA and the UK in the hope that comparative studies might sharpen the debate and generate deeper understanding over China’s corporate reorganisation law.
Commencement of Corporate Reorganisations in China
From an Anglo-American Perspective

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Abstract

This article is to investigate the commencement of corporate reorganisations in China from 2007 to 2014; specifically, it is focused on four questions surrounding these issues. The first question is to ask how many corporate reorganisation cases are entered during this eight-year period. The second question is to ask how Chinese courts conduct reorganisation entry tests when deliberating whether a reorganisation petition could be accepted. The third question is asking which parties are, in practice, liable to file reorganisation in Chinese courts, and the fourth question is to untangle the court jurisdictions over Chinese corporate reorganisations. Each answer is accompanied with a comparative analysis with the corporate reorganisation theories and practice in the USA and the UK in the hope that comparative studies might sharpen the debate and generate deeper understanding over China’s corporate reorganisation law.

Introduction

In 2006, China enacted the rescue-oriented Enterprise Bankruptcy Law (the EBL 2006) and placed a chapter on corporate reorganisation at the heart of this new law, with the aim to rehabilitate financially distressed but economically viable businesses so as to preserve going concern value and to reduce social costs of business failures. The EBL 2006 took effect on 1 June 2007. But it remains unknown as to how this law on corporate reorganisation has been used in recent years, and specifically, this article seeks to investigate the commencement issues of corporate reorganisations in China. To this end, this article particularly sheds light on four questions surrounding these issues.

The first is to ask how frequently China’s new corporate reorganisation law is used; this question mainly looks at how many reorganisation cases were entered into from 1 June 2007, when the China Enterprise Bankruptcy Law (the
EBL 2006) took effect, to 31 December 2014, a time intended to cover latest cases, and this aims to give a glimpse of the general use of the China corporate reorganisation law.\(^1\) It is followed with a comparison of the use of such laws in the USA and the UK, in an effort to identify potential gaps of China’s implementation of the corporate rescue regime.\(^2\)

The second question is to ask what reorganisation entry tests are used in China to select suitable companies for reorganisation, since as is widely known that reorganisation must be selective, and that only certain types of companies could be rescued.\(^3\) In the meantime, given that reorganisation is part of the bankruptcy regime, it is also worth investigating whether the routine bankruptcy tests, such as the cash flow and balance sheet test,\(^4\) should be carried out to justify the entry of a reorganisation procedure in China.\(^5\) Then, a comparison with the Anglo-American systems on reorganisation entry tests will be followed so as to assess what lessons China could learn from these two jurisdictions.

The third question is investigating which party is liable to initiate an in-court reorganisation procedure in China; under the EBL 2006, several parties, including debtor, creditor and shareholder, may file for reorganisation before a court,\(^6\) but it remains to be seen as to in practice which party is more likely to trigger such a procedure, and it is equally important to ask what difficulties these applicants encounter when seeking for a reorganisation solution in court. In addition, as part of comparison, the reorganisation application theories and practice in the Anglo-American jurisdictions will be included and analysed in hopes to suggest some policy reforms for China.

The final question is to ask in which court a corporate reorganisation petition could be filed in China.\(^7\) It is noteworthy that China, like the UK,\(^8\) does not have a special bankruptcy court system, which means that reorganisation petitioners must choose a normal court to file.\(^9\) The empirical data on this aspect will be examined to find out the court jurisdictions of the Chinese corporate reorganisations. It is followed with a discussion of the court jurisdictions of Anglo-American corporate reorganisations.

Through answering these four questions, it is expected that a holistic picture on how the Chinese corporate reorganisations are commenced can be painted. The rest of this article proceeds in five parts. Part 1 examines the statutory framework on the commencement of corporate reorganisations in China. Part 2 reports the number of corporate reorganisation cases taking place in the surveyed period, and a comparison on the use of the corporate reorganisation law with the UK and the USA will be followed so as to identify the gaps. Part 3 outlines and analyses the reorganisation entry/eligibility tests used in China. Part 4 sheds light on the issues on reorganisation applicants, and Part 5 is
devoted to the findings and analysis over China’s court jurisdictions of corporate reorganisations. Part 6 concludes.

1. The Statutory Framework of Commencing a Corporate Reorganisation Procedure under the EBL 2006

Before the EBL 2006, arguably, China did not have a functional corporate reorganisation law. In 1986, China enacted the Enterprise Bankruptcy Law of 1986 (For Trial Implementation) (the EBL 1986), but the 1986 law exclusively deals with the bankruptcy of state-owned enterprises (SOEs). Admittedly, that law does have several provisions that are designed to rehabilitate rather than liquidate bankrupt SOEs; however, the odd procedures make such provisions largely paralyzed in practice.

For example, that law stipulates that only in the case of an existing liquidation procedure for a SOE, a reorganisation proposal can be made; this means that reorganisation can only be initiated from an existing liquidation procedure; in other words, reorganisation could not be straightforwardly filed in court, even for a SOE. Meanwhile, under the EBL 1986 Article 17, reorganisation should be proposed by a government agency that is in charge of the SOE debtor: neither the debtor itself nor the creditors are able to apply for reorganisation. Arguably, these hurdles are to suppress, rather than to pave the way for, reorganisation efforts.

Perhaps for the aforementioned reasons, Professor Weiguo Wang, a leading Chinese bankruptcy scholar, observes that such a reorganisation procedure might have never been used in China before its revocation by the EBL 2006.

In fact, shortly after the promulgation of the EBL 1986, the China People’s Congress, China’s legislator, started to amend this law so as to accommodate its fast-growing socialist market economy. Unlike the previous EBL 1986, the EBL 2006 formally addresses the corporate reorganisation procedure by absorbing many advanced corporate rescue principles from abroad, including the USA, the UK and Germany.

1.1. Reorganisation Open for All

In light of the unprecedented growth of private economy in China during the past three decades, the new corporate reorganisation procedure enshrined in the EBL 2006 is now open for all companies, regardless of whether they are state-owned or private. In fact, any companies that are incorporated in China are eligible to resort to this new law for reorganisation, including foreign invested companies. For example, as recently as 2014, Sanjin Shipbuilding Limited, a company owned by Korean investors, that is based and operates in
the city of Weihai, Shandong Province, filed for reorganisation in a Chinese local court.\textsuperscript{17}

Such an inclusive approach is also part of the broad reform embedded in the new EBL 2006, because different from the old EBL 1986, which is exclusively made for SOEs, the new law applies for all companies, and the former distinction between SOEs and private companies has been abolished.\textsuperscript{18}

However, in terms of the prospective implementation of the new corporate reorganisation procedure, the expectation must be kept low for a number of reasons. First, one has to raise the doubt concerning whether Chinese courts are prepared to fully open the doors to accept corporate reorganisation filings, and this is particularly a concern against the backdrop that before the EBL 2006, most Chinese courts showed great reluctance in accepting corporate bankruptcy filings, and that in most bankruptcy cases, courts were more likely to play an assisting role in the shadow of strong government intervention.\textsuperscript{19}

Second, it should also not be forgotten that in the past, most Chinese courts were only occasionally deployed by local governments to deal with the bankruptcy of SOEs, and that for private companies, it was very rare to see their bankruptcy to be handled in courts, so that doubts have to be raised on whether private companies, which are the bulk of companies in number in China, can easily access such a bankruptcy reorganisation procedure.\textsuperscript{20}

Third, at constitutional level, it is equally important to remind that in general, legal rules in China are not adequately followed,\textsuperscript{21} and if considering the weak judicial systems in China\textsuperscript{22} and the authoritarian nature of its government,\textsuperscript{23} attention should be paid on to what extent such an innovative procedure can be delivered in practice.\textsuperscript{24} This chapter will examine these concerns.

1.2. Entry Tests for a Corporate Reorganisation Procedure

First and the foremost, under the EBL 2006 Article 2,\textsuperscript{25} a debtor company filing for reorganisation need not show evidence of bankruptcy, which means that the bankruptcy tests, including the cash flow and balance sheets test, can be relaxed;\textsuperscript{26} specifically, this Article says that a company that is likely to be bankrupt may be rehabilitated in the reorganisation procedure of this law. Apparently, China's lawmakers expect rescue efforts to be taken at an early stage, in the belief that the earlier a rescue, the more achievable the rescue task.\textsuperscript{27}

But the problem of Article 2 is that it is silent on who is authorised to make the judgement as to whether the debtor company is likely to be bankrupt in the very near future. For example, a debtor, unwilling to enter into such a formal bankruptcy procedure and speculating that it may weather current financial
storms soon, may never admit its likelihood of bankruptcy; by contrast, to keep aggressive creditors at bay, a besieged debtor may expect to enter the safe haven as early as possible by claiming the existence of such likelihood. Meanwhile, given that reorganisation is a court-involved procedure in China, a local court that shuns a reorganisation filing may narrowly interpret the likelihood of bankruptcy in order to reduce its workload. In other words, a lack of details of this Article may give rise to confusion in practice.

Professor Shuguang Li argues that an auditing report may be useful to assess the likelihood of bankruptcy at a time when reorganisation is attempted, but this may involve some costs of hiring an independent accountant, and this may also delay the filing process. Nevertheless, bankruptcy exemption is still a significant step forward for China to build an advanced corporate reorganisation regime.

Second, the Chinese new reorganisation procedure is intended to apply for large distressed companies for fears that potential huge costs of reorganisation may make it financially unwise to rescue small companies. To some extent, this policy intention might have been influenced by the concerns debated in the USA as for the alleged exorbitant costs of Chapter 11s. Also, the Chinese lawmakers were advised of the scope of the reorganisation laws in Japan and Taiwan, whose formal corporate reorganisation laws are exclusively made for public companies, which are supposed to be large in size. For this purpose, the EBL 2006 Article 2 stipulates that an enterprise that is an independent legal entity may use the reorganisation procedure for rehabilitation, in the belief that being an independent legal entity means that the enterprise is large or big in size.

But, the expression of Article 2 seems to be problematic for a number of reasons. First, in spite of the statutory intention, Article 2 fails to define what specific criteria can be used to judge whether a company is large or small, either by the value of assets or by the amount of liabilities of the distressed company. Such ambiguity may lead to disputes in practice. Second, both in theory and in practice, being an independent legal entity cannot be translated into that the enterprise is big or large in size, since under the China Company Law 2005, all enterprises incorporated under this Law are granted with independent legal status, irrespective of their size, i.e., even a small shop registered as a limited company under the Company Law 2005 is an independent legal entity. Therefore, it seems that Article 2 does not adequately reflect or address the intention of the lawmakers.

Furthermore, as for lessons learned from the USA regarding the high costs of Chapter 11s, some arguments would be misleading; the recent studies show that the relative costs of reorganisation cases in the USA vary hugely on the
case by case basis, and that even on average reorganisations cost no more than liquidations, so that designing the China corporate reorganisation law only for large companies simply to avoid huge costs may lack concrete evidence to support. More importantly, the majority of Chapter 11s in the USA are in fact reorganising small and medium businesses; therefore, it seems unconvincing that reorganisation should be exclusively used for large companies.

In addition, in terms of the scope of the reorganisation laws in Japan and Taiwan, these two jurisdictions do have the special and separate reorganisation statutes for public companies, but it should be noted that they also have reorganisation laws for small and medium companies, which are governed by the other statutes; hence, it may be misleading to say that in Japan and Taiwan only public companies can resort to formal reorganisation procedures for debt restructuring; as a result, the Chinese lawmakers might have been ill-advised, so that the conclusion that reorganisation is only for large companies seems to be untenable.

But the key thing here is that it remains to be seen whether and how this reorganisation-for-large-company intention is realized in practice.

The third reorganisation entry test is whether the company’s business is on the list of the national strategic industries. In fact, this test does not appear in the EBL 2006; it is released in a judicial notice issued by the China Supreme People’s Court in 2009. Every several years, the China central government, the State Council, publishes and updates a list of national strategic industries. It is expected that a distressed company within a national strategic industry may gain favor from a Chinese court to enter into a reorganisation procedure.

These three tests can be clearly identified from the China corporate reorganisation law, but in reality there are some other practical tests developed to help courts to select suitable reorganisation candidates, and they will be examined later in this chapter.

1.3. Reorganisation Applicants in China

As mentioned above, under the previous EBL 1986, a reorganisation procedure can only be filed by a government agency and must be converted from an existing liquidation procedure; but this has been changed by the EBL 2006.

First, under the EBL 2006 Article 7, a debtor can voluntarily file for reorganisation before a court, and as noted before, filing for reorganisation, the debtor does not need to show the existence of bankruptcy. More importantly, entering into a reorganisation procedure could bring an automatic stay, which
suspends all enforcement actions of creditors, including secured creditors; hence, filing for reorganisation could be used as a powerful leverage for the debtor to engage in meaningful pre-reorganisation negotiations with creditors.

Some are worried whether bankruptcy exemption would be abused by debtors to the detriment of creditors; this is particularly an issue in the Chinese context, since in the past, it was not rare to see that some debtors, especially SOEs, hide assets before entering into bankruptcy procedures. But the China Supreme People’s Court is quite confident about this, instructing that courts can fully exercise the discretion empowered by the EBL 2006 to invalidate such transactions so as to curb abuses.

Such a worry might also be unnecessary: Given that filing for reorganisation may considerably tarnish the debtor’s business reputation: it is a bankruptcy procedure, and that the application of the absolute priority principle in bankruptcy will leaves nothing to the debtor if creditors are not fully paid in the subsequent procedure, it is highly unlikely for a debtor to gamble in filing for reorganisation lightly.

Second, under the EBL 2006 Article 7, a creditor can also file for the reorganisation of a debtor, provided that the debtor is unable to pay the debt; namely the creditor must convince the court that the debtor has been bankrupt by the cash-flow test. However, devils are in the details: Article 7 does not specify how long a debt payment is delayed and whether there is a minimum amount of delayed payment that can justify an involuntary reorganisation filing. The lack of clarity seems to be against the general principles of the rule of law. In China, there are repeated calls from scholars to clearly specify or quantify the conditions for a reorganisation filing.

Apart from such a difficulty, creditors may find another difficulty to file. Since most creditors are not familiar with the debtor’s business, it may be unlikely for a creditor to raise a useful reorganisation proposal; this is because making a viability judgment regarding the debtor’s business requires much financial and operational information of the debtor, however, except for banks and long-term suppliers, it seems to be an empty offer to give creditors a right for file for the debtor’s reorganisation in court. Arguably, providing such a right to creditors is a step forward, but a meaningful reorganisation effort has to be largely relied upon debtors themselves.

Third, under the EBL 2006 Article 70, a shareholder is empowered to apply for reorganisation on the conditions that there is an already creditor-filed liquidation procedure and that the shareholder must own no less than 10 per cent of the debtor’s equity. The same right is also given to the debtor in the case of a
creditor-initiated liquidation under Article 70. If confirmed by the court, the liquidation will be converted into a reorganisation procedure.

Professor Zou argues that such a mechanism aims to protect shareholders, especially minority shareholders, and that the Congress expects to promote the use of reorganisation by allowing shareholders to file. Professors Wang and Xu addresses that this is in fact borrowed from Japan and Taiwan, since the reorganisation law of these two jurisdictions allows shareholders to file for reorganisation, but to prevent abuse, all of them require that the filing shareholder(s) must hold not less than 10 per cent of equity, and even the Taiwan law goes further by clarifying that such shareholding should last not less than six months ahead of applying for reorganisation.

Overall, a wide range of parties, including debtor, creditor and shareholder, can file for reorganisation in a Chinese court, and the next question is which court they should go to and to lodge the petition.

1.4. Court Jurisdiction of Reorganisations in China

Apart from normal people’s courts at various local levels and the China Supreme People’s Court at the top, China does have special courts, like military, railways, forest and marine courts, but there is no bankruptcy court. Corporate bankruptcy including reorganisation must be filed in a local people’s court.

First, under the EBL 2006 Article 3, corporate reorganisation should be filed to and be heard by a people’s court where a debtor company is domiciled. And under a 2002 judicial notice issued by the China Supreme People’s Court, the domicile of a company is where the company’s major business operations are located, and if the major business operations cannot be identified, the domicile of the company is its address officially registered at the Government Business Registration Authorities.

In most cases, a company’s registered address is also where its major business operations are conducted; therefore, finding a local court to file for reorganisation must rely on where the debtor’s domicile is. This also means that forum shopping in China is quite unlikely. At local levels, in general, there are three layers of courts in the hierarchy: a lowest county court, a prefecture intermediate court in the middle, and a province supreme court that is just below the China Supreme People’s Court; hence, the next question is at which level of a court reorganisation petitions should be lodged.

Second, to navigate in the rank of local courts, under the same 2002 judicial notice, it depends on the level of the Government Business Registration Authorities at which the debtor company is registered; more precisely, the
reorganisation of a company that is registered in a county’s Government Business Registration Authorities should be dealt with by a county court, and if registered at above the county level, including at prefecture, province and even national levels of such Authorities, these cases should be heard by a local prefecture intermediate court.

Presumably, the justification of such job allocation is that usually a county Government Business Registration Authorities is in charge of the registration of some small companies, which may render it appropriate for a county court to handle the reorganisations of these companies, and accordingly, the rest of such cases are better left to local intermediate courts.

Aside from this general principle, this notice also gives local courts discretion regarding elevating or lowering a particular case between county and prefecture intermediate courts, and even a prefecture intermediate court can ask for the province supreme court to handle an individual reorganisation case.60

During the deliberation of drafting the EBL 2006, some foreign experts suggested that in the new bankruptcy law, China elevate all bankruptcy cases to the intermediate court level so as to avoid local protectionism and to take advantage of better-educated judges in large cities, but the China lawmakers declined such advice for unknown reasons.61 But in reality, the similar practice can be easily found: For example, in Shenzhen, a metropolitan city adjacent to Hong Kong, the local Shenzhen Intermediate People’s Court bans local county courts from handling corporate bankruptcy cases, including reorganisations, i.e., all bankruptcy petitions must be filed to the local prefecture intermediate court.62

Overall, in theory, except the China Supreme People’s Court, all local courts are eligible to hear corporate reorganisations, and a reorganization petition should be filed to a local court where the company is domiciled; meanwhile, in general, a reorganization petition should be filed to a local intermediate court unless the debtor is officially registered at a county Government Business Registration Authorities.

After introducing the legal requirements for commencing corporate reorganisation in books, now attention is paid on how the law is implemented in the real world.

2. Emergence of Corporate Reorganizations after 2007 in China

China’s legal procedure of corporate reorganisation is established from scratch; after the EBL 2006 took effect from 1 June 2007, corporate reorganisation cases emerged gradually.
2.1. The Data Sources

All the cases reported here were manually collected from China People’s Court Daily, the newspaper published in Beijing and managed by the China Supreme People’s Court. The Daily is published seven days a week, and has designated pages for public notices on corporate bankruptcies in most days a week; since the Daily was founded on 1 October 1992, the China Supreme People’s Court has ordered that all court public notices must be advertised on the Daily, therefore, this book takes advantage of such a monopoly, though which is a commercially controversial practice in China.

In order to collect the reorganisation cases accepted by the Chinese courts nationally between 1 June 2007 and 31 December 2014, the hardcopies of the newspapers published between 1 June 2007 and 31 March 2015 were examined each. Expanding the time span to 31 March 2015 is because usually a public notice is advertised days or weeks after the reorganisation case is accepted. So, technically, if a reorganisation case was accepted before 31 December 2014, but its public notice was advertised after 31 March 2015, it may be omitted from this book’s data collection, though such likelihood is thin.

2.2. An Overview of the Use of Corporate Reorganisations in China

The numbers of corporate reorganisation cases accepted each year in China from 2007 to 2014 are presented in Figure 1. In total, there were 564 reorganisation cases accepted by Chinese courts during the surveyed period, and there were 48 debtor companies (8.51%) that are listed on China’s Shanghai or Shenzhen Stock Exchanges.

![Figure 1: The Annual Number of Corporate Reorganisations Accepted in China (2007-2014)](source: The China People's Court Daily)

The first reorganization case was for Guangdong Fenhua Technology Group Limited, a state-owned company based in the city of Zhaoqing, Guangdong Province; the reorganisation was filed by the debtor on 6 July 2007, and on 11
July 2007 the local Zhaoqing Intermediate People’s Court accepted the filing. Of these

As shown in Figure 1, the annual number of reorganisation cases rose from 19 in 2007 to 65 in 2009, then dropped to 34 in 2011; after 2011, it seems that it gained momentum and steadily climbed to 168 in 2014.

As for the drop of the case number between 2009 and 2011, given that the 2008 global financial crisis also struck China hard, in theory, the reorganisation cases are assumed to continue to rise after 2009, but the fact is that they fell considerably. This unexpected drop is probably because of China’s 2009 massive economic stimulus package, which injected four trillion yuan ($586 billion) into the China economy to alleviate the impacts caused by the 2008 global financial crisis. But the happy time did not last very long, as seen from the continuous rise of reorganisation cases from 2012 to 2014.

Although in general, the case number increased from 2007 to 2014, there is a huge imbalance between different regions as for the use of corporate reorganisations in China. Figure 2 shows the number of reorganisations accepted in each province during this 8-year period.

As seen in Figure 2, the Zhejiang Province takes a lead in using the new reorganisation law to rehabilitate local troubled businesses, and more precisely, almost a quarter of (133 out of 564) the Chinese corporate reorganisation cases were heard in this province. Moreover, the four provinces, Zhejiang, Jiangsu, Guangdong and Shandong, heard 60% (340 out of 564) of the China corporate reorganisations in total. These four provinces are located at the China coastal...
areas, the richest and most vibrant in the economic development; this may partially explain the frequent use of the new reorganisation law in these regions.

At the other end of the spectrum, in the five provinces, Gansu, Tibet, Hainan, Guizhou and Tianjin, there was no reorganisation case identified; it is highly likely that the new reorganisation law has never been used in these five provinces, most of them economically underdeveloped.

In the middle, the picture is far from promising. For example, the first reorganisation case in Anhui Province took place in 2011, which means during the first five years after the EBL 2006 came into force this law was not used in the whole province. But the oddity would be Beijing and Shanghai (at province level both economically and politically in China), whose economy and judicial infrastructure are more developed; but there are only six reorganisation cases in each city during the surveyed period; this means each year there was less than one reorganisation case heard in each of these two developed cities.

Overall, the use of the Chinese new corporate reorganisation law varied widely from province to province over this period. And the national trend of the use of this law, as illustrated in Figure 1, may be particularly encouraging, against the backdrop of the decline of corporate bankruptcy cases in China as a whole.

### 2.3. The Decline of In-Court Corporate Bankruptcy Cases in China

To make filing for bankruptcy in court easier, the EBL 2006 has removed many barriers or hurdles of the EBL 1986, and encourages companies to file for in-court bankruptcies, including reorganisation, conciliation and liquidation, the three main bankruptcy procedures under the new law. For example, in the past, a government department’s consent should be obtained before a court considers the acceptance of a bankruptcy filing; but the EBL 2006 abolishes such a burden.

Meanwhile, as noted before, before the EBL 2006 became effective, some were very optimistic and predicted that there would be a surge of corporate bankruptcy filings; unfortunately, they may be disappointed.

The annual numbers of corporate bankruptcy cases, including reorganisations, conciliations and liquidations, concluded in China from 2007 to 2014 are presented in Figure 3.
Ironically, rather than boosting the filings of corporate bankruptcies in China, the EBL 2006 has been accompanied with – if not resulted in – a steady decline of corporate bankruptcy cases over the first eight-year implementation. The annual number of corporate bankruptcy cases concluded (heard) by the Chinese courts as a whole fell from 4,200 in 2007 to 2,509 in 2014, over a half drop.

Arguably, a series of factors, including the lack of judicial independence, the Chinese social stability troubles and the predatory government services in China, contribute to the difficulties of implementing the EBL 2006.

Most bankrupt companies in China exit the market without using the formal bankruptcy procedures, although the China Company Act 2005 Article 188 and other related statutes make very clear that bankrupt companies must use in-court bankruptcy procedures to deal with unpaid debts upon being dissolved. Obviously, it is easier said than done.

Turning to the use of the Chinese new corporate reorganisation law, now, the question is how many reorganisation cases a year in China are supposed to be handled by Chinese courts; a comparison with the Anglo-American practice may provide an answer.

2.4. The Assumed Number of the Chinese Corporate Reorganisation Cases Suggested by the Anglo-American Practice

It must be admitted at first that international comparison is adventurous and risky, since many differences on, among other things, culture, legal convention and judicial infrastructure between different nations are simply placed aside and the comparison results would be considerably biased, but
the value of cross-border comparison is that it can offer a unique vantage point from which a legal phenomenon within one nation can be assessed differently.\textsuperscript{82} the conclusion may not be correct or accurate, but is still highly valuable. This is the rationale of comparing China with the USA and the UK over the use of corporate reorganisation law.

To this end, a national corporate reorganisation rate is purposely made for the comparisons between China, the USA and the UK. It is generated as a portion of the annual number of reorganisation cases out of the number of companies remaining on the government company registration books at the end of each year. The Table 1 provides the relevant statistics.

<table>
<thead>
<tr>
<th>Year</th>
<th>Companies</th>
<th>Reorganisation</th>
<th>Companies</th>
<th>Reorganisation</th>
<th>Companies</th>
<th>Reorganisation</th>
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</thead>
<tbody>
<tr>
<td>2014</td>
<td>5,775,055*</td>
<td>6,093</td>
<td>2,835,900</td>
<td>1,587</td>
<td>10,617,154</td>
<td>168</td>
</tr>
<tr>
<td>2013</td>
<td>5,775,055</td>
<td>7,660</td>
<td>2,663,100</td>
<td>2,009</td>
<td>8,208,273</td>
<td>112</td>
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<td>2012</td>
<td>5,726,160</td>
<td>8,900</td>
<td>2,498,700</td>
<td>2,334</td>
<td>8,286,653</td>
<td>75</td>
</tr>
<tr>
<td>2011</td>
<td>5,684,424</td>
<td>9,772</td>
<td>2,442,400</td>
<td>2,539</td>
<td>7,331,200</td>
<td>34</td>
</tr>
<tr>
<td>2010</td>
<td>5,734,538</td>
<td>11,774</td>
<td>2,583,500</td>
<td>2,835</td>
<td>6,517,670</td>
<td>46</td>
</tr>
<tr>
<td>2009</td>
<td>5,767,306</td>
<td>13,683</td>
<td>2,573,800</td>
<td>4,162</td>
<td>5,591,274*</td>
<td>65</td>
</tr>
<tr>
<td>2008</td>
<td>5,930,132</td>
<td>10,160</td>
<td>2,543,800</td>
<td>4,822</td>
<td>4,959,000</td>
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<td>2007</td>
<td>6,049,655</td>
<td>6,353</td>
<td>2,412,900</td>
<td>2,512</td>
<td>4,537,274*</td>
<td>19</td>
</tr>
</tbody>
</table>

Notes:
1. The UK's statistics only cover England and Wales.
2. In the USA, company is to replace its local concept firm, and reorganisations are restricted to Chapter 11 filings for businesses under the USA Bankruptcy Act 1978. Non-business Chapter 11 filings are excluded.
3. In the UK, reorganisation denotes administration, the main corporate reorganisation procedure, under the Enterprise Act 2002.
4. In China, company denotes enterprise with an independent legal status, which are subject to the EBL 2006.
* This figure is borrowed from the previous year, since at the time of writing, the US Census Bureau has not released the 2014 statistics.
** These two figures are estimated, since the National Bureau of Statistics of China does not publish the figures for these two calendar years.
Generated from the statistics collected in Table 1, Figure 4 outlines the annual corporate reorganisation rates of these three jurisdictions from 2007 to 2014.

According to Figure 4, apparently, during and after the 2008 global financial crisis, in both the USA and UK, the reorganisation filings increased sharply: In the USA, for example, there were, in 2007, on average 10.50 reorganisation filings under Chapter 11 out of every 10,000 companies, but shortly after the crisis, this number soared to 23.72 in 2009, over double the pre-crisis number; in the UK, the reorganisation (administration) filings increased to 18.96 every 10,000 companies in 2008 from 10.41 in the previous year of 2007. But overall, soon after the 2008 global financial crisis, the reorganisation filings in both the USA and UK dropped gradually.

As shown in Figure 4, in general, the USA had a higher corporate reorganisation filing rate than the UK. A number of factors may give a partial explanation: First, compared with the UK, the USA has a far longer history of the corporate reorganisation culture, and the trajectory of its current Chapter 11 can be traced back a century ago; the USA system is far more established; by contrast, in the UK, as recently as 2002, the promulgation of its Enterprise Act 2002 might arguably mark its starting point of its formal corporate reorganisation system; to a certain extent, the UK might still be at the formative stage comparatively.

Second, in the USA, many besieged debtors are willing – and have a right – to file for reorganisation so as to enter a safe haven for a breathing space and to keep aggressive creditors at bay, in part because of the debtor-in-possession control model, whereas in the UK, before 2002, commencing a reorganisation (administration) procedure has to obtain the permission of a court, which in turn may hinder the use of the reorganisation procedure, and after 2002, although such a hurdle is removed, a debtor company in the UK still needs the positive
rescue eligibility opinion from an insolvency practitioner to open an administration procedure.\textsuperscript{87}

Overall, in the USA, the corporate reorganisation procedure is considerably debtor-friendly, although it should be noted that many filings would be dismissed by courts for various reasons at later stages.\textsuperscript{88}

Turning to China, its corporate reorganisation filing rate is very low, in sharp contrast with the USA and the UK: its highest rate occurred in 2014, where there were only 0.16 reorganisation filings out of 10,000 companies. To be precise, as for these three jurisdictions, the mean corporate reorganisation filing rate over the surveyed period between 2007 and 2014 is 16.05 per 10,000 companies in the USA, 11.17 in the UK and 0.10 in China.

Put differently, if the USA is treated as a benchmark, it means that on average, every year, China should accept 11,245 corporate reorganisation filings, but the fact is that there are, on average, 71 cases accepted, and even at its peak of 2014, there were only 168 reorganisations dealt with by the Chinese courts; namely, the Chinese new corporate reorganisation law is only 0.62 per cent used. And, by the same token, if the UK is assumed as a standard, arithmetically, the Chinese such law is 0.89 per cent used. Hence, much attention should be paid on promoting the implementation of the Chinese new rescue law.

However, the aforementioned numbers cannot be used to deny the importance or value of the Chinese new corporate reorganisation law: First, in spite of the existing cases in small number, it should not be forgotten that these formal reorganisations have immensely affected how informal corporate rescues, which are the majority in proportion, are carried out; Second, as will be reported in chapter 4, the implementation of this law in China has proved its great strength in preserving going concern value in the form of considerably increased debt recovery rates for unsecured creditors; Third, it is worth noting that around ten per cent of the Chinese corporate reorganisations were used to rehabilitate listed companies, which may in turn have reshaped the China economy in the recent decade, especially given that these listed companies are very big in size and are of social and economic significance for local economies.\textsuperscript{89}

To increase the use of the Chinese corporate reorganisation law, conducting reorganisation entry tests can play a vital role in maintaining the legal certainty of interested parties in deciding whether and when to file for reorganisation; these tests are to be examined in the following part.

\section*{3. Reorganisation Eligibility Tests in China}
As noted earlier, there are three reorganisation entry tests that could be identified through analysing the Chinese current corporate reorganisation law; but the key concern is whether or to what extent these tests are conducted in the real world; this part is examining these three tests each and analysing other tests arising from the day-to-day practice in China.

3.1. Bankruptcy Exemption for Voluntary Reorganisations

As analysed before, to encourage early rescues, the EBL 2006 Article 2 empowers debtors to file for reorganisation without showing the existence of bankruptcy; in other words, the bankruptcy tests are not required if reorganisation is voluntarily filed for by a debtor itself. However, this Article has not been adequately implemented, since almost all Chinese courts still require the bankruptcy tests to be passed before accepting voluntary reorganisation filings.

For example, as for the first voluntary reorganisation filing in Yunan Province in 2008 for the debtor, Jurenxin Rubber Manufacture Limited, although the debtor had been financially bankrupt on the grounds that it was unable to pay about 100 million yuan judgment debt, which means that it had already passed the cash flow bankruptcy test, the Kunming Intermediate People’s Court still additionally required the debtor to provide an auditor’s report that made a balance sheet bankruptcy conclusion of the company;\(^\text{90}\) apparently, for the debtor, to reach the courthouse, it had to cross the hurdles of both the cash flow and balance sheet tests before its voluntary reorganisation filing was accepted; bankruptcy exemption for voluntary reorganisation filings was ignored.

A latest example was the reorganisation filing for Zhong Chen Group Limited in March 2014 in Zhejiang Province, which excels in accepting reorganisations in China; when the debtor lodged its reorganisation petition, it had to submit the evidence of bankruptcy, in the form of its inability of paying massive judgment debts, namely the cash flow bankruptcy test, to Wenzhou Intermediate People’s Court; interestingly, the acceptance of this case was sanctioned by Zhejiang Supreme People’s Court, and this may ironically indicate that even the best performer in China also does not recognize the bankruptcy exemption for voluntary reorganisation filings.\(^\text{91}\)

Such a situation might be attributed by a handful of causes. First, education on the understanding of the EBL 2006 Article 2, especially for practitioners including judges, could be improved. Although the Chinese leading bankruptcy scholars have made clear that a voluntary reorganisation filing does not need to prove bankruptcy under the EBL 2006 Article 2,\(^\text{92}\) it is rare to see the similar views shared or expressed by practitioners.\(^\text{93}\)
Second, ideally, the wording of the EBL 2006 Article 2 itself could be further clarified, since it only says that a company that is likely to be bankrupt could file for reorganisation but fails to go a step further by explaining the legislators’ real intention in a crystal clear way. The vagueness of this Article’s wording arguably leads to confusion, especially of key players, judges, in China. A straightforward expression that a debtor filing for reorganisation does not need to be bankrupt seems to be a priority in the future amendment of the EBL 2006.

Third and most important, most Chinese courts try to avoid hearing corporate bankruptcy cases, including corporate reorganisation ones, because of the current court performance assessment system in China. One aspect of a corporate reorganisation case makes courts and judges quite nervous or uncomfortable: a potential protest launched by unpaid employees in large number. If a protest happens, the court will be negatively assessed by the local party-controlled government, and even individual judges will be disciplined, regardless of whether the protest is caused by the behavior of the judge. Understandably, most Chinese courts are keen to see a bankruptcy-free caseload. This could be also one of the major factors that leads to Chinese courts narrowly interpreting the EBL 2006 Article 2 in order to distance reorganisation filings.

With bankruptcy exemption neglected, it may be quite inconvenient for debtors to seek a formal reorganisation in court, which somewhat attributes to the small number of reorganisation cases in China.

3.2. The Large-Company-Only Eligibility Test

Similar to the vagueness of the bankruptcy exemption eligibility test, the large-company-only entry test seems also to be vaguely worded under the EBL 2006; but, this entry test is vigorously, if not excessively, enforced in practice.

Although it is difficult to ascertain or generalize the exact criteria used by Chinese courts in gauging whether a debtor company is large enough for reorganisation, either by the amount of assets or liabilities, or by the number of employees, it is apparent that most of the existing companies in reorganisation are big by various parameters.

As noted before, around eight per cent of the reorganised companies in China are listed on the Shanghai or Shenzhen Stock Exchanges, and in the context of China’s stock markets, these companies are usually massive in terms of assets, liabilities and employees. A typical example is Hebei Baoshuo Limited, which is listed on the Shanghai Stock Exchange; when allowed to enter the reorganisation procedure in Baoding Intermediate People’s Court, Hebei Province in 2008, it had 3,962 employees, with its annual turnover of 1.2 billion
yuan ($180 million), and the company contributed 33 million yuan ($5.05 million) of tax to the local government.98 Even by the UK standard, Baoshuo is a very large company.99

Apart from listed companies, other private companies admitted for reorganisation are also considerably large. For example, in the city Fuyan in Zhejiang Province, the debtor company, Hualun Group Limited, which entered into reorganisation in 2009, employed 4,650 workers, had 795 million yuan assets ($121 million), and paid annual 152 million yuan ($23 million) in tax.100

In addition, in qualifying a large company for reorganisation, a clear pattern is that a company of a decent size in a small town is more likely to be recognized as a large company for a judicial rescue. Even it is safe to say that most Chinese company reorganisations heard by courts at county level fall into such a category.

For example, as recently as 2014, in a less developed city, Qufu, Shandong Province, a local company Jinghuang Technology Limited was admitted by the local Qufu County People’s Court for reorganisation; the debtor employed about 1,400 workers and had assets worth 310 million yuan ($47 million); in general, it is more like a medium-sized enterprise, but it is located in Qufu, a small city; not surprisingly, by local standards, this company is too big to fail, thereby a formal reorganisation procedure was commenced to rehabilitate it in the interest of local communities.101

On the contrary, this may also explain why several Chinese big cities, such as Shanghai, Beijing, as mentioned before, have few reorganisation cases; these big cities generally have strong economy and more importantly they are generously subsidized by the Chinese central government for political reasons; the failure of several considerably large companies will not affect their municipal economies, and as a result, a large company by common sense may still be deemed as not big enough for a reorganisation procedure in these cities. Therefore, without a specific definition, there is great leeway to interpret whether a company is large or not, especially between small and big cities in China.

However, one clear point is that in spite of the ambiguity of the EBL 2006 in defining a large company for reorganisation, in reality, such a principle is regularly exercised in favor of large companies that are of importance to local economy and communities.

But, arguably, in the interest of the rule of law, if the Chinese lawmakers really aim to provide reorganisation exclusively for large companies, the standard used by the Chinese National Bureau of Statistics in surveying large
manufacturing enterprises may be useful to clarify what companies can be categorized as large to be covered by the new reorganisation law; according to the Bureau, from 2011 on, for the statistical purposes, a manufacturing enterprise is designated as a large company if its annual turnover reaches 20 million yuan ($3.06 million) and over; before 2011, the line was drawn at 5 million yuan ($0.76 million). If this standard can be transplanted into the bankruptcy reorganisation law, at least, the legal certainty on this could be immensely improved. It is worth noting that most of the existing companies in reorganisation meet this standard as for the annual turnover.

However, there is a growing concern raised in China, especially by some bankruptcy practitioners, that small- and medium-sized enterprises (SMEs) should not be neglected in the use of the new corporate reorganization law. As noted before, reorganisation is legally available for all enterprises that have independent legal status; given that most of SMEs are incorporated under the China Company Law 2005 and have such a status, currently, denying reorganisation filings of SMEs seems to be a breach of the EBL 2006 Article 2. So, it is not a surprise to see that, in 2011, for instance, the Zhejiang Supreme People’s Court urged the law courts in Zhejiang to accept more reorganisation filings for SMEs. More importantly, it should not be forgotten that in the USA, whose modern corporate reorganisation law inspires many nations, the vast majority of reorganisations are for SMEs. So, hopefully, in the near future, the Chinese law enforcers may change their minds and embrace SMEs in formal corporate reorganisation procedures.

3.3. The National Strategic Industry Entry Test

In general, the strict compliance with this entry test is not highly visible. This is in part because the national strategic industry list is quite broad, thereby it is too general to follow. Another reason would be that some companies in financial difficulties do belong to the national strategic industries, for example, the solar panel manufacturing industry, but the over-crowded market on the supply side means that it is unrealistic or unnecessary to reorganise everyone in distress.

Again, take the solar panel industry as an example, during the industry downturn of this industry between 2012 and 2014, reportedly, over half of the solar panel makers in China simply went bust and were dissolved, and only a few lucky ones were rehabilitated in the formal corporate reorganisation procedure. But, apparently, being included in the list of national strategic industries is an advantage but not a safe ticket for a reorganisation filing in China.
By contrast, many companies that do not fall into the China national strategic industries are also given the chance of debt restructuring under the new corporate reorganisation law. For instance, in the pioneer province of Zhejiang, over the year of 2014, there were at least four real estate developer companies admitted into the reorganisation procedure for rehabilitation, and there were also three paper manufacturing companies, which are serious water polluters and are supposed to be closed down as quickly as possible, entering into the formal reorganisation process; all these companies are not on the list of strategic industries.

In a word, arguably, it is desirable for a company filing for reorganisation to belong to the China national strategic industries, but if not, it also does not seriously matter.

Along with these three tests, a new test emerges in practice: the survivability test.

3.4. The Survivability Test

Many Chinese scholars and practitioners argue that a reorganisation filing must pass the survivability test before being accepted, although others contest that this test seems to literally go beyond the wording of the EBL 2006 Article 2.

Generally speaking, survivability could be understood as that the debtor company or its business operation can be brought back to normal through a reorganisation procedure; on the contrary, the company fails to pass this test if its business cannot be financially sustained even after a reorganisation operation, i.e. a debt reduction. It is fair to say that such a test is also considerably vague and is subject to various interpretations.

In part due to its ambiguity, different courts use different measures to assess the survivability of reorganisation candidates. For instance, in Hangzhou Intermediate People’s Court, Zhejiang Province, when a reorganisation petition is filed, the Court will conduct the survivability test by examining: 1 whether the company’s core business can still generate sufficient profits after meeting costs, 2 whether there is a consensus between the debtor, key creditors, major shareholders and employees, wishing to rescue rather than to liquidate the company, 3 whether there is a strategic investor (company buyer) emerging, who is interested in taking over the company, and 4 whether a preliminary reorganisation proposal has been presented by the applicant.

In Wuxi Intermediate People’s Court, Jiangsu Province, in carrying out the survivability test, the Court tends to focus on: 1 consulting with local
government, employee representatives, large creditors in order to hear their views over whether the company can survive after the reorganisation, 2 investigating main causes resulting in the company’s distress, and 3 summoning an informal creditors’ meeting in which an intense discussion or debate over the fate of the company between the debtor and the creditors can help the court to assess whether the survivability test could be passed.\textsuperscript{117}

In a word, courts have full discretion concerning how a survivability test can be interpreted and conducted, in spite of the ambiguity of its meaning and content. But, this test is largely a double-edged sword: On the one hand, passing such a test may filter doomed companies for the sake of improving the efficiency and effectiveness of a corporate reorganisation system, on the other hand, this test may constitute an insurmountable hurdle that excludes many distressed companies from accessing the formal corporate reorganisation procedure.\textsuperscript{118}

In 2012, the China Supreme People’s Court also mentioned this test in a judicial notice by stating that a company may be considered for reorganisation if it is likely to survive after the reorganisation procedure,\textsuperscript{119} and again there was no detailed explanation on its definition; probably, the Supreme Court wishes to maintain the great leeway of courts in conducting the survivability test for some viable rescues, notwithstanding some suggests that this test is a commercial judgment instead of a legal one,\textsuperscript{120} hinting that judges are not in the position to perform this test.

Overall, as for these four reorganisation entry tests in China, the first bankruptcy exemption test, which is powerfully pro-rescue, is largely in disuse; the second reorganisation-for-large-company test is excessively used by Chinese courts to shun SMEs in favour of considerably large companies; the third national strategic industry test is not seriously treated, and the fourth survivability test, growing from practice, is carried out at the discretion of China courts.

After investigating the statutory and practical entry tests for a corporate reorganisation procedure in China, attention is now turned to their counterparts used in the Anglo-American jurisdictions so as to make an international comparison.

3.5. The Anglo-American Reorganisation Entry Tests

First of all, as for bankruptcy exemption, basically, in the USA, a debtor filing for reorganisation does not need to show the existence of bankruptcy, and even such an exemption test is well understood and is widely used in this jurisdiction.\textsuperscript{121} By contrast, in the UK, its main corporate reorganisation procedure, administration, requires that a debtor company be insolvent in advance of a formal administration process,\textsuperscript{122} although it is noteworthy that in
the UK a less frequently\textsuperscript{123} used reorganisation (rescue) procedure, Company Voluntary Arrangement (CVA), permits a solvent company to use this formal reorganisation procedure in pursuit of a rescue outcome,\textsuperscript{124} and that bankruptcy exemption also applies in another UK’s popular debt restructuring tool, scheme of arrangement, which is government by Companies Act 2006.\textsuperscript{125}

As for concerns regarding potential abuses by debtors in the case of bankruptcy exemption, it should not be forgotten that the application of the fundamental equity principle, debt to be paid before equity,\textsuperscript{126} will leave nothing to the debtor if the creditors are not fully paid in the subsequent reorganisation procedure, namely, it seems to be illogical for debtors to file for formal reorganisation lightly. More importantly, the great value of bankruptcy exemption lies in that it may considerably promote early rescues.\textsuperscript{127}

Second, as far as the Chinese large-company-only entry test is concerned, the Anglo-American approaches are quite opposite: both of the two jurisdictions promote the use of corporate reorganisation by SMEs, and even both try to streamline existing rules especially in favour of them.\textsuperscript{128}

Admittedly, if due to cost concerns, China continues its large-company-only reorganisation entry test, some alternatives for SMEs must be seriously considered; under the current legal climate, the bankruptcy conciliation procedure embedded in chapter 9 of EBL 2006 may be used as a reorganisation alternative for Chinese SMEs.

Third, in terms of the Chinese strategic-industry reorganisation entry test, it seems to be difficult to find the corresponding tests used by the Anglo-American corporate reorganisation laws. Such a test in China reflects to a large extent the policy intention of the Chinese state to promote strategic industries, but restricting the judicial reorganisation procedure only for companies within such industries may do more harm than good, and it also deviates from what the EBL 2006 intends to cover.

Indeed, in the Anglo-American jurisdictions, government policies do influence the use of corporate reorganisation procedures. For example, during or immediately after an economic recession, both the USA\textsuperscript{129} and UK\textsuperscript{130} governments would react strongly by urging the reform of their respective corporate rescue laws for the purpose of alleviating the widespread failures of businesses.\textsuperscript{131} Even both governments tend to give a hand to individual companies in the interest of the national economy, for instance, the rescue of General Motor\textsuperscript{132} in the USA and Royal Bank of Scotland\textsuperscript{133} in the UK.\textsuperscript{134} But the key concern is that whatever the USA, UK or China, the government must operate within the law; twisting law for government policy priorities should be avoided.
Fourth, in relation to the survivability test developed in the Chinese corporate reorganisation practice, to some extent, it echoes with the theoretic analysis regarding business distress models widely circulated in both the USA and UK. In theory, in the face of business difficulties, a company may suffer from either an economic distress or a financial one, or both. An economic distress suggests that the company’s business is unable to generate a profit after meeting the operation costs: The company continues to lose money, as a result of which it should be pushed into liquidation rather than reorganisation. On the contrary, a financially distressed company is in trouble mainly or solely because of over indebtedness but its business operation by itself can still produce a profit, and obviously with the over indebtedness removed or reduced, the company could be brought back to the state of profitability again; such a company is what a modern corporate reorganisation regime aims to save, or in the circumstance of China’s corporate reorganisations, this company can survive after reorganisation.

But in Anglo-American corporate reorganisations, generally speaking, courts do not explicitly conduct a kind of the survivability test prior to commencing a reorganisation procedure: in the USA, courts tend to leave this judgement to reorganisation applicants, most of them debtors, but later such a judgement can – and should – be challenged by other parties, like creditors, as for whether it is achievable to rehabilitate the company; in the UK, courts usually rely on the judgement of administrators as to whether the company has a future, but rarely interfere with the professional opinions of administrators.

In addition, one theory related to corporate reorganisation entry tests is that a company admitted for reorganisation should have going concern value that deserves to be preserved for the benefits of a wide range of stakeholders; although this theory is well regarded in Anglo-American jurisdictions, there is little discussion on this in China, even in academic circles. A company is a web of relationships between assets, tangible and intangible, between managers and employees, between the company and suppliers and customers, and between the company and local communities, so on and so forth; such relationships embody going concern value, which would be lost in the event of piecemeal liquidation. This might be the fundamental rationale to rescue rather than to liquidate some distressed companies.

Apparently, many Chinese insolvency practitioners well understand the existence of such going concern value in troubled companies but are unable to clearly conceptualise its definition; introducing some basic theories of Anglo-American corporate reorganisations to China may considerably enrich the understanding of these practitioners about corporate rescue and conduces to the more use of the new corporate reorganisation regime in China.
To sum up, while Chinese courts prefer to use the reorganisation entry tests with a view to culling hopeless reorganisation candidates, Anglo-American courts take a quite liberal stance: reorganise as you wish. Given the high barriers of the Chinese reorganisation entry tests, the question that should be asked is which party is able to convince courts to accept reorganisation applications under the EBL 2006.

4. Corporate Reorganisation Applicants in China

Since identifying the applicants of reorganisations depends on the different routes into reorganisation procedures, a two-step approach is used here to find these parties. The first step is to separate reorganisations according to their entrance routes, and then the second step is to identify who these parties are.

As noted before, there are two general routes leading to a corporate reorganisation procedure in China under the EBL 2006: a petition for reorganisation can be directly filed to a court, or a eligible party can apply to the court to convert an existing liquidation procedure into a reorganisation one; in this chapter, the former is defined as a direct filing and the latter as a conversion filing.

As for all 564 reorganisation cases surveyed in this book, it is found that there are 530 direct filings and 34 conversion ones, namely, there are 94% of the cases that are directly filed to the courts in China, and the conversion ones are supplementary and are used in 6% of the cases. But the conversion ones do raise some interesting issues that will be examined later in this part.

4.1 Applicants in the Direct Filings

In these 530 direct filings, the identities of the applicants in 489 cases (92%) are publicly accessible, with those in the remaining 41 cases (8%) missing, so overall the general pattern can still be comfortably summarised.

Excluding the 41 cases, as shown in Figure 5, it is found that there are 222 reorganisations filed by creditors and 267 by debtors.
Clearly, over half of these cases were initiated by debtors themselves; it is quite understandable, since a reorganisation effort can be useless unless and until the party that possesses the information, financial and operational, about the company’s business can step forward; with the input of knowledge, information and expertise of the company’s business from the debtor, the viability of a reorganisation application can be immensely improved.

In the interest of viable rescues, therefore, much attention should be paid on encouraging debtors in China to voluntarily file for reorganisation, but they may be hesitant to do so for a number of reasons. First of all, many debtors in China are worried about losing control to an outsider, a bankruptcy administrator, immediately after a reorganisation procedure commences; Under the EBL 2006 Article 13, an administrator will be appointed by the court to replace the debtor in charge of the company’s assets and businesses at a time when a formal reorganisation procedure begins, which means the debtor’s management team will be instantly disarmed; this is considerably unacceptable for most debtors.

More importantly, one interviewee, an accountant who was appointed as administrators twice in handling reorganisation issues in China, said that at the heart of debtors’ concerns over losing control is the exposure of the evidence of tax evasion, which is widespread in Chinese business sectors, to outsiders. Tax evasion is indeed an issue in China, and one senior national official admitted that there are at least 90% of Chinese businesses, especially SMEs, evading tax in one way or another.

Second, as noted before, although under the EBL 2006 Article 2, a debtor who files for reorganisation does not need to show the existence of bankruptcy, in reality, courts, however, regularly require the debtor to provide the evidence of bankruptcy by the balance-sheet test, which means that an auditor’s special
report should be presented by the debtor to convince the court; this may increase the cost of filing for reorganisation by debtors, and in turn undermines their willingness to seek a formal rescue in court.

In addition, many debtor companies, especially equity-managed ones, may have little financial incentive to apply for a formal corporate reorganisation in China, because the vigorous application of the absolute priority principle will usually leave nothing to them, given that even unsecured creditors are unlikely to be fully repaid.147

Surprisingly, as shown in Figure 5, there are 45% of direct filings lodged by creditors in China; the conventional wisdom is that most creditors, such as suppliers, are unable to access the business information of debtors, thereby it may be impracticable to rely on creditors to launch a reorganisation project.148 The question now is why so many reorganisations in China were filed by creditors instead.

On closer inspection, it is soon found that many of these creditors were insiders or related parties; for example, in the reorganisation of Zhejiang Nanwang Technology Limited in 2008, the filing creditor, Sanhua Group Limited, is also one of the company’s major shareholders.149

Meanwhile, it can also be observed that many of these filing creditors are banks. For example, in the reorganisation of Zhejiang Jianshan Solar Panel Limited in 2013, the reorganisation petition was presented by Haining Rural Financing Co-Operative Limited, a local bank.150 In many cases, banks are major creditors holding substantial amounts of debts, as a result, they may actively engage in a reorganisation case.

For example, when the debtor company, Wuxi Suntech Limited, entered into reorganisation in 2013, it was revealed that the debts owned to the banks amounted to 7.16 billion yuan ($ 1.10 billion) (75.64%) out of the debtor’s whole debts at 9.46 billion yuan.151 Hence, it is not surprising that many banks not only act as the reorganisation applicants but also show great willingness in serving in creditor committees or even volunteer to be chairpersons of creditor meetings.152

In the meantime, given that banks are repeat players in the financial markets and usually have many professional staff, especially in-house lawyers, compared with other creditors, banks are technically able to fill the gap of filing for reorganisation as creditors in a more cost-effective way.

Whoever files for reorganisation in China, one point is quite certain: The filings must be supported by a local government, otherwise, it is highly unlikely for the
filings to be accepted by a local court. One report indicates that in at least 80% of Chinese corporate bankruptcy cases, including reorganisation ones, the filings are supported – or agreed with – by local governments in one form or another.\textsuperscript{153}

Therefore, the reality is that if a local government decides to back a local company’s reorganisation it is a matter of convenience to choose either the debtor itself or a creditor to file; this is largely to fulfil the formality.

4.2. Applicants in the Conversion Filings

As mentioned before, although there are only 34 conversion filings, i.e., these reorganisations were brought from the previous liquidations, they do raise some fresh issues that might be valuable for the future development of the Chinese corporate reorganisation law.

Strictly speaking, under the EBL 2006 Article 70, a conversion filing could only be initiated by the debtor or its shareholders, after a creditor-filed liquidation procedure has commenced; out of these 34 cases, there are 25 conversion filings falling into this category: they were either requested by the debtors (17 cases) or by the shareholders (8 cases).

But, the problem is that if it is a debtor-filed liquidation whether it can be converted into reorganisation at the request of certain parties, and that in the case of a creditor-filed liquidation whether parties other than the debtor and its shareholders are allowed to apply for a conversion. This problem is encountered in practice and is boldly solved by Chinese courts.

First, it is found that in the remaining 9 conversion cases, there are 5 reorganisation cases converted from the debtor-filed liquidations,\textsuperscript{154} two of them requested by the debtors themselves, another two by the creditors and the last one by the shareholders. For example, in the reorganisation of Kaifeng China-Petrol Refinery Limited in 2011, the reorganisation procedure was transformed from the previous liquidation voluntarily filed by the debtor at the request of a creditor; according to the administrator, a senior lawyer based in Henan Province, the court was of the view that the China new bankruptcy law is pro-rescue, so that Article 70 should be broadly interpreted, although the lawyer disclosed that the judges were under enormous pressures in sanctioning the conversion.\textsuperscript{155}

Second, there are 4 conversion cases based on the creditor-filed liquidations and requested not by the debtors or the shareholders but by other parties;\textsuperscript{156} specifically, the conversion was applied by other creditors in 3 cases, and the last one was asked by the administrator.
In principle, it seems that these abnormal conversions cannot be justified by what the EBL 2006 Article 70 allows. But given that the reorganisations were preferred by the interested parties, the courts indeed face a dilemma: on the one hand, sanctioning the conversion seems to be unlawful, but on the other hand, refusing to sanction may lead to a less favourable outcome for the stakeholders as a whole.

This dilemma suggests that some provisions in the liquidation chapter of EBL 2006 be updated to accommodate the diverse needs claimed by interested parties in bankruptcy. Under the current EBL 2006 Articles 70 and 95, in the event of a liquidation procedure, converting to reorganisation, as noted before, can only be applied by the debtor and its shareholders on the condition that the already liquidation is filed by a creditor, and converting to conciliation is also restricted to the debtor; ideally, in the future, more parties, as found in this book, should be permitted to apply for a conversion only if a reorganisation can serve the best interests of the stakeholders as a whole.

More importantly, the decision of whether to convert liquidation into reorganisation or not is better left to the creditors’ meeting instead of the court to made; law courts should be neutral and only need to scrutinise whether some minority parties would be unfairly discriminated by such a decision, if dissenting voices are raised.  

Nevertheless, as to the applicants of a corporate reorganisation procedure in China, the practice does raise some challenges that the future amendment of the EBL 2006 should address. Now, attention is turned to the Anglo-American corporate reorganisations so as to make a comparison.

**4.3. Reorganisation Applicants in the USA and UK**

Basically, similar to the Chinese corporate reorganisation regime, both debtors and creditors are allowed to straightforwardly file for reorganisation in court under the USA’s Chapter 11s and the UK’s administrations, but certain limits apply in the UK.

First, from the point of view of debtors, the USA Chapter 11 is considerably pro-debtor: as noted before, if a debtor files for reorganisation, it does not need to show the existence of bankruptcy, and to a large extent, filing for reorganisation is a right for them. Meanwhile, debtors may have great incentive to file, even at an early stage of distress, for a number of reasons: an automatic moratorium will stay almost all hostile debt enforcement actions of creditors, namely a safe haven could be entered into immediately once the debtor files; in most cases, the debtor can use the debtor-in-possession model to continue staying in office and steering its own businesses; and, usually the debtor will be granted an
exclusive six-month period to propose a reorganisation plan, and before it expires, other parties are not allowed to interfere with. Perhaps, for these reasons, one study discovers that the majority of Chapter 11s in the USA are filed by debtors themselves.\textsuperscript{158}

In the UK, a debtor can file for administration, but such a filing must be accompanied with a supporting opinion of an administrator, a qualified insolvency practitioner in the UK.\textsuperscript{159} Logically, without a supporting report (statement) from an insolvency practitioner, it is highly unlikely for a debtor company in the UK to enter into the administration procedure.\textsuperscript{160} This may also explain the UK’s slightly lower reorganisation rate compared with the USA, as analysed before. However, unlike the Chinese corporate reorganisation regime, a company’s directors in the UK can also file for administration under the UK insolvency law.\textsuperscript{161} This can be a major difference as to the applicants of corporate reorganisation between China and the UK.

In general, American debtors have greatest freedom to use reorganisation, and British companies must cross a rescue eligibility test conducted by administrators ahead of a formal reorganisation procedure; for Chinese debtors, in order to enter a safe haven of reorganisation, they must cross the technical eligibility tests, as examined before, and overcome the less developed rule of law.

Second, on the side of creditors, in the USA, under the Bankruptcy Act 1978, they may file for an involuntary reorganisation so as to push a defaulting debtor into a corporate rescue procedure, and even if a fraud is alleged, the creditor may ask the court to appoint a trustee to replace the debtor and to take control of the company.\textsuperscript{162} As noted before, partly due to collective action problems\textsuperscript{163} and partly due to a lack of information, a small proportion of the USA Chapter 11s are filed by creditors, though they are legally entitled to do so.

In the UK, under the Insolvency Act 1986,\textsuperscript{164} a creditor, secured or unsecured, can also apply for the administration of a debtor, but in practice, it is usually a secured creditor, a floating charge holder, who can bring the defaulting debtor into administration. There is little evidence suggesting that unsecured creditors can exercise the power to force a debtor into administration in the UK.\textsuperscript{165} In addition, in spite of the statutory entitlement of appointing an administrator, floating charge holders, banks, usually pressure debtors to file by themselves for reputation purposes.\textsuperscript{166}

Hence, as to forcing debtors into reorganisation, Chinese creditors are in the similar position with their USA counterparts; however, in the UK, except powerful bank creditors, many creditors, especially unsecured ones, would be in a very weak position, and even they would be more disadvantaged, if they
are deemed to be out-of-money parties in a formal rescue process, which means that they have little participation over the debt restructuring procedure,\textsuperscript{167} notwithstanding British lawmakers have been making efforts to alleviate negative effects against unsecured creditors.\textsuperscript{168}

In addition, Chinese debtors are allowed to apply for a conversion from liquidation into reorganisation, and the USA bankruptcy law has a similar mechanism, according to which a business debtor may switch between Chapter 11 on reorganisation and Chapter 7 on liquidation if certain statutory conditions are met.\textsuperscript{169} The UK law also allows debtors to convert liquidation into other bankruptcy procedures on the conditions that the conversion is in the interest of creditors as a whole and is proposed in good faith; meanwhile, the shareholders of a company is given the same right during a liquidation procedure in the UK.\textsuperscript{170} But little is know whether such conversions are regularly sought in the UK.

As for the position of American shareholders in the company’s liquidation, arguably, given the insolvency of the company, they are unlikely to be granted the right to change the course; in very limited situations, shareholders may be permitted to officially participate in the bankruptcy reorganisation process, but generally speaking, there is no allocated place for shareholders in a liquidation process, let alone to given them the right to apply for reorganisation.\textsuperscript{171} This would be another key difference between the USA and Chinese bankruptcy laws in terms of the treatment of shareholders in liquidation.

5. Court Jurisdictions of Corporate Reorganisations in China

To find a court to file for reorganisation, the first step is to ascertain the venue where a court has the power to accept and hear the case, and the second one is to choose a court at the appropriate level.

5.1. Territorial Jurisdictions over Corporate Reorganisations in China

As to the jurisdiction of reorganisations in China, in general, nearly all surveyed cases were heard by the courts whether the debtors are domiciled, which is in line with what the EBL Article 3 requires.

For instance, in 2007, when the debtor, Hunan Maisui Food Limited, based in Jinshi City, Hunan Province, voluntarily filed for reorganisation, its case was accepted by its local Jinshi County People’s Court.\textsuperscript{172} In the event of an involuntary reorganisation, the filing creditor must also submit its reorganisation petition to a court where the debtor is located. For example, in 2014, the creditor, Shanghai Haibo Xinghui Commodities Limited, which is a Shanghai company, filed for the reorganisation of the debtor, Shanxi Haixing Steel Group Limited,
which is in Yunchen City, Shanxi Province; the creditor had to travel over one thousand miles from Shanghai to Shanxi Province to file the case in the debtor’s local court, Yunchen Prefecture Intermediate People’s Court.\textsuperscript{173}

It is safe to say that, for most Chinese companies, their registered address in government company registration agencies is the same place where their main business is operated. Hence, apparently, identifying the registered address of a debtor is the easiest way to select a court to file for reorganisation. But in the case of a clear difference between these two places, in principle, as noted earlier, the location of main business operation prevails; however, in practice, it seems that this principle is not adequately applied.

There are two high-profile reorganisation cases, which offer clear evidence. The first is the reorganisation of Qingtai Trust Limited; Qingtai is a financial broker company whose registered address is at Xining City, Qinghai Province, but its main business operation is in Shanghai, a global financial hub; when the company entered reorganisation in 2009, it was the court in Xining City rather than in Shanghai that dealt with the case.\textsuperscript{174}

The second case is for the debtor, Powerise Information Technology Limited; the company operated in Changsha City, Hunan Province, but its registered address is in Shenzhen City, Guangdong Province; under the China Supreme People’s Court’s regulation, its reorganisation should be heard in a Changsha court, but the reality is that it was a Shenzhen court accepting and handling its reorganisation.\textsuperscript{175}

But it is also wrong to conclude that this principle is utterly abandoned in practice, since one particular opposite case is identified, where this principle is used. In 2013, Jiangsu Zhongda New Materials Limited entered into reorganisation, but its case was handled in Wuxi Intermediate People’s Court, where the company’s main business was performed, although its registered address was in Nanjing, another city in Jiangsu Province.\textsuperscript{176}

In view of the strict application of territorial jurisdiction rules over corporate reorganisations, forum shopping for courts or judges is very rare in China. Interestingly, it did occur in China, although conducting forum shopping is considerably costly.

On 4 February 2010, Shanghai Hongshen Technology Limited, a public company listed on the Shanghai Stock Exchange, applied for reorganisation in Shanghai First Intermediate People’s Court, and six months later, the court told the company that the reorganisation application could not be accepted; frustrated with the decision of the Shanghai court, on 12 October 2010, the company decided to move its registered address from Shanghai to Xi’an, the
capital city of Shaanxi Province; correspondingly, the company name was also changed to Xi’an Hongshen Technology Limited, but it was still listed on the Shanghai Stock Exchange; not surprisingly, on 27 October 2010, its reorganisation application was accepted by Xi’an Intermediate People’s Court. Obviously, it is a marathon for the debtor company to seek reorganisation in court.

5.2. Vertical Jurisdictions over Corporate Reorganisations in China

Turning to the levels of courts hearing reorganisations in China. As noted, a reorganisation case could be heard by either a local county court, prefecture intermediate court, or by a provincial supreme court. It is, as illustrated in Figure 6, found that out of these 564 cases there are 331 cases (58.69%) heard by county courts, 232 (41.13%) by prefecture intermediate courts and one (0.2%) by a provincial supreme court.

Figure 6: Court Jurisdictions over Corporate Reorganisations at Different Levels in China (from 2007 to 2014)
Source: China People’s Court Daily

- Reorganisations Heard by County Courts (331)
- Reorganisations Heard by Prefecture Intermediate Courts (232)
- Reorganisations Heard by Provincial Supreme Courts (1)

Hence, the vast majority of the reorganisations were heard by the courts at the county and prefecture levels, with only one exception, the case of Qingtai Trust Limited handled by Qinghai Provincial Supreme People’s Court. To a large extent, the China Supreme People’s Court’s policies on the bankruptcy allocation between courts at different levels are well followed in practice, namely, the levels of jurisdictions on bankruptcy depends on the levels of government business registration authorities where companies are registered.

Occasionally, it is evident that some reorganisation cases may move between courts at different levels, since the China Supreme People’s Court allows courts to internally negotiate over the jurisdiction of an individual bankruptcy case. For example, in 2014, the debtor, Wenzhou Zhongchen Construction Limited, was distressed and filed for reorganisation; given that the company was registered
at Wenzhou Prefecture Government Business Registration Authority,\textsuperscript{178} it did file the case in Wenzhou Intermediate People’s Court according to the aforementioned Supreme Court policies, but later the court sent the whole case down to one of its inferior courts, Wenzhou Ouhai District People’s Court, which is at the county level, to handle.\textsuperscript{179} It is worth noting this happened but very occasionally.

5.3. Reorganisation Jurisdictions in the USA and UK

In the USA, a reorganisation case can be filed to a district court where the company’s executive office is located, its main business operation is conducted, its principal assets are located, or the company is incorporated, so a wide range of court venues can be selected by a filing applicant.\textsuperscript{180} In light of these options, choosing a friendly court or judge in the form of “forum shopping” is quite common in the USA,\textsuperscript{181} especially for large companies, which could afford extra costs by travelling to another city for so-called efficiency or convenience; for example, as recently as 2014, large American companies still preferred the bankruptcy court of the Southern District of New York.\textsuperscript{182}

Compared with American companies, Chinese companies, to a large extent, only have one option: Filing for reorganisation in the courts where they are incorporated; in Chinese terms, it is where their registered addresses are.

In the UK, partly because of the EU regulations, a company bankruptcy including administration must be heard by a court where the debtor’s centre of main interest (COMI) is located;\textsuperscript{183} in England in particular, the only choice of jurisdiction is the High Court in London, whose judges may travel to other cities within the country to hear bankruptcy cases.\textsuperscript{184} Since in most cases, judges tend to seriously scrutinise the COMI of a debtor company, forum shopping, even for foreign companies, is very rare in the UK.\textsuperscript{185}

Apparently, in terms of court choices, Chinese companies are in a similar status with their UK counterparts, namely there are few alternatives.

However, both the USA and the UK have specialised judges to deal with corporate bankruptcies: in the USA, there is a whole system of bankruptcy courts and judges,\textsuperscript{186} while the UK High Court Chancery Division consists de facto bankruptcy judges.\textsuperscript{187} This is what China substantially lacks at the moment.

6. Conclusion

Over the years between 2007 and 2014, there is a growing number of corporate reorganisations in China after its pro-rescue enterprise bankruptcy law took effect since 2007; but compared with the proportion of corporate rescues in the
USA and the UK, there is still a long way ahead for China to catch up. Although the Chinese lawmakers intended to use the bankruptcy exemption test to promote more early rescues, the practice is far from ideal, and moreover, Chinese courts either narrowly interpret the existing statutory tests or artificially set up their own tests beyond the law in order to distance themselves from dealing with corporate reorganisations.

On the positive side, however, Chinese courts do skilfully allow more rescues to be carried out, which is evident on the creative conversions arising from the previous liquidations. Finally, similar to the UK practice, the jurisdiction of Chinese corporate reorganisations is largely restricted to where the debtor company is domiciled; the popular “forum shopping” in the landscape of the USA corporate reorganisations is uncommon in China.


4 See a general discussion of these two basic tests at Vanessa Finch, Corporate Insolvency Law, Perspectives and Principles (2ND ed, CUP, 2009) Chapter 4 Corporate Failure especially.


6 See Shuguang Li, ‘Designing Two Agencies to Solve the Difficulties of the Economy’ (2010) 1 China Think-tank 30, 33-34 (suggesting to set up a government agency to deal with corporate bankruptcies in China).

7 Some call for a bankruptcy service agency to be built in government at local levels in China, but the likelihood of establishing a government agency in charge of, or coordinating, corporate bankruptcy in China, may be very thin. See Shuguang Li, ‘Designing Two Agencies to Solve the Difficulties of the Economy’ (2010) 1 China Think-tank 30, 33-34 (suggesting to set up a government agency to deal with corporate bankruptcies in China).


17 The EBL 2006, art. 2 (it generally states that an enterprise may file for reorganisation if it is bankrupt or if it is likely to be bankrupt very soon, without differentiating SOEs from private enterprises).


19 The EBL 2006, art. 2. See also Charles D Booth, ‘The 2006 PRC Enterprise Bankruptcy Law: The Wait is Finally Over’ (2008) 20 Singapore Academy of Law Journal 275, 283 (arguing that the EBL 2006 is a unified bankruptcy statute applying for both SOEs and private enterprises, including foreign invested enterprises).


21 See Ronald Winston Harmer, ‘Insolvency Law and Reform in the People’s Republic of China’ (1996) 64 Fordham Law Review 2563, 2575 (arguing Chinese courts may be overshadowed by government intervention in bankruptcy processes). See also Shuguang Li, ‘Bankruptcy Law in China: Lessons of the Past Twelve Years’ (2001/Winter) Harvard Asian Quarterly 1 (reporting that the vast majority of bankruptcy cases were for either SOEs or collectively owned enterprises in China).

22 According to the World Justice Project, China is ranked at 72 out of all 102 surveyed countries as for the adherence to the rule of law in 2015, which largely means that the rule of law in China remains under developed. See World Justice Project, Rule of Law Index 2015 (the World Justice Project, 2015).


25 Shuguang Li, ‘Problems of Enacting the New Enterprise Bankruptcy Law in China’ (2002) 7 China Licensed Accountants 55, 58 (predicting an explosive increase of enterprise bankruptcy filings after the new law takes effect).

26 Zhijie Jia, ‘Several Issues of the Draft of the China Enterprise Bankruptcy Law’ (2006) 7 Journal of the China People’s Congress 575, 578 (making clear that under the proposed new law a debtor filing for reorganisation does not need to be bankrupt so as to encourage more early rescues).

27 See Liming Wang, ‘Problems of Amending the Bankruptcy Law’ (2005) 3 Legal Science 3, 11 (supporting the view that a company that is likely to be insolvent should be allowed to use the reorganisation procedure before it is too late), and see also Shuguang Li, ‘Some Issues on New Bankruptcy Law’ (2006) 6 China Law Express 17, 18 (arguing that the likelihood of bankruptcy can justify the entry of a reorganisation procedure under the new EBL 2006).


29 See generally Sida Liu, ‘Beyond Global Convergence: Conflicts of Legitimacy in a Chinese Lower Court’ (2006) 31 Law & Social Inquiry 75 (examining that local courts in China may operate under enormous political pressure from local governments).


China

33 (in Chinese) 78, 82 (mentioning that reorganisation in Japan is for public companies).

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35 (noting that in the USA the previous Chapter X reorganisation is exclusively for debtor companies whose reorganisation candidate must be an independent legal entity).

11 Reorganisation (2006) 61 The Journal of Finance 1253 (reporting that liquidations cost no more than

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(2015) 23 Bankruptcy Law 54 (arguing the urgency of clarifying the conditions of bankruptcy filings in China).

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04/30/content_8196533.htm China Net (Beijing, China, 30 April 2007) (Professor Xinxin Wang was interviewed and discussed the conditions of bankruptcy petition acceptance by Chinese courts). See also Xinxin Wang, 'Several Issues of Amendng China's Bankruptcy Law' (2002) 5 China Legal Science (in Chinese) 78, 84.


33 Zhijie Jia, ‘Several Issues of the Draft of the China Enterprise Bankruptcy Law’ (2006) 7 Journal of the China People’s Congress 575, 577 (noting that reorganisation is aimed for large companies, so the reorganisation candidate must be an independent legal entity).

34 See generally Eugene V. Rostow and Lloyd N. Cutler, ‘Competing Systems of Corporate Reorganisation: Chapter X and XI of the Bankruptcy Act (1939) 48 The Yale Law Journal 1334, 1338 (noting that in the USA the previous Chapter X reorganisation is exclusively for debtor companies whose liabilities exceed $250,000 under the USA Bankruptcy Act s. 156 before 1978).

35 The Company Law 2005, art. 3.


41 The EBL 2006, art. 19.


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49 Some scholars in China criticize that the lack of details on this front makes it quite difficult for creditors to push defaulting debtors into reorganisation or liquidation. See Shihu Wang and Yingye Chen, ‘Empowering Creditors in Filing for Bankruptcy: Lessons from the UK’ (2014) 32 Hebei Law Science 45. See also Gerard McCormack, Corporate Rescue Law – An Anglo-American Perspective (Edward Elgar, 2008) 125 (mentioning that in the USA a creditor holding more than $10,000 undisputed debt can push the debtor into reorganisation).

50 See generally Andrei Marmor, ‘The Rule of Law and Its Limits (2004) 23 Law and Philosophy 1, 5-7 (arguing that legal rules should be clear enough to be followed, and that clarity is one of the significant elements of rule of law).

51 For example, Weihong Fan and Peng Wang, ‘Conditions of the Acceptance of Bankruptcy Petitions’ (2013) 4 Academic Exploration 66 (examining the difficulties caused by the lack of details on the conditions of bankruptcy petition acceptance by Chinese courts). See also Xinxin Wang, ‘Case Registration and Bankruptcy Filings’ (2015) 10 Journal of Law Application 36 (arguing the urgency of clarifying the conditions of bankruptcy filings in China).


54 A recent study shows that over 90 per cent of Chapter 11 cases in the USA are filed by debtors themselves. See American Bankruptcy Institute, ‘ABI Commission to Study the Reform of Chapter 11’ (2015) 23 ABI Law Review 1, 19.

59 The China Supreme People’s Court, Several Issues of Handling Enterprise Bankruptcy (Beijing, China, 30 July 2002) Part 1.


61 The China Supreme People’s Court, Several Issues of Handling Enterprise Bankruptcy (Beijing, China, 30 July 2002) Part 1.


64 ‘This Newspaper is Managed by the China Supreme People’s Court’ China People’s Court Daily (Beijing, China, 19 February 2016) 1.


69 See generally John Whalley and Chunbing Xing, ‘The Regional Distribution of Skill Premia in Urban China: Implications for Growth and Inequality’ (2014) 153 International Labour Review 395, 398 (noting that the coastal area is the powerful engine of the China economy in recent decades).

70 Strictly speaking, Tibet is an autonomous region at the same political level as a province in China, and the similar is the City of Tianjin, Chongqing, Beijing and Shanghai. For simplicity, this book treats them as provinces.


72 See also Chuanhua Han, ‘A Potential Surge of Bankruptcy Cases after the EBL 2006 Takes Effect Soon’ China People’s Court Daily (Beijing, China, 31 May 2007) 5.


75 See for example, Jianxing Xu, Haiting Ju and Yiran Wang, ‘Proposals of Simplifying Corporate Bankruptcy Procedures’ (2014) 8 Journal of Law Application 102-103 (noting that many government departments deliberately make troubles when bankruptcy cases are heard in courts).

76 Shenfeng Xu and Shen Zhang, ‘The Deficiency of the Corporate Bankruptcy Procedure in China’ (2015) 1 Law and Economy 50 (noting that the majority of bankrupt companies do not use the bankruptcy procedure to terminate the businesses, with unpaid creditors left in a desperate situation).

77 For example under the China Civil Procedure Law 2012, a court must convert an individual debt enforcement into a bankruptcy procedure, in the case that the debtor’s assets could not meet the
judgment debt. See a comprehensive discussion of this at Shuai Li, ‘Conversion to Bankruptcy from
85 See generally Gerard McCormack, ‘Apples and Oranges? Corporate Rescue and Functional
86 See generally David Kennedy, ‘The Methods and the Politics’ in Pierre Legrand and Roderick Munday
(eds), Comparative Legal Studies: Traditions and Transitions (CUP, 2003) 345.
87 See generally Peer Zumbansen, ‘Transnational Comparisons: Theory and Practice of Comparative
Law as a Critique of Global Governance’ in Marrice Adams and Jacco Bomhoff (eds), Practice and
Theory in Comparative Law (CUP 2014) 186.
88 See Edward I. Altman, Corporate Bankruptcy in America (Heath Lexington Books, 1971) Chapter 1
Bankruptcy in Perspective.
Modern Law Review 247, and see also Rebecca Parry, ‘Is UK Insolvency Law Failing Struggling
Companies?’ (2009) 18 Nottingham Law Journal 42. Strictly speaking, the Cork report might open the
era of corporate rescue in the UK from the 1980s, see Ian F. Fletcher, ‘UK Corporate Rescue: Recent
Developments – Changes to Administrative Receivership, Administration, and Company Voluntary
90 See generally Thomas G. Kelch, ‘The Phantom Fiduciary: The Debtor in Possession in Chapter 11’
91 See Andrew Campbell, ‘Company Rescue: the Legal Response to the Potential Rescue of Insolvent
93 See Elizabeth Warren and Jay Lawrence Westbrook, ‘The Success of Chapter 11: A Challenge to the
Critics’ (2009) 107 Michigan Law Review 603, 614 (reporting the relative low confirmation rate of
Chapter 11 reorganisation plans in the USA).
94 See Zinian Zhang, ‘Corporate Reorganisations of China’s Listed Companies: Winners and Losers’
(2016) 16 Journal of Corporate Law Studies 1 (reporting the number of listed company reorganisations
95 Yan Dai and Wenyang Wang, ‘A Win-Win Result of the First Reorganisation Case in Yunnan’ China
96 Yin Zhang and Wen Ou, ‘Zhong Chen Entered Reorganisation and Its Undisputed Debts Amounted to
Journal of China University of Political Science and Law 48, 51, Weiguo Wang, China’s Bankruptcy Law
(China People’s Court Press, 1999) 197, and Liming Wang, ‘Several Issues of Amending China’s
98 See Xiaqin Tan and Jiang Xia, ‘Problems of Converting Individual Enforcement into Reorganisation’
99 Xiaoming Song, Yongjiao Zhang and Min Liu, ‘Understanding the Judicial Notice of the Supreme
Court on Corporate Bankruptcy’ (2011) 21 People’s Judicature 25, 27 (noting judges’ confusion of the
wording of the EBL 2006 Article 2 on the likelihood of bankruptcy).
100 See Shenfeng Xu and Sheng Zhang, ‘An Empirical Study of the Lack of Corporate Bankruptcy Cases in
China’ (2015) 1 Law and Economy 16, 18 (examining that the social stability assessment system
makes courts quite reluctant to hearing corporate bankruptcies in China).
101 See Beijing First Intermediate People’s Court, ‘A Report of Social Stability Events with the Judicial
Sector’ (2012) 11 People’s Judicature 54 (reporting that courts are under pressure when in face of
protests), and see also Jialong Tao and Jian Chen, ‘Rethinking the Xinfang System’ (2006) 75 Journal
of Law Application 76, 78 (arguing that judges are unfairly treated when a protest happens).
102 Pratyush Bharati, In Lee and Abhijit Chaudhury, Global Perspectives on Small and Medium
Enterprises and Strategic Information Systems: International Approaches (Business Science Reference,
2010) 147 (noting that some countries use the number of employees to define whether a company is
large, and that some use the annual turnover to differentiate large from small and medium enterprises).
104 Company Act 2006 s. 466 para (4) (a company is defined as a large company if it employs more than
250 employees and has an annual turnover of over £ 22.8 million)
105 Youjia Ying and Zhenyi Wu, ‘Hualun is Troubled with Back-Street Loans and Jinding is Embroided’
Shanghai Stock News (Shanghai, China, 19 May 2009) B3.
106 Qufu County People’s Court, ‘Reorganisation Revives Jinghuang Technology Limited’
108 Dianhua Fan, ‘Wenzhou: the Difficulties of Implementing the Bankruptcy Law Nanfang Weekend
(Guangzhou, Guangdong, China, 24 January 2014) <http://www.infzm.com/content/97756> accessed
27 February 2016 (a Zhejiang lawyer argues that SMEs should be equally treated in the use of the new corporate reorganisation law). Yamin Mao, ‘Informal Reorganisation for SMEs’ (2012) 9 China Entrepreneur 112 (arguing that it is urgent to use the reorganisation law to rehabilitate SMEs in trouble), and Weihai Intermediate People’s Court, ‘Enhancing the Reorganisation of Limited Liabilities Companies in China’ (2013) 29 Shandong Justice 32, 35 (the judges recommend that there should be a special reorganisation procedure tailored for SMEs).


See American Bankruptcy Institute, ‘ABI Commission to Study the Reform of Chapter 11’ (2015) 23 ABI Law Review 1, 5 (mentioning that “the overwhelming number of business bankruptcies (reorganisations) are by small and medium-sized enterprises.”).


Ibid, Part 17 stipulates that the solar power manufacturing industry is the national strategic industry.


They are Deshen in Shangyu, Huayang in Pinghu, Zhongchen in Wenzhou, Qingshiu in Hangzhou, and Jingchen in Jiande.

They are Wanxing, Zhongyi and Jingtai in the city of Fuyang, Zhejiang.


See the statistics mentioned in a report that compared with administrations, CVAs are less used in practice at Insolvency Practices Council, ‘Insolvency Practices Council Annual Report 2010’ (2011) 24 Insolvency Intelligence 102, 104.


156 They are Shenzhen Wanghai Industry Limited, Zhangzhou Steel Limited, Sicuhan Changzheng Pharmaceuticals Limited, and Yangjiang Jiangchen Construction Limited.
159 Insolvency Act 1986 Sch. B1 29 (3) (b).
162 US Code Title 11 – Bankruptcy § 1104.
167 Sandra Frisby, ‘A Preliminary Analysis of Pre-Packaged Administrations’ (Report to the Association of Business Recovery Professionals, August 2007) 28 (noting the little participation of unsecured creditors in pre-packed administration cases in the UK).
168 Vanessa Finch, Corporate Insolvency Law, Perspectives and Principles (2nd edn, CUP, 2009) 382 (examining that the Enterprise Act 2002 requires that the new administration procedure serve the best interest of creditors as a whole, clearly with unsecured creditors included).
170 See generally Steven A. Frieze, ‘Converting Compulsory Liquidation to Voluntary Arrangement’ (1989) 2 Insolvency Intelligence 35.
172 ‘Bankruptcy Public Notice: Hunan Maisui Food Limited Accepted for Reorganisation by Jinshi County People’s Court’ China People’s Court Daily (Beijing, China, 26 October 2007) 7.
173 By Chen, ‘Haixing Enters into Reorganisation and It is the Last Resort for Mino People’s Court’ China People’s Court Daily (Beijing, China, 26 October 2007) 7.
175 They are Shenzhen Wanghai Industry Limited, Zhangzhou Steel Limited, Sicuhan Changzheng Pharmaceuticals Limited, and Yangjiang Jiangchen Construction Limited.
181 See Theodore Eisenberg and Lynn M. LoPucki, ‘Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganisations’ (1999) 84 Cornell Law Review 967, 968 (reporting that more than half of large corporate reorganisations chose a court in the venue other than where their executive offices are located).
Insolvency issues and small business

The treatment of SMEs in bankruptcy across various systems
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Small Business and Bankruptcy: The Kosovo Experiment

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Introduction

Small and Medium Enterprises (SMEs) are ubiquitous. In 2014 they accounted for 99.8% of all enterprises in the non-financial business sector in the twenty-eight states of the European Union (EU).¹ For every square kilometer of land surface the EU has an average of five SMEs.² Moreover, in 2014 SMEs employed almost 90 million people - 67% of total employment — in the EU.³ The situation in the United States is similar. Small businesses account for 99.7% of all employers, and about 48.5% of private sector employment.⁴ If sole proprietors (technically not employees) are added in, the percentage rises to 97.9%.⁵

SMEs are variously defined. In the EU, SMEs are defined as businesses which employ less than 250 staff and have an annual turnover of less than €50 million, or their balance sheet total is less than €43 million.⁶ In the US, until recently the definition of an SME was an enterprise that employed less than 500 individuals.⁷ Within the last year, however, the United States Small Business Administration has significantly changed the definition by providing different metrics depending on what industry the business is in. Businesses in the mining trade, for example, may have up to 1,500 employees and still be classified as a small business, while others, such as new car dealers, are capped at 200 employees.⁸

This paper focuses on the smaller end of this scale: the micro SMEs. In the EU, a micro SME has ten or fewer employees, and either less than €2 million in turnover, or fewer than €2 in assets on their balance sheet.⁹ Almost all SMEs — 93% — in the EU are micro SMEs employing less than 10 people.¹⁰ The number is similar in the US. Approximately 79% of all business have fewer than 10 employees, while 89% have fewer than 20.¹¹ This 89% benchmark quickly rises to 97.9%, however, when you add the 23.6 million sole proprietorships extant in 2013.¹²

The point is that the bulk of all businesses are small. In addition, they are more fragile and prone to failure than larger businesses.

Should We Expect Higher Rates Of Failure For SMEs?

Business failure is a constant. Approximately half of all businesses started die within five years;¹³ two thirds don't make it to ten.¹⁴ Within that failure group, SMEs are well represented. Compared with large firms, European SMEs in general are more leveraged and reliant on bank financing and have significantly higher non-performing loan (NPL) ratios.¹⁵ Over the last few years, SME borrowing rates have not declined as much as yields on sovereign bonds, and remain high compared with those for large firms.¹⁶

These failures don't often result in court-supervised bankruptcies. Indeed, as Professor Edward Morrison has noted, the vast majority of SME failures are handled privately, without the need for a collective action involving all creditors.¹⁷
But some SMEs might be good candidates for rescue. Given the sheer number of such businesses, it is not a stretch to say that insolvency law should at least attempt to respond to the viable small, or even micro, SME.

**Different Countries' Treatment**

There have been many government efforts at addressing SME failure over the last thirty years, usually at the administrative and non-bankruptcy level. These efforts have included government-sponsored guaranties, as well as some tax incentives. They have also include government direction to asset management companies on how to deal with SME defaults if SME loans wind up being held by an asset management company. Some notable efforts are listed below.18

**Indonesia**

In 1998, the Indonesian authorities established a new governmental agency, the Jakarta Initiative TASK Force, which provided a one-stop forum to facilitate out-of-court workouts for corporates. Using simplified templates, the Jakarta Initiative TASK Force also targeted SMEs. However, few SME cases were resolved through the Jakarta Initiative TASK Force due to the government's priority to resolving large corporates and the sheer number of distressed SMEs.

More than 100,000 SME NPLs were transferred to the Indonesian Bank Restructuring Agency, an asset management company. The Indonesian Bank Restructuring Agency adopted an across-the-board approach to SME debt restructuring. SME loans were either targeted for resolution through cash settlement (with interest and principal discounts) or sold through an open tender auction to other financial restructuring agencies.

**Japan**

In 2000, the Civil Rehabilitation Act—which, albeit not explicitly applicable to SMEs, aims at providing simplified, expedited, and prepackaged procedures for distressed SMEs—came into force. Both debtors and creditors may initiate the procedure under the Civil Rehabilitation Act. Under this Act, the court needs to ascertain whether the debtor is experiencing actual or potential balance sheet insolvency. Any application proposing an infeasible plan or suggesting bad faith by the debtor needs to be rejected by the court.

Key features of the Civil Rehabilitation Act include the following: (1) the rights of secured creditors may not be changed without their consent; (2) rights of unsecured creditors may be impaired by a simple majority of creditors holding more than half the total amount of unsecured claims; (3) there is no automatic stay, but temporary stays imposed by a court enable a time period to negotiate; (4) consent of shareholders is not required to dispose of the business or reduce capital; (5) post-petition financing has first priority in a class together with administrative expenses; and (6) the debtor remains in possession during the restructuring, is subject to the duty to act honestly and fairly, and requires court permission to undertake certain actions (for example, liquidate assets, acquire new loans, settle or pursue lawsuits, and hand over collateral). The court confirms a plan unless it violates the law, is a product of fraud, has no possibility of success, or is against the general interests of the creditors.

In 2000, the Japanese Ministry of Economy Trade and Industry established 47 support centers to facilitate consultations with SMEs and help formulate restructuring plans. Over 17,000 SMEs used the support centers and more than 2,000 restructuring
plans were formulated. The Ministry of Economy and Trade also established 17 SME restructuring funds, which raised 51.5 billion yen, which were underutilized.

In 2009, the Japanese government enacted the "Act Concerning Temporary Actions to Facilitate Financing of SMEs" (the "SME Act") in response to the financial crisis, which was extended twice and expired in 2013. The SME Act formed part of a concerted effort to assist SMEs through various special support programs, including credit guarantees and public loans. The SME Act obliged banks to use best efforts to amend the terms and conditions of distressed loans at the request of SMEs. To incentivize banks to process applications, the supervisory guidelines for banks were relaxed, and restructured SME loans were no longer required to be treated as NPLs.

Korea

In 1999, Korea separated the distressed corporate sector into three segments: large, medium, and SME (IMF 2000b). For the latter, the government instructed banks to evaluate the financial soundness of SMEs and identify targets for workouts, and set up individual workout departments in banks to review the restructuring plans. Banks evaluated the status of about 22,000 SMEs and classified 40 percent as viable. Restructuring options included rolling over SME loans, providing grace periods for repayment, reducing interest rates, and, for larger and stronger banks, injecting liquidity by providing fresh money. The government also played a role in establishing government-sponsored credit guarantee funds to provide loan guarantees to SMEs to enhance the availability of credit to the sector, and setting up Corporate Restructuring Funds to provide liquidity to SMEs through both debt and equity investment.

The level of state support provided to SMEs suggests that SME over-indebtedness was delayed or inhibited rather than resolved. The state guarantees were available to SMEs with ties to the larger corporates. Bank lending was concentrated around firms that could secure these guarantees, which skewed incentives in favor of existing firms, as the guarantees were constantly rolled over, creating a barrier for entry. For microenterprises, support to SMEs has meant support to the household sector (IMF 2010).

In 2004, the government started a creditor-led restructuring program for SMEs under a revised version of the Corporate Restructuring Promotion Act ("Corporate Act"). The revised Corporate Act stipulates shorter deadlines, allows debtor in possession, and permits shareholders to repurchase converted equity. About 7,300 SMEs underwent this program, and half were restructured and one-quarter were liquidated. Assessments by the Bank of Korea suggest that banks' implementation of the program was too lenient and thus only moderately successful to resolve the debt overhang since, in some instances, nonviable SMEs also received debt restructurings (IMF 2010).

Malaysia

In 1999, Malaysia offered SMEs (with debts up to RM 50 million) bridge financing from the loan monitoring unit of the central bank while the SMEs pursued debt restructuring.

Thailand

In 1999, Thailand promoted several mechanisms targeted at SMEs: (1) the Corporate Debt Restructuring Advisory Committee, formed within the Bank of Thailand, introduced a simplified version of its inter-creditor and debtor-creditor agreements for SMEs; (2) the Bank of Thailand set monthly targets for financial institutions to resolve...
SMEs cases; and (3) the Bank of Thailand led a consortium to purchase promissory notes issued by creditworthy SMEs at a discount. The facility was priced at below the average cost of funds to the banks in order to encourage its use.

Turkey

In 2006, Turkey established the "Anatolia Approach" targeted at SMEs. The "Law for the Restructuring of Debts Owed by Small and Medium Sized Enterprises to the Financial Sector" (the "SME Law") aimed at rehabilitating 70,000 Turkish SMEs with debts in excess of YTL 1.7 billion, thus preserving jobs. Under the SME Law, the regulation concerning the general conditions for agreements was developed by the Banking Regulation and Supervision Board. Framework agreements prepared by the Turkish Bankers' Association consistent with the regulation were approved by the Banking Regulation and Supervision Board for a two-year term and were signed by 21 commercial banks. Under these framework agreements, NPLs could be restructured in a variety of ways, including through extending maturities, rolling over loans, providing fresh loans, decreasing principal/interest rate/default interest rate, and debt-to-equity swaps. Success was limited since by 2008, only 97 restructuring agreements had been signed, mainly because of limited interest and participation by the 21 commercial banks.

Significant Considerations in Drafting SME Bankruptcy Provisions

These administrative efforts have not, with the possible exception of Japan, lead to many efforts craft legislative solutions through better in-court procedures. And those that have tried, have had mixed success. In the US, for example, special provisions in Chapter 11 for small business, defined as business with less than $2,566,050 in mature and uncontested debts. These limits have existed since 1994, but the substantive provisions linked to this definition mainly increase reporting burdens while accelerating the confirmation process. Chapter 13 processes significant numbers of individual debtors (since Chapter 13 is restricted to human debtors), but its debt limits hamper its usefulness as a business reorganization device: only 2,404 individual chapter 13 business cases were filed in the twelve months ending March 31, 2016.

A number of countries have introduced simplified procedures for SMEs in their general insolvency regimes (Germany, Greece, Slovenia, Spain) or special processes (Italy). The Italian over-indebtedness agreement (concordato preventivo) is specifically designed for micro and small SMEs and is part of the in-court toolkit. It involves a stay and a majority voting process (60 percent of creditors in value).

There have been many studies and articles regarding SME bankruptcy. In designing statutes for insolvent SMEs, it is relevant to note the differences between SMEs and larger and more mature businesses. SMEs tend to have more bank debt and more highly leveraged. Although they sometimes have assets that can be used as collateral, the quantity and perceived quality of the collateral may be of lesser desirability. They tend to use guaranties more, and the guaranties tend to be from friends and relatives.

A central puzzle is that, to the extent that the business is entrepreneurial, there is a fuzzy line between the entrepreneur and the business. This has legal and business consequences. The entrepreneur/owner is often the heart of the business' assets, yet cannot (we hope) be collateralized and liquidated in the same way that a pure corporation's assets can be realized. Legal recourse is often clouded by whether the entrepreneur/owner has selected a limited liability vehicle for the business, or whether he

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or she has remained a sole proprietor (or has given guaranties that essentially expose his or her assets to a particular creditor the same as if he or she has remained a sole proprietor). Added to this mix is the relatively fragility of an SME's finances, which are often unable to handle the added costs that restructuring professionals represent.

From this, there are some standard tropes that need to be considered when drafting legislation. Costs should be reduced, and the most common way to keep costs low is to simplify and speed up the process. So too is the taint of bankruptcy. In the small world in which SMEs operate, failure reverberates. One SME's failure to pay is often another SME's lost revenue, and nonpayment often carries a grudge.

But perhaps the most perplexing, and potentially emotional, issue is an economic one: many SMEs are simply not viable. Despite their owners' wishes, they should not receive assistance to survive; doing so only diverts resources and time away from otherwise viable businesses.

**Elements of a Successful SME Approach**

This background suggests certain elements of a legislative response to SME insolvency. First, the process must acknowledge that many SMEs simply do not merit rescue, and thus procedures should be in place to conduct "triage" on entities who file to test whether they deserve the court's scarce time. Second, creditors' expectations of a recovery must be addressed, and clear indications of entitlements on insolvency should be set. Finally, given the overlapping identity between entrepreneur and his or her business, there should be relief available not only for the legal form of the business, but also for the owners of the business.

On the first point, sorting the meritorious from the detritus is a daunting task. Feasibility analysis is rarely simple, and requires more than superficial knowledge of the debtor's finances. The cost of an independent review of these finances would thus be equally daunting. There does, however, exist a rough proxy that can be used. SMEs use bank financing to a higher degree than most other businesses. Before extending this credit, the bank generally examines the debtor's finances in much the same way a screening mechanism would for an insolvency procedure. As the SME's encounters business problems, the bank generally is monitoring the effect of these challenges on its existing analysis of the SME's viability. Finally, if new financing is required to meet the challenge, the bank is typically the only source of such funds. These generalizations suggest that the feasibility of the rescue of an SME is often assessed by the involved financial institution; indeed, as it is likely the only source of exit financing, that financial institution will control whether the SME reorganizes, or liquidates. As a consequence, the willingness of an SME's bank to go forward is an available, and likely necessary, proxy for the feasibility and viability of an SME reorganization.

The second point -- the plight of other creditors -- must also be taken into account. These creditors also have a role in recovery. Their willingness to continue to extend credit may be a factor in whether the business can survive. But what can these other, non-bank creditors, expect? They likely understand that the support of a bank or other financial institution will be necessary for the survival of the debtor. They also know that banks will put their own interests first. But they do not expect that the bank will run the business for its own benefit; that is, legitimate self-interest ends with debt repayment. This roughly translates into an expectation that adjustment of their debts will not be so radical as to deprive them of what they would have received if the debtor has simply closed up shop.
and liquidated. In short, non-bank creditors have a legitimate interest in tolerating a reorganization only if it returns to them at least what they would have received in a liquidation. This so-called "best interest" test is often a touchstone of any reorganization. In SME reorganization, however, if may have lesser significance, as the result of an SME liquidation is usually zero return to non-bank creditors -- thus making the "best interest" test somewhat easily met.

Finally, the legislation must address the interests of the SME's ownership. If there is value in the SME left after debts are paid, that must be preserved. More likely, however, either directly or through guaranties, the owner will be liable for various business-related debts. The owner/entrepreneur must have some ability, beyond private order negotiation, to deal with such debt, either through the availability of proceedings offering a debt discharge, or through direct cancellation of the debt.

**Kosovo's Approach**

Kosovo is a country of about 1.85 million people. About 66% of all businesses have some form of bank financing, with 23% of all firms using bank loans for working capital finance. Most of the credit is on a secured basis, or supported by several personal guaranties. It is a relatively poor country, with almost 30% of its population living in poverty. Until quite recently, it has had no bankruptcy law; well, it had a bankruptcy law, but its drafting left holes to be filled by regulations. Those regulations were never written.

In drafting the law, the working group responsible for shepherding the legislation expressed an interest in an expedited procedure for SMEs. That procedure was drafted as Chapter II of the law, and its text appears as an appendix.

SMEs were designated as businesses (which in Kosovo can be legal entities or individual sole proprietors) that have 25 or fewer employees, and less than €1,000,000 in turnover.

If the debtor qualifies, then it has an election. The special SME rules do not apply unless the SME files an election to take the SME treatment within ten days of opening the case. Even if it does elect, however, most of the reorganization provisions will still apply unless otherwise stated. For example, one rule that has been kept the same in both types of cases is the best interest of creditors test: a plan proponent must show that the property distributed and to be distributed under the plan must, for every creditor, equal or exceed what that creditor would have received had the case been a liquidation case.

If the debtor elects the SME treatment, there are several key differences from the regular reorganization procedure. Initially, the first difference in an SME case is its speed. An SME must file a plan within thirty days of the case's opening, and upon request of a party in interest, the court must dismiss the case if no plan is confirmed with sixty days.

A second difference is that in each SME case the court appoints a monitor, chosen from regular liquidation case administrators. This monitor consults with the debtor as to business issues and as to the content of any plan to be filed. The monitor is also responsible for assessing the feasibility of the plan.

A third difference is in the voting requirements. Unlike the simple majority rules for regular reorganizations, the court will confirm an SME plan only if 75% of all secured classes voting approve, and at least 33% of all unsecured classes voting approve. This somewhat unusual voting was driven by the realization that SMEs will not survive in
Kosovo without the support of their bank; put another way, cram down of banks for SMEs is not realistic. The low amount set for unsecured classes reflects that there needs to be some support, but that if three-quarters or more of secured creditors support the plan, and if the best interest of creditors test is met (which is also a requirement), then unsecured creditors have been protected.

A fourth difference is how to satisfy the requirement of feasibility. This can be met in four different ways.39

First, if there is unanimous support from the secured creditors, the plan is deemed feasible.40 The thinking behind this is that if all banks (or if the only bank) supports the plan, then its self-interest can serve as a rough proxy for future feasibility.

Second, once the debtor decides to ballot creditors, the monitor is required to perform his or her own feasibility assessment. As monitors are drawn from the pool of bankruptcy administrators (which will have professional standards required), they should have familiarity with such determinations. At this point, however, the response of the monitor is flipped from the traditional role: the monitor reports only if he or she believes that the plan is not feasible. Silence in this case is treated as a tacit approval of the plan's feasibility.41 This option was chosen to conserve costs. If the debtor has its bank or banks approval, there is little reason for the monitor to say "me too," and thus silence effectively communicates agreement.

Third, if the unsecured creditors approve the plan by more than a 50% margin, feasibility is again deemed to be present.42 The basis for this is that in this case, because unsecured creditors have the protection of the best interest test, the vote is really over the allocation of the going concern surplus. Traditionally, this has been divided by majority vote. With a majority vote of unsecured creditors, and a super-majority vote of secured creditors, the time and cost of a feasibility proof would be generally wasteful.

Finally, the debtor may choose to prove feasibility as if it were not in a SME case.43

The fifth and final difference is the abolition of the absolute priority rule — the rule that all debt must be paid in full or consent before equity holders retain any interest. Here, the reasoning is that the blurred lines between entrepreneur and the entity’s worth do not justify the necessity of requiring full payment as a condition of confirmation. On a going forward basis, the basic protection is that provided by the best interests test. If the liability of the owner/entrepreneur is desired, the creditor has always had the ability to negotiate for a personal guaranty.

If the plan is confirmed, the discharge is entered upon confirmation.44

With respect to the entrepreneur, the law provides, for the first time, a limited discharge of all business debts of individuals. As a result, if an entrepreneur has incorporated his business, but has still give guaranties, he can cause the business to file and then he or she can also file their own bankruptcy, and have the cases heard together. In this way, the entrepreneur can receive a discharge of his or her debts to the same extent as the discharge received by the business.
Appendix: SME Provisions of Kosovo Law

CHAPTER II

EXPEDITED PROCEEDINGS FOR SMALL AND MEDIUM ENTERPRISE RELIEF, AND FOR PRE-AGREED PLANS

Article 10
SME Relief

Chapter II of this Law provides for a speedy reorganization of SMEs.

Article 11
SME Definition

For purposes of this Law, an “SME” shall be a business, either conducted by a legal person or an individual, which has no more than 25 employees and no more than €1,000,000 in annual turnover.

Article 12
SME Procedure

1. A case involving an SME debtor shall, unless specified in this Chapter to the contrary, be treated in all respects as a reorganization case.

2. In each SME case, the SME debtor must file a plan within 30 days of the opening of the case.

3. If the debtor is an individual, then only the debtor may file plan. If the debtor in a SME case is a legal person, then only the debtor may file a plan for the first 30 days after the opening of a case.

4. If a SME debtor’s case does not produce a confirmed plan within 60 of the opening of the case, the court shall dismiss the case upon the request of a party in interest.

Article 13
Monitor

1. In each case when an SME is a bankruptcy debtor, the court shall appoint a monitor.

2. The court may select the monitors from any eligible panel or listing of Administrators.

3. The court shall consider the monitor a professional person, and the monitor may apply for compensation from the estate as provided in Chapter IV.

4. After appointment, the monitor shall consult with the debtor regarding the debtor’s business, its prospects, and its ability to formulate a plan that creditors will accept.

5. A monitor shall review each plan a SME debtor files to determine whether it proposes an economically feasible plan. The review may occur before or after the debtor files the plan with the court.
6. If the debtor intends to solicit votes on any plan, it shall inform the monitor of that decision, and the monitor shall then have 10 days in which it may file with the court a report containing the monitor’s opinion on the feasibility of the plan.

7. If a monitor does not file a report, the court shall conclude that the plan is feasible.

**Article 14**  
**SME Relief**

1. An SME debtor may confirm a plan without meeting all the requirements of Chapter VI, if the court finds each of these conditions are satisfied:

   1.1. It files with the court a written election to use this Chapter 2 within ten days of the opening of the case;

   1.2. If the monitor appointed under this Chapter has filed a report on the feasibility of the plan, the report shall have been served upon all parties in interest before any vote is solicited. If the monitor does not timely file its report, the debtor shall inform the court that no monitor report is available;

   1.3. It proves that it solicited the vote of all creditors impaired under the plan, and that the plan has been approved by:

      1.3.1. 75% of all classes of secured claims voting on the plan; and
      1.3.2. At least 33.33% of all unsecured creditors voting on the plan;

   1.4. The court concludes the plan is feasible when:

      1.4.1. The monitor has not submitted a report and Article 13 applies; or

      1.4.2. At least [50%] of all unsecured creditors voting on the plan accept; or

   1.5. The debtor proves that the plan will pay all impaired creditors no less than they would have received had the debtor filed a liquidation case.

**Article 15**  
**SME Discharge**

A SME debtor shall receive a discharge upon confirmation of its plan. A discharge under this Article shall have the same effect on claims against the SME debtor as would a discharge under Chapter VI.

**Definitions from Other Parts of the Law**

"Feasibility", as a condition of confirmation of a plan of reorganization, means that confirmation of the plan is not likely to be followed by the need for further financial reorganization or liquidation (unless the plan calls for liquidation). Unless otherwise specified, the plan proponent has the burden of proving that a plan is feasible, and must meet that burden by a preponderance of the evidence.
1.3. “Administrator” means an entity appointed under Chapter VII of this Law as the representative of the bankruptcy estate;


2 Id.

3 Id.


8 13 C.F.R. § 121.201 (2016).


11 These numbers are as of 2013. http://www.census.gov/econ/susb/

12 http://censtats.census.gov/cgi-bin/nonemployer/nonsect.pl


16 Id.


19 11 U.S.C. § 101(51D). This limit was originally $2,000,000, and has been increased due to inflation indexing. Soon after adoption, in 1997, it was estimated that the $2,000,000 limit captured about 72% of all chapter 11 filers. National Bankruptcy Review Commission, Bankruptcy: The Next Twenty Years 630 (Oct. 20, 1997), available at http://govinfo.library.unt.edu/nbrc/reporttitlepg.html.

20 See, e.g., 11 U.S.C. §§ 1116 (reporting requirements), 112(e) (exclusivity requirements) & 1129(e) (confirmation requirements).

21 A chapter 13 debtor may not have more than $394,725 in uncontested and mature unsecured debt, and no more than $1,184,200 in uncontested and mature secured debt.

22 http://www.uscourts.gov/statistics/table/f-2/bankruptcy-filings/2016/03/31. This can be compared to the 299,989 consumer cases filed under chapter 13 during the same period. Id.


24 Id.

25 In addition to the articles already cited, see Michelle M. Harner, Are Small- And Medium-Sized Companies Worth Saving?, Am. Bankr. Inst. J. 8 (July 2015); Edward R. Morrison, Bargaining Around Bankruptcy: Small Business Workouts and State Law, 38 Journal of Legal Studies 255 (2009); Donald R. Korobkin, Vulnerability, Survival, and the Problem of Small Business Bankruptcy, 23 Cap. U. L. Rev. 413, 426–27 (1994) ("Larger businesses also tend to have more operational flexibility, and sometimes may weather economic slow-downs by shifting from one product line to another, or from one geographical area to another. In contrast, small businesses are less likely to have cash reserves, and they are generally undiversified in their products and customer base. Furthermore, small businesses are often in industries characterized by intense price competition. During inflationary times, they may not have the luxury of raising prices in order to compensate for rising operating expenses. Meanwhile, regulatory burdens and tax increases hit small business the hardest, depleting severely limited working capital.") (citations omitted); European Commission, Enterprise and Industry Directorate-General, Final Report Of The Expert Group, A Second Chance For Entrepreneurs: Prevention Of Bankruptcy, Simplification Of Bankruptcy Procedures and Support For A Fresh Start (2011), available at http://ec.europa.eu/DocsRoom/documents/10451/attachments/1/translations/en/renditions/native.

26 Report of The High Level Expert Group On SME and Infrastructure Financing, Finance For Growth 5 (2013) ("In general, young and small companies face larger obstacles to accessing capital.")
finance and, once they do, they rely heavily on bank debt and pay higher financing costs.


28 http://data.worldbank.org/country/kosovo


30 http://data.worldbank.org/country/kosovo

31 At least I hope it is the text. In Kosovo, all legislation is adopted in three languages: Albanian, Serbian, and English. Although I have been told the law passed on June 9, as of this writing I have not seen the final text.

32 Kosovo Law, art. 11.

33 Kosovo Law, art. 14.1.1.

34 Kosovo Law, art. 14.1.5.

35 Kosovo Law, art. 12.2 & 12.4.

36 Kosovo Law, art. 13.

37 The law has a separate definition of feasibility. Unless displaced by other SME provisions, feasibility is defined "as a condition of confirmation of a plan of reorganization, means that confirmation of the plan is not likely to be followed by the need for further financial reorganization or liquidation (unless the plan calls for liquidation). Unless otherwise specified, the plan proponent has the burden of proving that a plan is feasible, and must meet that burden by a preponderance of the evidence."

38 Kosovo Law, art. 14.1.3.

39 Kosovo Law, art. 14.1.4.

40 Kosovo Law, art. 14.1.4.3.

41 Kosovo Law, art. 14.1.4.1.

42 Kosovo Law, art. 14.1.4.2.

43 Kosovo Law, art. 14.1.4.4.

44 Kosovo Law, art. 15.
Regional developments

A new European approach to business failure and insolvency

Professor Gerard McCormack, University of Leeds

The European Law Institute (Vienna) project re business rescue in insolvency law in the EU

Emeritus Professor Bob Wessels, Leiden University, and Professor Stephan Madaus, Martin Luther University Halle-Wittenberg
Gerry McCormack is Professor of International Business Law at the University of Leeds. Among his previous posts, he has been a Professor of Law at the University of Manchester and a Visiting Professor at the National University of Singapore.


He has also given expert evidence to courts and tribunals both in and outside the UK.
This paper will analyse critically the European Commission Recommendation of March 2014 on a new approach to business failure and insolvency. The Recommendation is part of the Europe 2020 strategy designed to foster economic recovery and sustainable growth. It encourages EU Member States to “put in place a framework that enables the efficient restructuring of viable enterprises in financial difficulty” and to provide for “minimum standards on … preventive restructuring frameworks.”

The Capital Markets Action Plan of September 2015 proposed translating the Recommendation into legislation; addressing the most important barriers to the free flow of capital and building on national regimes that work well. It is argued that differences in the implementation of the Recommendation mean continuing legal uncertainty and additional costs for investors in assessing their risks. The paper assesses whether the initiative is worthwhile; is in line with international developments and whether legislation is appropriate.
Prof. Dr. Stephan Madaus assumed the professorship at Martin-Luther-University Halle-Wittenberg in April 2014 after teaching several years in Regensburg. His principal research interests are German and international insolvency and company law, particularly procedures aiming at rescuing failing companies. With Prof. Bob Wessels (Leiden University) and Kristin van Zwieten (University of Oxford), he runs the ELI Project on the ‘Rescue of Business in Insolvency Law’ established in September of 2013.

His articles on German, European and international insolvency and company law have published in prominent legal journals in Germany and Europe. Having worked as a “visiting scholar” on bankruptcy law and complex litigation at Stanford Law School, U.S.A. (2008 - 2009), he went on to write a treatise on the fundamentals and doctrinal nature of rescue plans: “Der Insolvenzplan” (Jus Privatum: Volume 157, 2011,).

Stephan Madaus teaches insolvency law (including European and international insolvency law), civil procedure, company, contract and tort law.

Bob Wessels (1949; PhD in Civil Law: Amsterdam 1988) was Professor of International Insolvency Law in Leiden (2007-2014) and of Civil and Commercial Law, Vrije University, Amsterdam (1988-2008).

He acted as international consultant to the IMF, the World Bank and, since 2010 to the European Commission in matters of resolution of banks and rescue and insolvency of businesses. Since 1999 he is the single author of “Wessels Insolventierecht” (Wessels Insolvency Law), a 10 Volume series, in all some 4000 pages, presently in its 4th edition.

He is Visiting External Scientific Fellow at the Max Planck Institute Luxembourg for International, European and Regulatory Procedural Law; Deputy Justice at the Court of Appeal in The Hague; Member of the Joint Board of Appeal of the three European Supervisory Authorities (ESAs; ESMA, EBA and EIOPA respectively); past Chairman and Honorary Member of the Netherlands Association for Comparative and International Insolvency Law (NACIIL); past Chairman of the Academic Forum of INSOL Europe.
ELI Project on Business Rescue

Prof. Bob Wessels, Leiden (em.); Prof. Stephan Madaus, Halle

Abstract

Since the global financial crisis, insolvency law has been at the forefront of law reform initiatives in Europe and elsewhere. The specific topic of business rescue appears to rank top on the insolvency law related agenda of the EU institutions: with the economic recession of the past few years Europe faced a rapid growth of insolvencies, which clearly highlighted the importance of effective business rescue. Given the widespread and growing interest in insolvency law and particularly in business rescue, the European Law Institute (ELI) – an independent non-profit organisation established to initiate, conduct and facilitate research, make recommendations and provide practical guidance in the field of European legal development – has resolved that it is an appropriate time for it to engage in a scholarly and detailed assessment of the subject within the European context, and the prospects for reform. The project is analysing existing legal frameworks as they are on the books and as they work in practice, and will recommend (elements of) a legal framework that will enable the further development of coherent and functional rules for business rescue in Europe.

Today’s panel will present a brief excerpt of the project’s work by explaining the position of shareholders in the restructuring of a distressed company in various jurisdictions, the available approaches to determine a “best practice” and a possible recommendation for a legal framework.
Cross-border insolvency issues

Principles of cross-border insolvency law - and their value for judges and legislators
Professor Reinhard Bork, University of Hamburg

The Nortel international insolvency case: similarities between the Canadian and U.S. insolvency regimes
Professor John Pottow, University of Michigan

Shoppers’ paradise? Some realism about 21st century United States bankruptcy jurisdiction over non-US debtors
Professor Adrian Walters, Chicago-Kent College of Law
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I am currently working on a book on “Principles of Cross-Border Insolvency Law”. My thesis is that cross-border insolvency rules of all kinds (e.g. European Insolvency Regulation, UNCITRAL Model Law, ALI Principles for the NAFTA States, national laws such as Chapter 15 U.S. Bankruptcy Code or Sch. 1 Cross-Border Insolvency Regulation 2006) are founded on, and can be traced back to, basic values and aim to pursue and enforce such principles. Furthermore, several principles can be identified, distinguished and sorted into three groups: conflict of laws principles (e.g. unity, universality, equality, mutual trust, cooperation and communication, subsidiarity, proportionality), procedural principles (e.g. efficiency, transparency, predictability, procedural justice, priority) and substantive principles (e.g. equal treatment of creditors, optimal realisation of the debtor’s assets, debtor protection, protection of trust [for secured creditors or contractual partners], social protection [for employees or tenants]). If this thesis is correct, the outcome of my research might be helpful for both deciding cases and shaping cross-border insolvency law by using a principle-oriented approach. Legislators as well as courts could be offered some new substantive and methodological support in making decisions, e.g. where the treatment of secured creditors, support for foreign insolvency practitioners or even harmonisation of cross-border insolvency laws is at stake.
John Pottow, the John Philip Dawson Collegiate Professor of Law, is an internationally recognised expert in the field of bankruptcy and commercial law. His award-winning scholarship concentrates on the issues involved in the regulation of cross-border insolvencies as well as consumer financial distress.

On behalf of the United States, Professor Pottow serves as a delegate to the United Nations Commission on International Trade Law (UNCITRAL). He has published in prominent legal journals in the United States and Canada and testified before Congress. An oft-invited lecturer, he has presented his works at academic conferences around the world and frequently provides commentary for national and international media outlets, such as NPR, CNBC, CNN, C-SPAN, Al Jazeera America, and the BBC. He also has litigated bankruptcy cases before the U.S. Supreme Court, including his successful pro bono argument on behalf of the respondent in *Executive Benefits Insurance Agency v. Arkison* (2014).

Professor Pottow joined the University of Michigan Law School faculty in 2003. Prior to coming to Michigan Law, he worked at several bankruptcy firms, including Weil, Gotshal and Manges of New York and the former Hill & Barlow of Boston. His practice focused on debtor representation in complex Chapter 11 restructurings. He also was an active litigator whose cases included representing a gender-based asylum seeker from Afghanistan in U.S. Immigration Court and a small bankruptcy party before the U.S. Supreme Court.

He holds an AB in psychology, *summa cum laude*, from Harvard College and a JD, *magna cum laude*, from Harvard Law School, where he served as treasurer of the *Harvard Law Review*. Professor Pottow clerked for the Rt. Hon. Beverley McLachlin, Chief Justice of Canada, and the Hon. Guido Calabresi, U.S. Court of Appeals for the Second Circuit. He is licensed as a barrister and solicitor in Ontario and as an attorney in Massachusetts and Michigan. In 2005, he was presented the L. Hart Wright Award for Excellence in Teaching and, in 2012, received a pro bono award from the U.S. District Court of the Eastern District of Michigan. He is a member of the American College of Bankruptcy and the International Insolvency Institute.
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On behalf of the United States, Professor Pottow serves as a delegate to the United Nations Commission on International Trade Law (UNCITRAL). He has published in prominent legal journals in the United States and Canada and testified before Congress. An oft-invited lecturer, he has presented his works at academic conferences around the world and frequently provides commentary for national and international media outlets, such as NPR, CNBC, CNN, C-SPAN, Al Jazeera America, and the BBC. He also has litigated bankruptcy cases before the U.S. Supreme Court, including his successful pro bono argument on behalf of the respondent in *Executive Benefits Insurance Agency v. Arkison* (2014).

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Those in the cross-border bankruptcy community hiding under rocks may not have heard about the monumental decisions in the co-trials in the Canadian-US Nortel bankruptcy proceedings.¹ The decisions are thoughtful, innovative, practical, and important. They warrant a detailed case comment or two in their own right. This brief article, however, will not provide such worthy treatment.² Those hungering for in-depth reports of the cases and their holdings may stop reading now and devote their labours elsewhere. What this article will be is an appreciation of Nortel, explaining both why it is such an important opinion (or pair of opinions) for the cross-border bankruptcy world and why it should be seen as a triumph, albeit an incremental one, for the universalist school of transnational insolvency.³

I. THE NORTEL CASES

1. The Nortel Enterprise.

Nortel was an enormous telecommunications company of storied pedigree that foundered in the Great Recession. Although global in reach, one can fairly call it a “Canadian” company. Like many multinational business enterprises (MBE’s), it had, by definition, its tentacles well extended worldwide, but if anyone tried to assess the center of main interests (COMI) of the corporate group, it would likely have been Canada. As is often the case with such Canadian businesses, however, a considerable portion of its affairs were transacted in the United States, which produced the lion’s share of its revenue. Most relevant for present purposes is that a significant component of Nortel’s business was dependent upon intellectual property. The history and business model of Nortel, including its multiple product and service lines, is well recounted in both the

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¹ In re Nortel Networks, Inc., 532 B.R. 494 (Bankr. D. Del. May 12, 2015); Re Nortel Networks Corp., 2015 CarswellOnt 7072 (Ont. S.C.J. [Commercial List]).
² Others have taken up the charge. See, e.g., Robert Harlang & Mitch Vininsky, Nortel Networks: A New Twist on Substantive Consolidation?, 34 AM. BANKR. INST. J. 18, 66 (2015) (“The Nortel allocation case was unique in many respects and resulted in decisions that demonstrated the respective judges’ understanding of the business world and their creativity.”).
³ The reader is presumed to know the well-rehearsed international bankruptcy debates between the competing theories of “territorialism” and “universalism” as the preferred normative models for resolving multinational failures. While territorialism counsels following strict sovereign borders in allocating regulatory jurisdiction among nations over globally dispersed assets, universalism embraces a one-law approach: the application of one “exporting” country’s bankruptcy law extraterritorially to other “receiving” jurisdictions. John A.E. Pottow, Procedural Incrementalism: A Model for International Bankruptcy, 45 VA. J. INT’L. 935, 937 (2005).
Canadian and US bankruptcy court opinions; the curious reader is referred to either source for more detail.4

2. The Nortel Proceedings.

When Nortel first started to skid, reorganization was attempted, but the onslaught of the Great Recession hammered any lingering nails into its coffin. The company soon filed for bankruptcy protection. But it did not do so in the paradigmatic way anticipated by the dominant international instruments regulating cross-border insolvency proceedings, such as most notably, the UNICITRAL Model Law on Cross-Border Insolvency, 5 implemented in Canadian law through the Companies’ Creditors Arrangement Act 6 and US law through chapter 15 of the Bankruptcy Code.7 That is, there was not a “main” proceeding filed in Nortel’s COMI (Canada) and “ancillary” proceedings in the myriad other countries around the world where Nortel also had establishments. Rather, Nortel filed “parallel” proceedings in both Canada and the United States.8 The filings were coordinated and simultaneous. To be specific, Nortel was not one mega-corporation that filed multiple parallel bankruptcy proceedings in different jurisdictions around the world; Nortel filed its various proceedings chiefly by affiliation. That is, the main parent and Canadian operating subsidiary filed in Canada, the US operating subsidiary filed in the United States, and so on. Some entities stayed out of formal court proceedings altogether.9 Nortel, through multiple debtors in multiple proceedings, “went into bankruptcy”.

As mentioned, the starts at reorganization ultimately sputtered. Not helping was inter-corporate squabbling over transfer payments, which are the tax-animated headaches that arise when one corporate affiliate pays another for intra-enterprise transactions, all designed to assuage tax watchdogs that tax evasion through income flight is not afoot.10

4 See, supra note 1. For flavor: as of January 2009, Nortel’s lines of business were Carrier Networks, wireless networking solutions for providers of mobile voice, data and multimedia communications services over technologies; Enterprise Solutions, enterprise communications solutions addressing the headquarters, branch and homes office needs of large and small businesses; and Metro Ethernet Networks, optical networking and carrier grade Ethernet data networking solutions. In re Nortel Networks, Inc., 532 B.R. at 503.
6 RSC 1985, c C-36, as amended to February 26, 2015.
7 11 U.S.C. § 1501 et seq.
9 One example is Nortel Networks S.A., a French company.
10 From the late 1970s to December 31, 2000, Nortel operated under a series of Cost Sharing Agreements (CSAs), which were bilateral agreements between the Canadian parent, Nortel Networks Limited (NNL), and each of the other R&D-performing Nortel entities. The purpose of these CSAs was effectively to implement transfer pricing by allocating costs to respective corporate affiliates across the globe (and hence dictate the net taxable income for each such affiliate). This was never a smooth process at Nortel. For
The Canadian debtors also demanded financing from the US subsidiaries, contending that the financing was necessary to fund any sort of reorganization attempt. But eventually, the writing revealed itself on the walls, and talk turned to liquidation.

In an enterprise the size of Nortel, liquidation can mean anything from depressing auctions of office chairs to highly integrated cross-border sales of intact business lines subsumed within larger corporate groups. The Nortel stakeholders hungered for the latter. In an omnibus resolution of some of the inter-corporate financing bickering, the various Nortel debtors entered into a protocol to cooperate in the sale of the firms’ assets. This protocol, significantly, recognized that trying to resolve the inter-corporate squabbles would delay and even jeopardize the value-maximizing sale of the corporate assets, and so the consensus was reached to sell all of the viable business lines collectively and put the proceeds into an evocatively labeled “lockbox”. Disbursing the lockbox’s proceeds was left for a later day, after all the stakeholders had pulled together and beat the bushes for bidders. This protocol was successfully entered and survived appeal.

The lockbox approach proved successful. After the major business lines were sold off, the debtors were even able to monetize their “rump” portfolio of around 7,000 patents. So attractive were these IP assets that Nortel flirted with staying around as a

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11 In re Nortel Networks, Inc., 532 B.R. at 502; Re Nortel Networks Corp., 2015 CarswellOnt 7072 paras. 29-30 (Ont. S.C.J. [Commercial List]).

12 Interim Funding and Settlement Agreement, Bankrupt.com (law visited Sep. 20, 2015), http://bankrupt.com/misc/NortelInterimFundingAgreement.pdf [hereafter IFSA]. The IFSA settled the intercorporate tax claim at $2 billion. See supra note 10. The IFSA was later finalized into the Final Canadian Funding and Settlement Agreement, In re Nortel Networks, Inc., 532 B.R. at 511-12; Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 33.

13 “[T]he entire amount of the Sale Proceeds . . . shall be deposited in an escrow account pursuant to an escrow agreement, the terms of which shall be negotiated and agreed by all Selling Debtors, in each case acting reasonably . . . .” Id. at 11.

14 In re Nortel Networks, Inc., 737 F.3d 265 (3d. Cir. 2013).

sort of patent portfolio business, but ultimately decided to sell off those assets, too.\textsuperscript{16} Google arrived as a stalking horse for $900 million and served as a catalyst to jack up a final bid of $3 billion by a syndicate known as "Rockstar".\textsuperscript{17} All through, the sale of assets netted $7 billion or so to the lockbox.\textsuperscript{18}

So far, so good. Everyone agreed to pull together to sell assets for their greatest value and make the pie as big as possible. But then, as in many matters commercial, when it came time to divide the pie, things went less well. Despite a provision of the protocol counseling mediation over how to divide the proceeds amongst the three bankruptcy estates (Canada, US, and collectively, Europe, Middle East, and Africa (EMEA)), consensual allocation proved fruitless much to the dismay of the hapless mediators.\textsuperscript{19} Judicial determination, the backstop resolution procedure under the protocol, then had to be invoked.\textsuperscript{20}

3. The \textit{Nortel} Decision(s).

\textit{i. Background.}

The protocol provided for joint judicial resolution of the contested lockbox allocation. But joint judicial resolution is a strange beast, and there was no \textit{ex ante} reason to expect orderly harmonization of those two judicial proceedings in Canada and the United States absent the protocol or the force of the Model Law. Neither was a main proceeding in the jurisdictional hierarchy anticipated by the typical main/ancillary format of the Model Law that would be presumptively entitled to cooperation from the other proceeding. Thus, the parties were venturing out into uncharted terrain. It could very well be that the Canadian court would render its own decision on the assets, which might conflict with the US court’s determination. Indeed, the prospect of conflicting distributive determinations is not just a Nervous Nellie’s nightmare; in the \textit{Lernout \& Hauspie} bankruptcy, the US and Belgian courts came to diametric interpretations on the priority rights of aggrieved investors who had fraud claims against the debtor, which but for eventual settlement would have been a jurisprudential disaster.\textsuperscript{21}

\textsuperscript{16} \textit{In re Nortel Networks, Inc.}, 532 B.R. at 514-15; \textit{Re Nortel Networks Corp.}, 2015 CarswellOnt 7072 para. 105.
\textsuperscript{17} Rockstar is a consortium comprising Apple, Ericsson, Microsoft, Blackberry, EMC, and Sony. \textit{In re Nortel Networks, Inc.}, 532 B.R. at 502.
\textsuperscript{18} $7.3 billion, to be precise. \textit{Id.} at 525.
\textsuperscript{19} "In no case shall there be any distribution from the Escrow Account in advance of either (i) agreement of all of the Selling Debtors or (ii) in the case where the Selling Debtors fail to reach agreement, determination by the relevant dispute resolver(s) . . . ." IFSA at 11.
\textsuperscript{20} [E]ach Party . . . agrees to submit to the non-exclusive jurisdiction of the US and Canadian Courts (in a joint hearing conducted under the Cross-Boarder Protocol adopted by such Court, as it may be in effect from time to time), for purposes of all legal proceedings to the extent relating to the matters agreed in [the IFSA].
\textit{Id.} at 15.
The Nortel courts avoided disaster. They did so by invoking the procedures of the Model Law that facilitate cooperation as implemented through the protocol.\textsuperscript{22} So, for example, the trial on how to allocate the lockbox proceeds was run in two different courtrooms in Toronto and Wilmington simultaneously, with the judges engaged in frank and frequent communications between themselves.\textsuperscript{23} Witnesses were video-linked from one courtroom to the other, and litigants in each venue could see in live time what was afoot in the other. But as the respective courts made clear, each judge would arrive ultimately at his own determination on what the applicable bankruptcy law demanded for allocation of the lockbox proceeds across jurisdictional borders.\textsuperscript{24}

\textit{ii. The parties’ competing allocation proposals.}

While coordinated and integrated, the proceedings were still woolly. The parties advanced sharply divergent approaches of how best to allocate the lockbox proceeds. Surprising perhaps no-one, the parties’ positions were, as one judge aptly characterized, “self-serving.”\textsuperscript{25} Proving the adage that a picture says a thousand words, the US court graphically demonstrated how each constituency’s approach to dividing the spoils just so happened to accord its members the largest share.

\begin{figure}[h]
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\caption{Allocation of Lockbox Proceeds}
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\textsuperscript{23} “The Courts have had discussions following the trial of the Allocation Dispute in an effort to avoid the travesty of reaching contrary results which would lead to further and potentially greater uncertainty and delay.” \textit{In re Nortel Networks, Inc.}, 532 B.R. at 532.

\textsuperscript{24} \textit{Id.} at 556 (“[T]he U.S. Court and the Canadian Court independently arrived at the same conclusion.”); \textit{Re Nortel Networks Corp.}, 2015 CarswellOnt 7072 para. 10 (Ont. S.C.J. [Commercial List]) (“We have come to this conclusion in the exercise of our independent and exclusive jurisdiction in each of our jurisdictions.”).

\textsuperscript{25} “[T]he self-serving allocation positions of the Canadian Interests, the U.S. Interests and the EMEA Debtors are not determinative or helpful.” \textit{In re Nortel Networks, Inc.}, 532 B.R. at 532.

\textsuperscript{26} \textit{Id.} at 522; “The Court compares the Allocation Dispute to three people trying to reach the top of a mountain by pulling the others down. In other words, no one gets to the top.” \textit{Id.} at 556.
Perhaps in a way, the naked self-interest of the parties liberated the judges to blaze their own trail, which they did when rejecting all the party-advocated approaches in coming to their own allocation rule.

As mentioned, a considerable part of Nortel’s global assets were tied up in patent portfolios, and so the question became how should the bankruptcy estates share in the proceeds realized upon the sale of those portfolios? Of course, the simplest solution would have obtained were there only one bankruptcy estate, or perhaps even one main bankruptcy estate: all the money would go into that one pot. Unfortunately, the multi-jurisdictional parallel proceeding posture of Nortel made that simple outcome impossible. Each constituency made its own pitch, boiled down into three major positions as typified by the arguments of the Canadian, EMEA, and US debtors.27

The formalist position was advanced by the Canadians, who argued that all the intellectual property was owned by the Canadian affiliates, and so the sale of that property should naturally inure to the benefit of the Canadian estate. The EMEA stakeholders took a somewhat Lockean approach and argued that because the legal title to the intellectual property was parked in Canada for arbitrary (more precisely, tax-related) reasons, allocating all the lockbox value based on that legal location would be unfair if not absurd, especially in light of Nortel’s worldwide operations. Rather, they argued, the allocation should match the means of production (or perhaps factors of production if Research & Development (R&D) expenditures is a proper proxy): because much of the worldwide R&D effort that occurred to generate those Canadian intellectual assets occurred in Europe and elsewhere, the proceeds from those assets’ sales should be allocated in proportion to each jurisdiction’s share of the R&D spending.28

Finally, the US interests partially joined the EMEA position in rejecting the Canadian debtor’s “ownership” approach but veered off onto their own proposal, which might be called an “economic” approach. This tack was built upon the premise that the purpose of the intellectual property nominally owned by the Canadian entities was to generate money for a once-profitable worldwide business, and the US affiliates brought in the lion’s share of that business. As such, the sale proceeds should be allocated in proportion to the respective affiliates’ contribution to the global conglomerate’s income.29

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27 The only parties who made a full-hearted pro rata pitch were the UK pension claimants. Wilmington Trust advocated a pro rata approach, but only as an alternate theory to its primary argument. Id. at 530.
28 Id. at 547-48; Re Nortel Networks Corp., 2015 CarswellOnt 7072 paras. 64-66. The EMEA alternatively argued (in an argument that went nowhere) that the residual profit entities (RPEs) should have ownership of the IP under common law principles “by reason of the IP belonging to the RPEs that employed the inventors.” Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 186. Under the Master R & D Agreement (MDRA), each Licensed Participant vested legal titled in NNL to the IP it created in exchange for which NNL granted an exclusive license back to each Licensed Participant. In re Nortel Networks, Inc., 532 B.R. at 510.
The courts’ decision – independently reached but surely preceded by Model Law-sanctioned communication – was to reject all these approaches and adopt a novel alternative that they called a modified pro rata allocation. The pot was divided in proportion to total creditors’ claims.

iii. The modified pro rata allocation solution: pro rata.

Before explaining the courts’ approach it is first helpful to situate the outcome at the highest level of abstraction, and that is that the courts rejected the formalism of the Canadian approach and adopted a much more functional, even pragmatic lens toward Nortel’s assets. That is, the “biggest picture” underpinning of the courts’ opinions was to reject the idea that legal title of the intellectual property assets held in Canada entitled the Canadian estate to the proportionate proceeds of the lockbox (let alone the lockbox proceeds related to the business line sales). Rather, the courts accepted the principle, even if not the calculation metric, of the other creditors that such an approach would shower a windfall upon the Canadian estate that did not reflect the economic substance of the R&D and other inter-connected operational aspects of this global firm. This departure from focus on physical location in itself is a shattering repudiation of the doctrine of territorialism, a point to be explored below, but the main observation for present discussion is that the court went beyond asset ownership in crafting an equitable solution to allocation.

Once that door had been opened, one can conjecture it became relatively simple to craft an allocation formula: share in the pot not based on the debtors’ budget or revenue as had been self-servingly proposed, but equally by creditor, invoking a “fundamental tenet” of bankruptcy law in the words of one court. This is the meaning behind the courts’ pro rata allocation decision. In other words, if the total value of the claims in the

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30 In re Nortel Networks, Inc., 532 B.R. at 549-60; Re Nortel Networks Corp., 2015 CarswellOnt 7072 paras. 193-249.
31 In re Nortel Networks, Inc., 532 B.R. at 533 (“The Canadian Debtors are nothing short of narcissistic in allocating the bulk of the Sales Proceeds to themselves and in their failure to recognize the contributions of the other Nortel companies and the realities of the manner in which the Nortel enterprise operated on a day-to-day basis.”). Re Nortel Networks Corp., 2015 CarswellOnt 7072 paras. 196-97

In so far as the IP is concerned, while the patents were registered in the name of NNL, I would not for that reason hold that NNL is entitled to the proceeds of the IP sales. The patents and application rights to apply for patents were held in the name of IP for administrative purposes. It was best practices in a multi-national enterprise to have all patents assigned to one company, in this case to NNL, as explained by Ms. Anderson and Ms. De Walton, and made management of the portfolio much easier. While these witnesses expressed subjective views that it was NNL who owned the patents, these views are not determinative, as acknowledged in the Monitor’s reply brief at paras 65-66. This was not one corporation and one set of employees inventing IP that led to patents. Nortel was a highly integrated multi-national enterprise with all RPEs doing R&D that led to patents being granted. It was R&D that drove Nortel’s business. R&D and the intellectual property created from it was the primary driver of Nortel’s value and profits. All parties agree on that. It would unjustly enrich NNL to deprive all of the other RPEs of the work that they did in creating the IP just because the patents were registered in NNL’s name. (Emphasis added).

32 “It is a fundamental tenet of insolvency law that all debts shall be paid pari passu and all unsecured creditors receive equal treatment.” Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 209.
Canadian estate were $1, and the total claims in the EMEA estate also $1, and the total in the US estate were $2, meaning that there would be $4 of worldwide claims, the courts would order distribution of the lockbox 25% to Canada and EMEA each and 50% to the United States.\(^{33}\) The result of this was to acknowledge everyone worldwide contributed to the value of Nortel as an MBE and that the conceit of trying to craft each constituency’s precise, perfectly calibrated share was a fool’s errand. It is interesting to speculate had the non-Canadian estates offered less self-serving counter-formulae whether one might have taken root, but that is likely unanswerable. In the end, once recognizing that the Canadians could not take it all (or most) and opening the door to worldwide participation, the deep-seated bankruptcy baseline of pro rata equality was difficult to shake. Perhaps viewed another way, no party made a sufficiently compelling case why the distribution should not be pro rata in light of the courts’ desires to share the allocation beyond Canada.

\(^{33}\) “The allocation each Debtor Estate will be entitled to receive from the lockbox funds is the percentage that all accepted claims against that Estate bear to the total claims against all Debtor Estates.” Id. at para. 250.

\(^{34}\) “[Both courts] agree that their methodology does not constitute global substantive consolidation.” In re Nortel Networks, Inc., 532 B.R. at 551.

\(^{35}\) Id.


\(^{37}\) The discussion of pro rata allocation requires a discussion of substantive consolidation and, more importantly, why the Court’s approach is not that seemingly offensive outcome . . . . The Court, for one, is not ordering payments to the “most deserving” creditors as the Bondholders fear. The Court is not ordering a distribution scheme. Instead, the Court is directing an allocation among the Estates for the Estates to distribute in an appropriate manner. It is a distinction with a difference.

\(\text{In re Nortel Networks, Inc., 532 B.R. at 556.}\)
As just partially presaged, the second reason the courts insisted this was not a fully pro rata allocation rests upon an apparent terror with being accused of effecting a substantive consolidation of the debtors’ estates (which apparently was seen as a consequence of fully pro rata allocation).38 The US court was especially fearful of this allegation, the Canadian court less so. In fact, the Canadian court cheerfully launched into an alternative discussion saying that even if pro rata allocation was substantive consolidation, that remedy would be fully indicated under Canadian law on the facts of the case.39 But the US court would have none of it. Indeed, more broadly, the US court was anxious to assure that it was not adopting “universalism,” presumably an unwelcome cognate to substantive consolidation.40

The source of the courts’ concerns is hard to pin down, and these comments may not reflect one coherent argument so much as a collection of stray thoughts. The confusion stems in part from a conflation of pro rata allocation with substantive consolidation and/or both with universalism.41 Because it is difficult to grasp fully the courts’ reasoning, or even direction, it might help simply to break the logical chain that universalism need equate to substantive consolidation. (Whether pro rata allocation equates with substantive consolidation is a separate issue explored below.) Recall that universalism in its pluralist form42 advocates the disposition of a multinational debtor’s assets in accordance with the substantive bankruptcy law of its COMI.43 But universalism (or more precisely, its advocates) have not definitively figured out how to address interwoven corporate groups, where multiple corporate debtors within a broader group have different COMIs. Universalism thus has nothing conclusive to say on the

38 See id.
39 “Even if it could be said that a pro rata allocation involved substantive consolidation, which it cannot, I do not see case law precluding it in the unique circumstances of this international case. Even in domestic cases, CCAA plans involving substantive consolidation are not unknown.” Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 214.
40 “To be clear, the Court's pro rata allocation is not the ‘new order’ which the pro rata proponents urge with terms such as ‘universalism’”. In re Nortel Networks, Inc., 532 B.R. at 558.
41 For example, the courts note that they were recognizing inter-corporate debt, In re Nortel Networks, Inc., 532 B.R. at 532; Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 214, which indeed would be ignored in applying the doctrine of substantive consolidation, In re Nortel Networks, Inc., 532 B.R. at 532; Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 214. But that simply speaks to whether pro rata allocation is tantamount to substantive consolidation (suggesting that it is). It has nothing to do with universalism, which is indifferent to inter-corporate debt.
42 In its purest conceptual form, universalism aspires to the harmonization of one worldwide, substantive law of bankruptcy. The most common model of universalism, however, follows a pluralist route. Sidestepping the issue of which substantive provisions the ideal bankruptcy law would possess, it simply selects from one of the pre-existing bankruptcy regimes ex post. To the extent that other courts are needed (to give legal force to the orders of the courts of the governing jurisdiction), such courts could convene ancillary proceedings designed to effectuate the controlling court’s orders. The current universalist paradigm thus concedes the divergence of present domestic bankruptcy laws and advocates only a pluralist system of choice-of-law; its theory does not envision (or rely upon) substantive harmonization of those bankruptcy laws.

Pottow, supra note 3, at 948.
43 Id. at 949.
doctrine of substantive consolidation of corporate debtors. To be sure, squishing all the affiliates together into one giant “enterprise” and finding that enterprise’s COMI (or “E-COMI,” in the literature) for purposes of choice of substantive bankruptcy law would be a form of universalism analogous to substantive consolidation. But that “E-COMI” approach to corporate groups is not compelled by universalism. Indeed, while insisting upon an E-COMI approach has been recommended by some universalism advocates as the best approach to the corporate groups problem, it has not been advocated, for lack of a better term, universally. For example, a situation of discrete corporate subsidiaries incorporated throughout different jurisdictions without interwoven financial affairs could well yield a universalist outcome subsidiary-by-subsidiary for each entity’s cross-border assets without requiring substantive consolidation at the E-COMI level. In short, and contrary to the courts’ seeming concerns, universalism is agnostic to substantive consolidation.

There is not much point getting bogged down in this aspect of the courts’ opinions, however. Little turns on it, other than revealing the courts’ respective disinclinations toward substantive consolidation and at least one court’s apparent contempt for universalism. What matters more is the prior point that cash on hand was preserved by estate irrespective of proportionate creditor claims. That fact suffices to justify the label “modified” pro rata allocation, which the courts accurately used.

v. The allocation/distribution distinction.

Having jointly decided to take a modified pro rata approach to allocating the lockbox proceeds was not the end of the matter. The courts’ final step was to take the intriguing gesture of distinguishing allocation from distribution. This distinction is relevant for the debate between universalism and territorialism for the straightforward reason that in true universalism, the COMI state “exports” its substantive distribution rules across national borders to govern local asset distribution. (Modified universalism

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46 The most that could be said is that substantive consolidation is “harmonious” with a robust form of universalism applied to corporate groups.
47 See Legislative Guide.
48 “To be clear, the Court’s pro rata allocation is not the ‘new order’ which the pro rata proponents urge with terms such as ‘universalism’.” In re Nortel Networks, Inc., 532 B.R. 494, 558 (Bankr. D. Del. May 12, 2015). The court’s apparent dislike for universalism appears premised on a misunderstanding that chapter 15 of the Bankruptcy Code is not the enactment of the Model Law (which of course, it is). Awkwardly, Judge Gross insisted: “These cases are not proceeding under the purview of the Model Law, which is purely a proposal at this time. These cases are proceeding under the dictates of Chapters 11 and 15 of the US Bankruptcy Code.” Id. at 559 (emphasis added). Thus, one might charitably chalk the court’s disdain up to confusion.
49 “The Court is not ordering a distribution scheme. Instead, the Court is directing an allocation among the Estates for the Estates to distribute in an appropriate manner. It is a distinction with a difference. The difference is that intercompany claims, settlements, cash-on-hand will all be honored in the allocation.” Id. at 555.
Territorialism, by contrast, allows each individual state to implement its own distributive rules to assets within its jurisdiction. By underscoring the allocation/distribution distinction, the Nortel courts appeared to have been mollifying territorialists by assuring that local substantive bankruptcy rules would be alive and well to govern whatever share of the lockbox proceeds ended up being (re)patriated to the respective jurisdictions under the modified pro rata allocation. In other words, Canadian bankruptcy law – and priority rules – would govern the ranking of claims and distribution to the modified pro rata share of the lockbox proceeds that went to Canada, US rules to the piece sent to the United States, and so forth. While this may seem like fine bologna to slice, the sovereignty-animated distinction was unlikely to have been lost on many. Territorialist concerns of local bankruptcy laws applying were expressly acknowledged (and respected) by clarifying that distribution would be locally governed as a distinct stage subsequent to allocation. (Whether this bifurcation was as territorialism-vindicating as might appear on first blush remains to be seen.)

vi. Summary.

To summarize, the Nortel cross-border bankruptcy was resolved by a consensual, worldwide sale of the enterprise’s valuable business lines and then its residual portfolio of patents and intellectual property in a highly coordinated and productive manner. Surely related to this congenial approach was an agreement by protocol to defer the thorny question of proceeds allocation until after the sales had all been completed, and even to try to mediate that question to further consensual resolution. When that mediation failed, the parties proceeded to litigate the matter, as provided by their protocol, before the Canadian and US bankruptcy courts. Those courts conducted a highly coordinated and cooperative joint trial, complete with simultaneous video feeds, containing dozens of witnesses and even more lawyers running around.

Eventually, the courts came to the same conclusion: reject all the parties’ arguments and allocate the lockbox proceeds on a modified pro rata approach: pro rata because the allocation would be in proportion to the amount of claiming creditors in each estate (counting inter-creditor claims in the pot), and modified because only the lockbox assets and not, e.g., the cash on hand, would be allocated accordingly. The modified pro rata allocation approach, however, did not speak to ultimate distribution, which would be determined, a la territorialism, in accordance with the substantive bankruptcy laws of each respective jurisdiction receiving an allocation.

The ultimate resolution of the Nortel assets thus has a distinctly territorialist flair to it. Recognizing the separate estates and vindicating an implicit (at times explicit)
presumption that creditors in each estate were entitled to claim the assets within their physical jurisdiction (either ab initio or through allocation from the lockbox) seems to have reflected a territorialist mindset to the distribution question notwithstanding the happy coordination that occurred to get to that stage. And certainly the openly hostile digs at universalism made by at least one of the courts augments the interpretation that the decisions were attempting to follow territorialism. But that assessment belies the full significance of the opinions. The Nortel case should be seen not as ultimately backsliding into territorialist conceptions of vested right but as actually moving the universalism ball forward, and considerably so.

II. Nortel’s Universalism.

Properly viewed, Nortel should be seen as a significant step forward for universalism, notwithstanding its first-blush territorialist focus on estate-by-estate distribution. There are at least five ways in which it is accurate to characterize the decision as importantly (although far from completely) universalist.

1. Universalist Cooperation.

At the risk of stating the obvious, the courts worked very hard and very well together to synchronize their hearings and avoid the risk of inconsistent judgments that had plagued earlier cases like Lernout & Hauspie. Things were not all smooth sailing, of course. For example, at one stage in the case the Canadian bankruptcy court issued an order clarifying that prosecution of administrative proceedings for a so-called “financial support directive” in favour of UK pension claimants under section 96 of the Pensions Act 2004 in the United Kingdom would constitute a violation of the Canadian automatic stay.53 The UK pension authorities cheerfully ignored this order and went ahead to take the initial steps to determine potential pension liability.54 But all in all, the procedural integration of the co-trials – and not just the allocation trials, but indeed the whole proceedings – was commendable and a source of judicial statesmanship.

Fair enough – back-slapping all around. But is this a credit to universalism? After all, deeply sovereignty-conscious states can bask in territorialism yet nonetheless still be cordial and even cooperative with judicial colleagues in cross-border disputes without having to carry the banner of universalism.55 Thus, to be strictly precise, one might celebrate the profound degree of cooperation in the case not so much as a victory of universalism per se but as a victory of the UNCITRAL Model Law and similar instruments that strive for increased judicial dialogue, communication, and cooperation.56 Captured by its protocol, the Nortel case unquestionably illustrates a high-point of cross-border judicial cooperation.

53 Re Nortel Networks Corp., 2010 ONSC 1403 (Ont. S.C.J. [Commercial List]).
54 Re Nortel Networks Corp., 2015 ONSC 4170 para. 53 (Ont. S.C.J. [Commercial List]).
55 Cf. LoPucki, supra note 51 (arguing for “cooperative” territorialism).
56 MODEL LAW arts. 25-27; CoCo GUIDELINES.
One can take the next step, however, and claim that that cooperation in turn services the broader goals of universalism because it forces a necessary consideration of legal pluralism by counseling an otherwise autonomous judge to at least confer with an extra-territorial (indeed, extra-sovereign) peer.\textsuperscript{57} Given that one of the conceptual cornerstones of universalism is the acceptance of outcome differences and given further that incrementalist universalists have predicted an acclimation process whereby increased interaction and immersion in foreign law will desensitize judges to any reflexive resistance to the application of foreign law that universalism requires, it is a fair conclusion that the working together of the two courts in the two countries highlights a cosmopolitan mindset that will advance, even if just conceptually or atmospherically, the universalist agenda.\textsuperscript{58}

There is a further, inferential point regarding the importance of the procedural cooperation in this case (and others), and that is the possibility that procedural integration increased the likelihood or perhaps otherwise played a causal role in the substantive determination on the allocation question. That is, although the judges insisted strongly they were coming to their own independent conclusions on the proper approach, surely the regular interaction between them allowed them some opportunity to exchange thoughts and ideas on a novel question of cross-border insolvency law (who else, other than law clerks and the occasional professor, do judges get to bat ideas around with besides other judges?). It should shock nobody that two judges working so closely together just so happened to come to the same solution on allocation, especially one that transcended the self-serving approaches of each respective national constituency.\textsuperscript{59}

Importantly, it is not as if these two jurists were free from differences of legal opinion. Indeed, a bizarrely long portion of each judgment is devoted to interpretation of the tax-animated Master Research and Development Agreement (MRDA) – bizarre because both courts ultimately held it largely irrelevant to the allocation decision – and the two courts diverged significantly in their analyses.\textsuperscript{60} The focus on the MRDA interpretation could be professional path-dependency, i.e., that so much argument was

\textsuperscript{57} Cf. 11 U.S.C. § 1508 (“In interpreting this chapter, the court shall consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions.”).


\textsuperscript{60} Over 13 pages, Judge Gross rejected the Canadian Debtors argument that the MRDA gave them ownership of the IP and subsequent IP Sales Proceeds. \textit{In re Nortel Networks}, Inc., 532 B.R. 494, 538 (Bankr. D. Del. May 12, 2015). Rather, the US court looked to Nortel’s representations to tax authorities and its enforcement and sublicensing practices to find that the MRDA gave the US Debtors and the EMEA Debtors economic and beneficial ownership, and thus shared ownership, of the IP. \textit{Id.} at 540-47. Across the border and 23 pages, the Canadian court found that while under the MRDA, the Canadian Debtors had complete ownership of the IP subject to exceptions, it joined the US court in ultimately concluding that the MRDA itself was not controlling on the question of allocation of the IP Sales Proceeds, Re Nortel Networks Corp., 2015 CarswellOnt 7072 paras. 169, 171 (Ont. S.C.J. [Commercial List]), because “[t]he MRDA was an operating agreement and was not intended to, nor did it, deal with the disposal of all Nortel’s assets in a situation in which no revenue was being earned and no profit or losses were occurring.” \textit{Id.} at para. 172.
devoted to the interpretation of this agreement that the courts felt the need to respond to these arguments and offer their interpretations of the document. Or it could be that the courts, mindful of the novelty of their proposed pro rata allocation, where fleshing out alternative conclusions of law in anticipation of the inevitable onslaught of appeals. Whatever the reason, each court went out of its way to remark how it disagreed with the other court on the proper interpretation of the agreement. (The Canadian court put more emphasis on legal title of the licensed property, decrying “economic theory,” whereas the US court put more emphasis on the what it saw as the economic substance of the location of all meaningful legal rights to exploit a profit lying at the hands of the licensees.)

Perhaps the length of the discussion on this ultimately moot issue was simply a manifestation of two judges who had grown to respect each other trying to make their best case, forcefully but respectfully, for why the other was mistaken when they agreed on so much else. But there is another, more strategic possibility (one that could be complementary to the foregoing explanation). It could be that the judges were showing the world that they were not just deciding everything in lockstep but that they could, and did, disagree on matters. Perhaps they wanted the bankruptcy world to know that the courts were not simply two like-minded jurists who lucked into co-assignment but two judges working together who felt no reservation about expressing differences of opinion when necessary. But when the ultimate question had to be resolved, however, they came together and reached the same result. Given some of the scoldings regarding the protracted state of the litigation, it could well be that they came together as a united front to make clear that this matter had to end, once and for all, and to send a strong signal that they were willing to do so even as judges who could disagree on other matters. In that regard, it is eminently fair to surmise that that convergence of outcome may well have been facilitated by the universalism-fostering cooperation and coordination of judicial proceedings that led to the mutual acceptance of a goal to end this nightmare (and try to blunt the appetite for appeals) by coming together with the same substantive decision. Procedural coordination may thus have affected substantive convergence.

2. Universal Allocation Offsetting Territorial Distribution.

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62 As the US court candidly conceded, “The Courts have different interpretations of the MDRA . . . .” In re Nortel Networks, Inc., 532 B.R. at 532.
63 See supra note 60.
64 The parties’ complex arguments for their positions and against others supported by the enormous volume of supporting papers go around and around without end and without a definitive correct answer. It is fair to find that there is validity and error in all of the arguments, largely because the arguments are not rooted in an agreement which applies to the facts. In re Nortel Networks, Inc., 532 B.R. at 550.
In earlier academic work, I have discussed the role of (and distinction between) two vectors of territorialism, somewhat provocatively labeled “greed” and “pride”.\(^{65}\) These refer to the two concerns that territorialists have regarding universalism’s encroachment on so-called “local interests”. “Pride” is likely the more intractable and pertains to the sovereignty-conscious desire to see a nation’s normatively rich bankruptcy laws apply to assets within that jurisdiction’s borders. Thus, if a given country has a high priority ranking for labor claims, it is a hard swallow for many to send locally situated assets to a foreign main bankruptcy proceeding afoot in an MBE’s COMI, where that priority will not be recognized (all while local workers sit in the courtroom and look forlornly at the local judge).\(^{66}\) The “exportation” of the COMI’s bankruptcy laws upon the assets in the local jurisdiction affronts sovereignty (or, more cynically, upsets the rent-seeking divisions painstakingly inserted into local bankruptcy law).\(^{67}\)

“Greed”, by contrast, refers to good, old-fashioned local favoritism and depends on the asset coverage ratio of locally situated assets to cover local claims. Following the example above, local unsecured creditors with no priority couldn’t care less about sovereignty and would be happy with a universalist outcome that destroyed the priority of their employee-creditor rivals under local law. Indeed, this is what happened in *Lernout & Hauspie*.\(^{68}\) All these creditors care about is sharing the greatest amount of assets with the fewest number of creditors. So “greed” refers to the desire of creditors with a high ratio of local assets covering local claims not to share on a worldwide basis when to do so would dilute their dividend, irrespective of governing bankruptcy law. The reason greed is a less stable territorialist vector than pride is because it is generally only ascertainable *ex post*. No country can generally know *ex ante* how creditors in its jurisdiction will shake out in the asset scramble until there is an actual bankruptcy. Policymakers might hope that creditors within their jurisdictions will routinely be in “surplus” situations, in which the ratio of local assets to local claims beats the worldwide average, such that territorialism is attractive. Yet there is just as much chance that their creditors will find themselves in a “deficit” situation, in which case the local creditors will welcome universalism’s worldwide sharing.\(^{69}\)

Viewing *Nortel* through this lens, it is clear that sovereignty was alive and well: pride, though checked by cooperation, was prevalent. This conclusion is supported by the courts’ pointed insistence on distinguishing between allocation and distribution, with the latter being expressly reserved for the respective sovereign jurisdictions to vindicate

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\(^{66}\) It is very difficult for a court in Country B to tell a group of Country B employees who have worked in a branch office in Country B for years that they will not enjoy the special priority distribution rule accorded to workers under Country B’s bankruptcy laws, even though there are plentiful assets in Country B to cover such a payout, because their employer’s bankruptcy will be governed under the laws of Country A, which grants no such priority.

Pottow, *supra* note 3, at 951.

\(^{67}\) *See* Frederick Tung, *Fear of Commitment in International Bankruptcy*, 33 GEO. WASH. INT’L L. REV. 555, 566 n.44 (2001).


\(^{69}\) *See* Pottow, *supra* note 21, at 1912-15.
their policy-laden distribution rules and thus assuage their pride. As mentioned above, this puts a territorialist gloss on the Nortel proceedings.\textsuperscript{70}

On the other hand, greed was roundly, if not explicitly, quashed, striking a universalist blow against the insistence (ex post, of course) that creditors with a winning asset coverage ratio within a domestic territory have a “right” to collection from assets within their local jurisdiction. Consider the counterfactual of what a “greedy” territorialist allocation would have looked like: each group of domestic creditors would have insisted on its rights to have each asset situated within a specific jurisdiction seized and distributed according to local law, not sent off to global sharing under universalism. If Nortel were following traditional territorialism, the litigation would have been simple: nothing more than a fight about where (i.e., in which territory) the intellectual property assets were located, not, as it actually was, how to distribute the intellectual property sales proceeds most equitably.\textsuperscript{71}

To be sure, there is some conceptual overlap, because the outcome in Nortel might equally be explained by concluding that the courts tried at first to answer the “where” question, found it unanswerable, and then just settled for the hands-throwing-up answer “everywhere” – a territorialist methodology that yielded a universalist-seeming result. But that analysis is too quick, because if the courts were truly hell-bent on a territorialist asset-situation fight and nothing more, they would have winnowed down the patent location shortlist to Canada vs. the United States. Either the intellectual property assets were in Canada, where they were nominally owned (one predicts this would have been the strong presumptive territorialist argument), or at best they could have been said to be in the United States, on a pragmatic, economic functionalism argument that much of the profitable substance of the assets occurred through the exploitation of the licenses located there.\textsuperscript{72} Yet that is not what happened – far from it. Either recognizing the deleterious effects of incentivizing the territorialism lottery or simply acknowledging the inequity of such a result when applied to a truly integrated MBE like Nortel, both courts moved quickly beyond trying to figure out where the underlying assets “were” in allocating the proceeds of their sale. Rather, they appreciated what universalism advocates have maintained all along – that centralized administration and sharing of an insolvent multinational’s assets ultimately is the most efficient and fair way to process a bankruptcy regardless of assets’ territorial location.\textsuperscript{73} If territorialism were to rule the

\textsuperscript{70} See supra note 49.

\textsuperscript{71} “[T]he Court is attempting to apply an equitable result where parties could not agree upon one and did not prove the validity of any one of the conflicting views.” In re Nortel Networks, Inc., 532 B.R. 494, 556 (Bankr. D. Del. May 12, 2015); “It would unjustly enrich NNL to deprive all of the other RPEs of the work that they did in creating the IP just because the patents were registered in NNL’s name.” Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 197 (Ont. S.C.J. [Commercial List]).

\textsuperscript{72} Cf. In re Nortel Networks, Inc., 532 B.R. at 555 (preferring economic approach).

\textsuperscript{73} This was not one corporation and one set of employees inventing IP that led to patents. Nortel was a highly integrated multi-national enterprise with all RPEs doing R&D that led to patents being granted. It was R&D that drove Nortel’s business. R&D and the intellectual property created from it was the primary driver of Nortel’s value and profits. All parties agree on that. It would unjustly enrich NNL to deprive all of the other RPEs of the work that they did in creating the IP just because the patents were registered in NNL’s name.

Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 197.
day, the EMEA arguments would have been blown out of the water; the fact that there was international R&D contribution to the generation of the value-capturing intellectual property assets would have been interesting from a Marxist perspective but legally irrelevant. In fact, as soon as the Canadian formalist approach was rejected, it was clear the courts were moving beyond territorialism (which necessarily means, toward universalism).74

The final nail in the coffin of territorialist explanations of the asset allocation comes in the courts’ rejection of the intriguing reliance arguments made by the guaranteed bondholders. Some bondholders holding inter-corporate guarantees essentially claimed that they were entitled to supra-pro-rata recovery because they purchased their bonds in reliance on accessing multiple potential bankruptcy estates should the bonds default through the guarantees (i.e., pro rata for their primary bond claims and then pro rata again for their inter-corporate guarantees).75 This purported reliance led to a barrage of yield spread graphs pored over by the courts and even more interesting expert testimony concerning whether there is actually any appreciable difference in bond yields for inter-corporate guaranteed vs. non-guaranteed debt.76 Without jumping into the dispute, what is noteworthy is not just the courts’ ultimate rejection of the suggestion that settled expectations would somehow be undermined by sticking with the pro rata allocation formula given the demonstrated non-reliance of the parties, but the questioning whether there is ever actual reliance on intercorporate guarantees; there was serious discussion in both courts of the insolvency-state irrelevance of inter-corporate guarantees!77 The case should not be overstated, of course, for although ignored for pro rata allocation purposes, the guarantees were nonetheless preserved to buttress multiple possible claims at the distribution stage. Still, the foundation of territorialism’s vested rights argument – hypothetical, presumed reliance – suffered serious (and overdue) destabilization in looking at the actual (non)reliance on the guarantee by the parties in this case.78

3. **Nortel’s Specific Application: Near-Universalism.**

While perhaps not as significant as the prior two aspects of Nortel’s universalist leanings is the specific application of the courts’ holdings to mimic what a universalist

74 “Territorial wrangling significantly diminishes value for stakeholders in a global insolvency involving a highly-integrated multinational enterprise whose assets are entangled, and ought not to be condoned or rewarded.” *In re Nortel Networks, Inc.*, 532 B.R. at 531.
75 *Id.* at 559; *Re Nortel Networks Corp.*, 2015 CarswellOnt 7072 para. 229.
76 *In re Nortel Networks, Inc.*, 532 B.R. at 559; *Re Nortel Networks Corp.*, 2015 CarswellOnt 7072 para. 239.
77 “The guarantees did not restrict NNC or its subsidiaries from lending cash to, or making investments in, affiliates, or from incurring substantial amounts of additional indebtedness investors were warned of the possibility of consolidation, and that under applicable law principal and interest might not be paid. Thus, the Bondholders’ allegations of reliance on the outcome they now advocate are unfounded.” *In re Nortel Networks, Inc.*, 532 B.R. at 559.
result would look like. That is, although conceptually, the courts’ insistence on
distribution by estate invoked the pride component of territorial concern over local
interests, the actual application in this case suggests that that pride will be minimally
disruptive, almost trivial. This is because on the facts of this particular case, there were
no secured creditors claiming the lockbox proceeds and the biggest potential candidate
for an unsecured priority claim – the UK pension claimants – had been adjudicated not to
have priority but general unsecured status (those claims to be fixed by UK
proceedings).79 If, as here, priority – especially the nettlesome priority of security – is
stripped out of a case, then pro rata allocation by estate merges into universalism.

Running some numbers might help substantiate this assertion. Sticking with the
earlier hypothetical,80 consider the situation in which $1 of claims in Canada and $1 in
EMEA each compete with $2 of claims in the United States. Under pro rata allocation,
the lockbox proceeds would be disbursed 25%, 25%, 50% to Canada, EMEA, and the
States. It does not matter what the underlying assets are; they could be valued at X. Now
appreciate what would happen under territorialism, and to do so easily, assume that all
the assets are located in Canada. Under a territorialist regime where creditors can only
file in one estate (which is not necessarily the case with sophisticated creditors but is the
approach implicitly assumed in the Nortel courts’ disposition),81 the outcome would
entail all the money going to the Canadian creditors, with the rest getting zero. On a
purely universalist regime, however, everyone would file in Canada, or at least file in
ancillary proceedings that defer to Canada,82 and all the assets would be sent there for
distribution (although under this hypothetical they are already there) under Canadian law.
Under this universalist outcome, the Canadians would take 25% of X, EMEA 25% of X,
and US 50% X, exactly matching the pro rata allocation approach.

The universalist outcome is not necessarily congruent with the pro rata allocation
approach, however, because of redistributive bankruptcy priorities. Under the pro rata
allocation approach, assets are sent to the respective jurisdictions to be distributed under
each local jurisdiction’s bankruptcy laws, whereas under universalism, the distribution
would be effected by a Canadian court under Canadian bankruptcy laws. But the
principal relevance of distribution laws is whether they confer different priorities and
rankings for creditors that would make the choice of distribution law relevant, i.e.,
creating some winners and some losers depending on whose laws applied. In this
specific case, however, with no secured claims and the UKPC being non-priority, that
potential “distortion” of choice of distribution law is muted if not eliminated. For in the
absence of any priority creditors, and a fortiori the absence of any relevance of
differences in substantive bankruptcy distribution laws, the pro rata allocation approach
will indeed merge fully into universalism. The application of Canadian “vs.” US laws for

79 Re Nortel Networks Corp., 2015 ONSC 4170 para. 54.
80 See supra text accompanying note 33.
81 “In determining what the claims against a Debtor Estates are, a claim that can be made against more than
one Debtor Estate can only be calculated and recognized once.” Re Nortel Networks Corp., 2015
CarswellOnt 7072 para. 251; see also Jay Lawrence Westbrook, Universal Participation in Transnational
Bankruptcies, MAKING COMMERCIAL LAW: ESSAYS IN HONOUR OF ROY GOODE 419, 436–37 (Ross
82 See Pottow, supra note 3, at 947.
distribution will be of no moment, and so the bifurcation of allocation and distribution will be irrelevant. Thus, protestations notwithstanding, the courts in Nortel have almost ordered what universalism would look like in this actual case, and the world has not stopped spinning.\(^{83}\) (To be sure, they were not at full universalism – recall the “modified” approach left cash on hand territorially in the local estates – but they got pretty close.)

4. Universalism’s “Uniqueness” Not So One-Off as Protested.

In ordering the modified pro rata allocation of the Nortel assets, the courts intermittently circled back to words like “extraordinary” or “unique” to describe both Nortel and their novel solution.\(^{84}\) And in one sense, they were surely correct: Nortel is unique in its worldwide cooperation of an asset sale of billions of dollars (as it might also be unique in its magnitude of squabbling over the distribution of those proceeds).\(^{85}\) It’s a big, heady, headline-grabbing case, and thus unique in many respects. But the courts’ factual analyses of the workings of a seething, cross-border behemoth reveal a business model that is not nearly so one-off as characterizations such as extraordinary and unique might imply. Quite the contrary, many of the financial and human resource integration practices explained by the courts seem like they could apply as descriptions of countless other MBEs. As the Canadian court summed up: “[Nortel] was not one corporation and one set of employees inventing IP that led to patents. Nortel was a highly integrated multinational enterprise . . . .”\(^{86}\) So, too, did the US court find functional integration.

“[Principals] did not run the business with any real knowledge of the statutory entities at all. . . . Decisions to allocate resources and performances were not based on legal entity lines, but by lines of business. Nortel reported its finances on a consolidated basis without regard for its different legal entities. . . .

Although employed by a particular legal entity, employee work responsibilities were directed to the entire Nortel. . . .

\(^{83}\) Most of the parties – save the plucky US interests – have not appealed the allocation decision, although they have filed contingent cross-appeals if the US appeals are granted. The appellate courts have rebuffed invitations to expedite these appeals. Gina Passarella, Nortel Bankruptcy Appeals Denied Fast Track to Third Circuit, DELAWARE LAW WEEKLY (Aug. 5, 2015), http://www.delawarelawweekly.com/id=1202733834964/Nortel-Bankruptcy-Appeals-Denied-Fast-Track-to-Third-Circuit?slreturn=20150905125146.

\(^{84}\) “Pro rata is, to say the least, an extraordinary result . . . .” In re Nortel Networks, Inc., 532 B.R. 494, 560 (Bankr. D. Del. May 12, 2015). “[D]oing what is just in the unique circumstances of this case should govern the allocation.” Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 204.

\(^{85}\) “The Court can only speculate why the parties, all represented by the ablest of lawyers and sparing no expense, were unable to reach a settlement on allocation.” In re Nortel Networks, Inc., 532 B.R. at 500.

\(^{86}\) Re Nortel Networks Corp., 2015 CarswellOnt 7072 para. 197 (Ont. S.C.J. [Commercial List]); id. at para. 218 (noting “significant intertwining of the debtor companies, including multiple instances of inter-company debts, cross-default provisions and guarantees and the existence and operation of a centralized cash-management system”).
To the outside world, including Nortel’s customers, suppliers, and the rest of the world, the [corporate] logo referred to all of Nortel, and not to any one geographic entity. 87

Whether Nortel was an exemplar or outlier in how it ran its operations is of course an empirical question, but there is good reason to suspect that Nortel’s practices may be widespread. And if Nortel was indeed something close to a typical MBE in terms of its corporate interweaving of operations, then the case for universalist allocation of sales proceeds may be far from unique but actually expected. Nortel may thus serve as a focal point of salience for many future cross-border proceedings, further advancing universalism with its asset-sharing approach.

5. The Primordial Allure of Universalism.

The final way in which Nortel foments universalism is by underscoring the simple point that sharing *pari passu* is a deeply engrained construct in many insolvency systems around the world. 88 It should thus surprise nobody that when the courts threw out the self-serving allocation proposals offered by the parties and looked at the reality of the operational integration of the Nortel empire, they decided to revert to first principles of equality as equity. 89 This further shows the allure of universalism, because wholly apart from its efficiency arguments – which are normatively compelling – universalism fights back at what has been referred to earlier as the lottery aspect of territorialism. Given the ease with which some assets can move across borders, it makes no sense to privilege asset location in spreading losses of financially insolvent MBE debtors across creditors. 90 And, indeed, the bond spread analysis of Nortel shows how weak the “vested rights” arguments truly are that get trotted out to defend the charged unfairness of the lottery. 91 While it is ironic at some level that the assets most territorially privileged in the modified *pro rata* allocation approach in this case are the ones most susceptible to cross-border territory shopping (namely, cash), 92 the broader point remains that the unfairness of pinning the creditors’ dividend to the sometimes random location of assets on bankruptcy day – the conceptual lynchpin of territorialism – clearly weighed upon the judges in the case of an integrated MBE when they crafted the *pro rata* approach. (Recall that the situation of the intellectual property in Canada alone was for tax convenience.) 93 As such, whether the courts recognized their being guided by universalist impulses or not, the equality norm of bankruptcy law, and its implementation through a universalist approach to cross-border proceedings, was strongly on display in Nortel.

III. CONCLUSION.

87 In re Nortel Networks, Inc., 532 B.R. at 551-52.
88 See LEGISLATIVE GUIDE.
89 Modified by the cash on hand, to be sure, but still *pro rata* in the main.
92 See Pottow, supra note 90.
93 See supra note 60.
"Nortel was a remarkable display of judicial cooperation and innovation, designing the nuanced and novel approach of (modified) pro rata allocation of the proceeds of a globally integrated insolvency sales procedure. Although the focus on estate-by-estate distribution of this pro-rated allocation might at first blush seem territorialist, properly viewed in context, Nortel is actually a considerable illustration – and advancement – of universalism. Nortel is far from a full-throated clarion cry for universalism, however, so at most two cheers can be mustered and not a full three.\footnote{94 This territorial backslide can seen, for example, by the modification to the pro rata approach, the vocal protestations that this was neither substantive consolidation nor universalism, and the aforementioned fixation on territorial estates. In re Nortel Networks, Inc., 532 B.R. at 550, 558, 538; Re Nortel Networks Corp., 2015 CarswellOnt 7072 paras. 212, 88 (Ont. S.C.J. [Commercial List]).} But universalism is likely only to be reached along an incrementalist path anyway,\footnote{95 Pottow, supra note 3.} and Nortel has moved the ball forward. In their own way, perhaps covertly, perhaps subconsciously, perhaps unintentionally, or perhaps simply judiciously, the Nortel judges in their two different jurisdictions with their two coordinated and harmonious opinions have shown how universalism can work and how its allure remains strong.
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Shoppers’ paradise? Some realism about 21st century United States bankruptcy jurisdiction over non-US debtors

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The overall track record of the United States since 1978 in recognizing foreign insolvency proceedings and giving effect to foreign insolvency law within its territorial jurisdiction is second to none. Bankruptcy courts in the United States routinely extend comity to foreign restructuring plans and, in so doing, permit foreign bankruptcy law to discharge or modify obligations under US law governed transactions.1 This practice was already established before the US enacted the UNCITRAL Model Law on Cross-Border Insolvency in 2005 as Chapter 15 of the Bankruptcy Code,2 and has accelerated since.3 Courts consistently resist attempts by US-based holdout creditors to resort to US lawsuits4 or US involuntary bankruptcy proceedings5 as a mechanism to leverage their


2 See eg In re Board of Directors of Multicanal S.A. 314 BR 486 (2004).

3 UK schemes of arrangement in respect of non-UK entities have been a particular beneficiary of US largesse: see Walters (n 1). For a recent case where the US bankruptcy court gave effect to a Brazilian reorganization plan in the US, see In re Rede Energia S.A. 515 BR 69 (2014).

4 See eg JP Morgan Chase Bank v Altos Hornos de Mexico, S.A. de C.V. 412 F.3d 418 (2nd Cir, 2005) and the other Second Circuit authorities discussed in In re Northshore Mainland Services, Inc 537 BR 192 (2015), 207. See also KA Mayr, ‘Enforcing Prepackaged Restructurings of Foreign Debtors Under the U.S. Bankruptcy Code’ (2006) 14 Am Bankr Inst LJ 469, 504 (text to n 129 citing to extensive authority illustrating the routine invocation by US courts of comity to dismiss lawsuits in deference to foreign insolvency proceedings).

5 Multicanal (n 2). For another example, see In re Compañía de Alimentos Fargo, S.A. 376 BR 427 (2007). More recently, in the Suntech case, the hostility of the US courts to involuntary filings prompted a settlement between the debtor and a minority group of bondholders that resulted in a Cayman filing assisted by a US chapter 15 case rather than a US chapter 11 case: see GW Shuster, Jr & BW Loveland, ‘Will Chapter 15 be the “Exclusive Destination” for Foreign Debtors’ (2015) 34 Am Bankr Inst J 42-43, 90; ACW Tang & Christina LM Lam, Wuxi Suntech Power Co., Ltd: The First PRC Reorganisation Involving Shareholders Subject to Foreign Proceedings (INSOL International Case Study No. 7, May 2016).
position in foreign insolvency proceedings already pending in the jurisdiction of the
debtor’s centre of main interests (COMI). US courts are also disinclined to let party
autonomy in the non-bankruptcy realm (i.e. New York governing law and jurisdiction
clauses in contracts) serve as a rampart against the effects of a foreign insolvency
proceeding. The contrast with the UK could not be more obvious.

But US bankruptcy courts also routinely allow forum shopping non-US entities to file full
chapter 11 proceedings in the US. And, in this respect, as far as its critics are concerned,
the US comes unstuck. Critics point to the ease with which bankruptcy jurisdiction can be
manufactured, because of the low bar to entry in section 109(a) of the Bankruptcy Code,
combined with the expansive reach of sections 362 (the automatic stay) and 541 (the
bankruptcy estate). They cite cases such as Avianca6 (a successful US Chapter 11 case
filed by Colombia’s national airline) and Yukos10 (a fleeting US Chapter 11 case filed by
a Russian oil giant that had the effect of restraining various banks from participating in an
expropriatory tax auction) as exemplars of US jurisdictional exorbitance and
unseemliness.11 The consequence, they claim, is a “parade of horribles”: abusive forum
shopping designed to benefit debtors at the expense of creditors; imposition of US law on
unsuspecting remote stakeholders; US overreaching at the expense of the policy choices
of other countries; costly procedural inconvenience for foreign creditors forced to contest
US jurisdiction; increased risk of jurisdictional conflict. The thinly veiled implication of
the critique is clear. Undesirable aspects of American exceptionalism are in play. By
asserting global jurisdiction in cross-border insolvency cases on a flimsy basis the US
encourages harmful forum shopping and engages in the hubristic export of US norms.
The US should raise its barrier to entry and make it harder for forum shoppers to file
under chapter 11. As Professor McCormack puts it in an article that criticizes Avianca

6 Altos Hornos (n 4) 428-429.

7 For empirical evidence see O Couwenberg & S Lubben, ‘Corporate Bankruptcy

8 “A dollar, a dime, or a peppercorn” of property in the US suffices: see In re Theresa
Mctague 198 BR 428 (1996), 431.

9 In re Aerovias Nacionales de Colombia S.A. Avianca 303 BR 1 (2003).

10 In re Yukos Oil Co 321 BR 396 (2005).

11 See eg G McCormack, ‘Bankruptcy Forum Shopping: The UK and US as Venues of
Choice for Foreign Companies’ (2014) 63 ICLQ 815, 816, 822-824, 836-839, 841-842.
See also G Affaki, ‘A European View on the US Courts’ Approach to Cross-Border
Insolvency – Lessons from Yukos’ in G Affaki (ed), Cross-Border Insolvency and
and Yukos: “[i]f the jurisdictional threshold was higher, this would reduce the risk of inappropriate proceedings being filed.”12

My paper for the 2016 Colloquium is an early work in progress forming part of a wider inquiry I wish to pursue into the role judges and private actors play, through the instruments of domestic and private international law, in the governance of what I refer to as the “global shopping precinct” or, perhaps more accurately, the “transatlantic shopping precinct”, given the continuing allure of New York, Wilmington, and London to bankruptcy case placers. My purpose is to provide, from an Anglo-American, Mid-Atlantic perspective, a provisional, alternative account of how US bankruptcy jurisdiction is actually exercised over non-US debtors in practice and to identify ways in which US practice may be evolving, and has plausibly evolved, since cases such as Avianca, Yukos, and Cenargo13 that tend to attract the opprobrium of the critics.

Several things are not in doubt. First, the US does have a low bar to entry. Second, the US does make expansive claims about the theoretical reach of its bankruptcy law as regards any corporate debtor, domestic or foreign, that files a US case.14 Third, forum shopping will persist insofar as there are legal or procedural advantages (perceived or real) to be gained from it and, of course, it continues to persist in the face of harmonization initiatives of various kinds.15 Fourth, the US is attractive to forum shoppers and case placers for a host of well-rehearsed reasons,16 not least its “restructuring friendly” environment. Fifth, given its power and various other comparative advantages, including New York’s role as a global financial centre, the US

12 McCormack (n 11) 838.


14 Though there is considerable internal contestation within the US currently about the proper bounds of long arm jurisdiction both within the bankruptcy context (especially as regards the reach of avoiding powers) and more widely. See eg Morrison v National Australia Bank 561 US 247; SIPC v Bernard L Madoff Investment Securities 513 BR 222 (2014) and discussion in ER Morrison, ‘Extraterritorial Avoidance Actions: Lessons from Madoff’ (2014) 9 Brooklyn J Corp Fin & Com L 268. On personal jurisdiction see text to n 50 below.

15 See, e.g., F Mucciarelli, ‘The Unavoidable Persistence of Forum Shopping in European Insolvency Law’ http://papers.ssm.com/sol3/papers.cfm?abstract_id=2375654. Indeed, without incredibly restrictive venue rules, forum shopping would persist even if insolvency law were globally uniform as shoppers would still shop among different procedural dispensations, different local legal cultures, and/or different interpretations of uniform law. Domestic bankruptcy law in the US illustrates the point graphically.

16 O Couwenberg & S Lubben (n 7); McCormack (n 11) 826-828.
has become a much sought after destination for shoppers.\textsuperscript{17} So the US unquestionably has a highly accessible bankruptcy system that presents shopping opportunities to non-US debtors and case placers.

Furthermore, it is a core aspect of US bankruptcy culture that debtors should have swift and unconstrained access at point of entry to the bankruptcy system. The US eschews the kind of access barriers that are common in many other countries, such as “insolvency” eligibility requirements. Litigation over eligibility on “Day One” of a bankruptcy case is structurally discouraged. The legal framework reflects an article of faith of US legal culture: the deep normative commitment to the notion that every debtor should presumptively be given a fair chance to reorganize. Accordingly, the Bankruptcy Code does not constrain \textit{debtor eligibility} at point of entry and discourages overly premature testing of the likelihood of successful reorganization. Feasibility testing usually comes later. The US prefers not to strangle cases at birth.

Nevertheless, two Code mechanisms constrain the continuance of bankruptcy \textit{protection} and the actual grant of bankruptcy \textit{relief}: the court’s abstention power in section 305 and the court’s power to dismiss for cause on the ground of bad faith filing in section 1112(b). As time has gone on and as US practice has evolved, courts have used both powers to halt “shopped” cases in their tracks well in advance of a plan confirmation hearing. However, as critics are quick – and correct – to point out, the onus is on those parties who \textit{object} to US jurisdiction to trigger these mechanisms. And so, the argument runs, there is a risk that highly asymmetric cases with skewed global effects based on slim jurisdictional foundations will gather momentum and cause mischief in the meantime.\textsuperscript{18}

Once a bankruptcy court recognizes a foreign main proceeding under chapter 15, its own role is jurisdictionally limited. A foreign representative will need to commence a chapter 11 to gain access to US avoiding powers but once a foreign proceeding is recognized, the scope of any subsequent parallel chapter 11 proceeding is constrained.\textsuperscript{19} Things work slightly differently if the US chapter 11 is filed before the chapter 15 case. In that situation, the chapter 11 case remains, at least initially, in the driver’s seat.\textsuperscript{20} Either way, the cooperation and coordination imperative of the Model Law configures the court’s jurisdiction in the plenary case and, by virtue of section 1529(4), chapter 15 expressly

\textsuperscript{17} Probably rivaled only by the UK: see Couwenberg & Lubben (n 7). In flights of fancy, I think (stereotypically) of the US as having the restructuring “megastore” in the global shopping precinct, just around the corner from the UK’s deceptively large, though charmingly genteel, restructuring “boutique.”

\textsuperscript{18} McCormack (n 11).

\textsuperscript{19} 11 USC 1528, 1529(2).

\textsuperscript{20} 11 USC 1529(1).
brings the court’s power of dismissal under section 305 into play as a coordinating
device. Thus, the scope of the “asymmetric overreach” risk, such as it may be, is confined
to cases where: (i) no insolvency proceeding is yet pending in the “home” jurisdiction but
one might be contemplated; (ii) no insolvency proceeding is contemplated at all in the
“home” jurisdiction; (iii) an insolvency proceeding is pending or contemplated in the
“home” jurisdiction but chapter 15 recognition is yet to be sought. The cases in this
limited batch are mostly cases that, at point of filing, Jay Westbrook would characterize
as US “solitary non-main proceedings.” They may arise from different underlying
motivations. Some could be cases filed by shoppers (debtors or creditors) as a pre-
emptive strike to gain leverage in some way. Cenargo and Yukos are paradigmatic.
Others could be cases where the parties in functional control of the debtor prefer to
conduct a bankruptcy proceeding exclusively in the US and avoid a “home” filing
completely. Avianca is a case in point. The chapter 11 cases of Arcapita Bank B.S.C.(c.),
a Bahraini investment bank, and several of its subsidiaries and affiliates, furnish a more
recent example. Yet others fall somewhere in between. The Baha Mar case, discussed
below, is one such.

The main arguments of my paper are as follows.

First, it is plausible to suppose that the way that US bankruptcy courts actually exercise
jurisdiction in practice in solitary non-main proceedings (SNMPs) is restrained and
jurisdictionally congruent most of the time. By “jurisdictionally congruent”, I mean that
US courts exercise their powers and apply US law predominantly within the US in ways
that affects parties and assets well within the limits of their meaningful enforcement
powers.

Partly, this reflects feasibility constraints. For a US case to be successful, it makes sense
for case placers to structure it in ways that will impair the claims of creditors against
whom enforcement can realistically be achieved while leaving unimpaired the claims of
non-US stakeholders located in jurisdictions which are not guaranteed to provide
ancillary enforcement assistance to the US court. Partly, it reflects the realities of

21 JL Westbrook, ‘National Regulation of Multinational Default’ in M Monti et al (eds),
non-main proceeding arises where “a bankruptcy petition is filed in the United States
with respect to a corporate debtor whose center of main interests is in another country,
yet bankruptcy has not been filed there.”

22 Possibly managers and shareholders if creditors are diffuse and uncoordinated but more
plausibly a powerful constituency of coordinated lenders or bondholders.

23 See discussion in text after n 51.

24 As Couwenberg & Lubben (n 7) point out the flexibility of the creditor classification
rules in chapter 11 allows “the American courts to tailor the chapter 11 procedure to
match the scope of the court’s power.”
modern restructuring practice in the high yield market in which it is commonplace for financial and operational restructuring to be effectively partitioned.\footnote{Professor Rasmussen was alive to this development a decade ago: see RK Rasmussen, ‘Where Are All the Transnational Bankruptcies? The Puzzling Case for Universalism’ (2007) 32 Brooklyn J Intl L 983.} As a consequence bankruptcy cases often take the form of a forensically targeted bond restructuring in the group holding vehicle that “follows the money” to its source.\footnote{See Mayr (n 4), Counwenberg & Lubben (n 7), Rasmussen (n 25).} In other words, if the restructuring deal the non-US debtor needs to do is with the US-based holders of New York law governed high yield bonds, it makes perfect practical sense to use US chapter 11 to implement that deal regardless of where the debtor’s COMI is located. This type of financial restructuring, focused on a specific crisis in the debtor’s capital structure, is functionally equivalent to a “shopped” scheme of arrangement in the UK.

If these cases are the norm, and US bankruptcy courts more often than not act in restrained and congruent ways in SNMP cases, abusive forum shopping, characterized by the filing of asymmetrically skewed cases, is not going to be a large problem in practice.

Second, while criticism of Yukos is largely justified because a successful US reorganization was unfeasible at the outset,\footnote{The main objective of the filing was to prevent foreign banks with US branches from participating in an expropriatory tax auction of Yukos’s Russian assets organized by the Russian government: see MW Winkler, ‘Arbitration Without Privity and Russian Oil: The Yukos Case Before the Houston Court’ (2006) 27 University of Pennsylvania Journal of International Economic Law 115, 117-118.} criticism of Avianca is harder to understand. To be sure, Avianca’s COMI was clearly in Colombia. But this was not a “peppercorn” case. Avianca had revenue-generating assets flying in and out of Miami and New York that were highly susceptible to creditor seizure in the US. Avianca needed access for liquidity purposes to cash collateral in the form of US credit card receivables held in US accounts. By modern jurisdictional standards, Avianca clearly had a US “establishment”. Moreover, because Avianca successfully negotiated a “standstill” with its non-US creditors so as to ensure parity of treatment between US creditors (clearly subject to US jurisdiction) and non-US creditors (not subject to US jurisdiction), the bankruptcy court acted in a remarkably restrained and jurisdictionally congruent fashion.

In truth, Avianca presents universalists, whose instincts are, of course, that the airline should have filed its main proceeding in Colombia and sought ancillary assistance in the US,\footnote{This explains Professor Westbrook’s discomfort: see Westbrook (n 21) 787-789.} with the problem that not all laws and legal systems are created equally. Others no doubt regard the case as an affront to Colombian sovereignty. But the practical
alternatives to an SNMP in the US were: (i) file for reorganization under an untested
Colombian law and seek discretionary stay and other relief in the US under former
section 304; or (ii) file parallel proceedings in Colombia and the US and try to come up
with coordinated “mirror” plans in the two jurisdictions. Given the risks associated with
these alternatives, it is hard to criticize Avianca and its Colombian stakeholders for
opting to use the US bankruptcy system, well versed as it is in aviation cases, to deal with
its US stakeholders. The suggestion that the US behaved parochially\(^{29}\) in this particular
case is really quite hard to swallow when the US court had no foreign proceeding to defer
to and took careful steps to circumscribe its jurisdiction. A reasonable interpretation of
Avianca is that the airline, in conjunction with its Colombian stakeholders, chose in real
time the hope of an “American” deal with its US stakeholders over a perceptibly weaker
alternative – which was to have Colombia’s largest airline pursue a very large \(de facto\)
test case under a new law in a less than robust judicial and institutional environment, and
then try to export the effects to the US.\(^{30}\) Avianca is an easy case for pragmatists and
consequentialists, a hard case for universalists and sovereigntists. But a higher eligibility
bar (falling short of COMI) would not have forcibly reallocated the case to Colombia.
There would also need to have been some kind of forum conveniens inquiry right at the
start of the case as well. The main risk of the creative placement was discrimination
against US creditors who were squarely within the enforcement jurisdiction.

Third, as well as the risk of asymmetric SNMP filings (which I contend is more apparent
than real in practice), there is a risk that the US’s minimal eligibility constraints may be
exploited pre-emptively by non-US debtors in ways that exacerbate inter-stakeholder
conflicts. Cenargo is a case in point. The recent decision of the Delaware bankruptcy
court in \textit{In re Northshore Mainland Services, Inc}\(^{31}\) is also illustrative.

In \textit{Northshore}, the Bahamian developer of a huge resort complex called Baha Mar,
described in the record as “one of the most significant single-phase resorts under
development in the western hemisphere”,\(^{32}\) ran out of money before construction could

\(^{29}\) Within the year, the judge who presided over the Avianca case, Judge Gropper,
dismissed a chapter 11 case in deference to an Argentinian proceeding: see \textit{Multicanal}\(^\text{(n 2)}\). In \textit{Avianca}, he also refused to resolve Colombian labour claims, deferring to the
Colombian court’s adjudication of Colombian law even though the Colombian claimants
were keen for him to intervene. See 345 BR 120 (2006).

\(^{30}\) It took until last year for the Colombian government finally to agree a peace deal with
the FARC rebels after more than half a century of internal conflict: see ‘Colombia peace
deal with FARC is hailed as new model for ending conflicts’, \textit{The Observer}, 26
September 2015; ‘Colombia nears a peace deal with FARC rebels’, \textit{New York Times}, 23
September 2015.

\(^{31}\) 537 BR 192 (2015).

\(^{32}\) \textit{Ibid}, 196.
be completed. The project was financed by $2.45 billion of Chinese inward investment from a Chinese bank. The main contractor is also a Chinese entity. The project got badly behind schedule with the result that the local developer, who had a significant equity stake, could no longer work productively with the Chinese contractor. The Bahamian government, stuck between a rock and a hard place, has a vested interest in successful completion of the project,\footnote{According to the record, “[o]nce completed, the Baha Mar Resort will generate nearly 5,000 jobs and is projected to have annual payroll in excess of $130 million representing 12% of the GDP of The Bahamas”: \textit{ibid}.} as well, no doubt, as a powerful political imperative to keep the Chinese investors on board.

The developer engineered a chapter 11 filing of seven Bahamian entities in the developer’s group by depositing $10,000 per entity in US bank accounts. The group’s sole US subsidiary also filed chapter 11 on the basis of its Delaware domicile. Contemporaneously, the developer filed a lawsuit in the UK seeking damages under a performance guarantee of the contractor’s obligations in the main contract. In the chapter 11 cases, the Bahamian debtors got bankruptcy court approval for a debtor-in-possession facility of $80 million to fund payroll and operating expenses. They also sought recognition of the chapter 11 proceedings in the Bahamas.

The Bahamian government responded by petitioning for the winding up of the Bahamian entities and the appointment of provisional liquidators. Various interests, including the Chinese parties and the government opposed recognition, which was duly denied by the Bahamian court. The Chinese parties sought dismissal of the chapter 11 cases relating to the Bahamian entities on various grounds. The court ruled that the debtors were all clearly eligible to file.\footnote{\textit{Northshore}, 537 BR 192 (2015), 200-201.} The court refused to dismiss the cases for “bad faith” filing under section 1112(b).\footnote{\textit{Northshore}, 537 BR 192 (2015), 201-203.} It accepted (as the developer conceded) that the developer was using chapter 11 to wrest control of the project. But the developer also clearly had a genuine restructuring objective.\footnote{And was stumping up the fresh funding: \textit{Northshore}, 537 BR 192 (2015), 197 (“The Developer owns and controls the DIP Lender”).}

However, the court dismissed the cases under section 305(a)(1) on the statutory ground that “the interests of the debtors and creditors would best be served by dismissal”.\footnote{\textit{Northshore}, 537 BR 192 (2015), 203-208.} In determining whether to dismiss a bankruptcy case under section 305(a)(1) courts weigh
and balance several factors. While giving some weight to the developer’s preference for a US reorganization, the thrust of the court’s dismissal opinion is that this was a massive Bahamian “single asset real estate” case which implicated powerful Bahamian national interests, and it was best therefore for the US court to step aside in deference to the Bahamian court. In so concluding, the court also deftly sidestepped the developer’s argument that US law provided a much better alternative because restructuring options under Bahamian law were limited to liquidation. At the time of writing this outline, the case drags on in the Bahamas. As well as an adjourned winding up proceeding, a receiver has also now been appointed under the Chinese bank’s security. The receiver has put the partially completed resort up for sale.

In the circumstances, one might argue that the low bar to eligibility just served to incentivize the developer to file an asymmetrically skewed chapter 11 case that was always destined to be a costly, distracting, and ultimately futile sideshow. However, the willingness of the US court to dismiss what the judge clearly regarded as a case filed in good faith for genuine bankruptcy purposes, gives us a clue to how the exercise of US bankruptcy jurisdiction in SNMP cases may be evolving. This brings me to my next point, which is essentially a comparative law argument.

Fourth, while the US could consider toughening its eligibility criteria, it is unlikely to go down this path for legal cultural reasons already outlined. It will prefer instead to regulate abusive forum shopping through sections 305 and 1112(b) bolstered, on the one hand, by comity considerations and, on the other hand, by procedural sanctions against abusive filers and their attorneys. There are already moves afoot by the National Bankruptcy

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38 (1) The economy and efficiency of administration; (2) whether another forum is available to protect the interests of both parties or there is already pending a proceeding in state court; (3) whether federal proceedings are necessary to reach a just and equitable solution; (4) whether there is an alternative means of achieving an equitable distribution of assets; (5) whether the debtor and creditors are able to work out a less expensive out-of-court arrangement which better serves all interests in the case; (6) whether a non-federal insolvency has proceeded so far in those proceedings that it would be costly and time consuming to start afresh with the federal bankruptcy process; and (7) the purpose for which bankruptcy jurisdiction has been sought: Northshore, 537 BR 192 (2015) 203-204.

39 While bullish about the likely utility of a chapter 11 case “with all stakeholders participating”, the US court acknowledged the Bahamian court’s view that Bahamian law equipped “provisional liquidators with limited powers to preserve the Debtors’ assets while promoting a scheme/plan of compromise among all stakeholders”: Northshore, 537 BR 192 (2015) 205-206.

Conference to persuade Congress to amend section 305 so as to restrict SNMP cases that are asymmetrically skewed. The amendment would give bankruptcy courts the power to dismiss or suspend a US bankruptcy case if “the debtor’s center of main interests is not the United States and the court cannot exercise control over either the debtor or the debtor’s material assets.” This will reinforce the strong comity norm already baked into chapter 15 and further bias the US system towards jurisdictional congruence.

But even without the NBC’s amendment, I suggest that the existing and evolving case law under sections 305 and 1112(b) has likely created feedback loops that already constrain the behaviour of shoppers and case placers. Add some procedural sanctions into the mix – denial of attorney fee applications, penalties against attorneys for egregious filings that serve no meaningful bankruptcy purpose, and other such mechanisms – and the court’s dismissal powers are well capable of operating as deterrents to abusive forum shopping functionally equivalent to an ex ante jurisdictional hurdle-cum-forum conveniens screen that the debtor must clear before being granted access to the system. Northshore Mainland provides a synthesis and a snapshot of the current trajectory. On the one hand, it reflects the US culture of liberal access and bullishness about the merits and utility of chapter 11. On the other hand, it concedes that the case was the wrong way round and steers towards a universalist framing.

My provisional conclusions are that: (i) abusive forum shopping is not rampant in the US despite the low eligibility bar; and (ii) the US approach to constraining abusive forum shopping is on a different legal cultural path (which should come as no surprise).


42 The draft amendment would provide a surer basis for dealing with SNMPs but notice that it would not have altered the outcomes in Avianca, Yukos, and Northshore Mainland.

43 In Cenargo (n 13) the debtor’s attorneys were docked $140,000 for failing to pursue a parallel proceeding in the UK.

44 See Westbrook (n 21) 791.

45 In the TMT case in which twenty three non-US shipping companies manufactured jurisdiction in the Southern District of Texas, the bankruptcy court conditioned denial of a motion to dismiss on the debtors furnishing to the estates over $40 million of what the court’s order described as “good faith property” stipulated, among other things, to ensure compliance with court orders and provide a fund for payment of any sanctions ordered by the court against one or more of the debtors. See TMT Procurement Corporation v Vantage Drilling Company 764 F3d 512 (5th Cir 2014) 516.

46 See further Shuster & Loveland (n 5).
Furthermore, it is theoretically possible that the anti-abuse feedback loop created by a mixture of constraints (broad standards in sections 305 and 1112(b) allied to procedural sanctions) could be further bolstered by the US’s generally receptive and cooperative posture under chapter 15.\(^{47}\)

Needless to say, no system – certainly not one that wants to attract cases – will be a perfect “goldilocks” system in which the balance between “good” and “bad” forum shopping is “just right”. Any legal framework is subject to under-inclusivity or over-inclusivity problems, although robust and experienced judges armed with broad standards will do a pretty good job at striking a balance. There will always be troublesome cases, which push beyond the boundaries of jurisdictional congruence into the transnational “gap” between domestic systems of regulation. Shipping cases, of which a lot get filed in the US,\(^{48}\) are a good example. The assets are mobile, the debtor’s COMI often malleable. As that now notorious SNMP case, *Cambridge Gas*\(^{49}\) illustrates, the ability to make a restructuring solution stick will often require an outward projection of enforcement power that depends on other countries playing ball. This kind of case also shifts the focus of outside attention away from the low eligibility threshold and onto the US’s liberal rules of personal jurisdiction. While the reach of personal jurisdiction is internally contested within the US,\(^{50}\) other countries dislike the breadth of the “minimum contacts” doctrine. The UK, of course, is in the vanguard of the resistance. This resistance could have interesting effects on the exercise of US jurisdiction beyond the immediate scope of my paper.\(^{51}\)

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47 Though the jury is out because chapter 15’s recognition framework has, to some extent, limited the scope of relief that may previously have been available to some debtors under former section 304. Shuster & Loveland (n 5) 90 hint at this.

48 Couwenberg & Lubben (n 7).

49 *Cambridge Gas Transportation Corp v Official Committee of Unsecured Creditors of Navigator Holdings plc* [2007] 1 AC 508.


51 A less cooperative US? An even greater US inclination towards jurisdictionally congruent cases? The use of US soft power at UNCITRAL to progress the proposed Model Law on insolvency-related judgments to a swift conclusion? The short point is that
For those that worry about US overreaching, my advice is: forget Yukos and Avianca and consider instead the Arcapita case. The short version of this case is that a Bahraini investment bank with offices in “Atlanta, London, Hong Kong and Singapore in addition to its Bahrain headquarters” 52 and certain affiliates, including a Cayman subsidiary, filed US chapter 11 cases in New York. The cases were unopposed by the Central Bank of Bahrain and supported by a majority of Arcapita’s institutional lenders. Arcapita’s stated aim was to restructure a US $1.1 billion unsecured murabaha facility that was guaranteed by the Cayman subsidiary. 53 Practitioners involved on the creditor side of the case have suggested that the debtors and their institutional lenders chose the US because Bahraini law was not up to the task. 54 For example, without a worldwide automatic stay, Bahrain law could not stop involuntary insolvency proceedings allegedly threatened against an Arcapita subsidiary in the Cayman Islands. 55 The debtors successfully confirmed a plan of reorganization by cramdown. 56 While Arcapita’s plan was a liquidating plan, 57 the

if other countries do not cooperate, the reach of a US case is cabined by virtue of that non-cooperation.

52 In re Arcapita Bank B.S.C.(c) et al., Chapter 11 Case No. 12-11076 (Bankr. S.D.N.Y.), Declaration of Henry A. Thompson in Support of the Debtors’ Chapter 11 Petitions and First Day Motions and in Accordance with Local Rule 1007-2, dated March 19, 2012, docket no. 6, available at http://cases.gcginc.com/arcapita/pdflib/6_11076.pdf (Thompson Declaration). I gratefully acknowledge the assistance of Tally Wiener for setting me straight on the facts of the case and for directing my attention to primary source materials on the Arcapita case docket.

53 Thompson Declaration (n 52) 6.


55 That subsidiary, Arcapita Investment Holdings Limited (AIHL) became one of the Arcapita Chapter 11 debtors. Subsequent to becoming a Chapter 11 Debtor, AIHL issued a summons seeking ancillary relief from the Grand Court of the Cayman Island. Thompson Declaration (n 52) 1-2, 9.

56 In re Arcapita Bank B.S.C.(c) et al., Chapter 11 Case No. 12-11076 (Bankr. S.D.N.Y.), Findings of Fact, Conclusions of Law, and Order Confirming Second Amended Joint Plan of Reorganization of Arcapita Bank B.S.C.(c) and Related Debtors with Respect to Each Debtor Other than Falcon Gas Storage Company, Inc., Under Chapter 11 of the Bankruptcy Code, dated June 17, 2013, page 12 (“Although section 1129(a)(8) of the Bankruptcy Code is not satisfied with respect to the Deemed Rejecting Class, the Plan may nevertheless be confirmed because the Plan satisfies section 1129(b) of the Bankruptcy Code with respect to the Deemed Rejecting Class. Section 5.3 of the Plan contemplates the non-consensual confirmation of the Plan.”).
case is a shop window for the US to attract cases from debtors that attract funding on the basis of being Shari’ah compliant and, that having become insolvent, wish to formulate a restructuring solution utilizing pre-bankruptcy Shari’ah structures.\(^{58}\) However, cases like Arcapita raise due process and legitimacy concerns and require very careful management.

The Arcapita plan impairs some stakeholders and leaves others “out of the money.” Most of these stakeholders are in the Middle East outside of US jurisdiction. It may well be that they would have received little or nothing in a formal insolvency proceeding regardless of where the case had been commenced. But this kind of case demands a high degree of cultural sensitivity having regard to the obvious language and culture gaps.\(^{59}\) The case is also “reachy” on the back end because the plan authorizes the Creditors’ Committee to bring avoidance actions that are currently testing the outer limits of US personal jurisdiction.\(^{60}\) This case, like Avianca and Baha Mar, illustrates the problem that not all laws and legal systems are created equally. By English standards, the filing is defensible as a “good” shop because “what is being attempted is [designed] to achieve a position where resort can be had to the law of a particular jurisdiction, not in order to


(“The transactions contemplated by the Plan will (i) provide sufficient working capital to fund the Debtors’ emergence from chapter 11, and appropriately capitalize Reorganized Debtors and the New Holding Companies formed pursuant to the Plan (collectively with their non-Debtor affiliates, the ‘Reorganized Arcapita Group’), and (ii) facilitate the implementation of the Reorganized Arcapita Group’s business plan, which consists primarily of the management of the orderly wind-down of the Debtors’ existing portfolio of investment assets pursuant to the Business Plan (as defined below). . . . The Debtors believe that, under the circumstances, the managed disposition of the Debtors’ existing portfolio of assets contemplated by the Plan offers the best possible recovery to the Debtors’ creditor body.”).


\(^{59}\) Due to the prevalence of Arab speaking stakeholders, the Notice of Confirmation Order was provided in both English and Arabic. http://cases.gcginc.com/arcapita/pdflib/confirmation-entry-notice%20%28Arabic%29.pdf

\(^{60}\) *Arcapita* (n 50) above.
evade debts but rather with a view to achieving the best outcome for creditors.” 61 It may hasten insolvency law reforms in the Middle East. 62 What I say here is in no way intended to criticize the bankruptcy court’s handling of the Arcapita case, which is still open at the time of writing. But in this kind of complex, ambitious, transcultural bankruptcy case in which Western restructuring meets Islamic finance, the US courts would be wise to proceed carefully. It would not be an understatement to say that Arcapita is “Avianca squared”.

61 Per Newey J. in *Re Codere Finance (UK) Ltd* [2015] EWHC 3778 (Ch) [18].

62 Sprayregen et al (n 54).
Global initiative on MSME insolvency

The need for a new framework for micro small and medium (MSME) enterprise insolvency – policy objectives and rationale
Dr Janis Sarra, University of British Columbia

The procedural framework for the treatment of MSME
Professor Stephan Madaus, Martin Luther University Halle-Wittenberg

The debtor’s obligations under the new framework
Dr Irit Mevorach, University of Nottingham

The treatment of employees in MSME Insolvency
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Doctoral students research forum

Asset sales and secured creditor control in restructuring: a comparison of the UK, US and Canadian models
Alfonso Nocilla, PhD Candidate, University College London

Ways forward for secured creditors when insolvency strikes
Andreea Hlihor, PhD Candidate, Bucharest University

Protection of small businesses facing debtors' insolvency: the Italian way
Eugenio Vaccari, PhD Candidate, City University London
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Alfonso has published a number of articles and spoken at academic conferences on insolvency and restructuring law in Canada. In 2017, he will be a Visiting Professor at Western University teaching comparative insolvency law. Previously, he practiced corporate and commercial law in Toronto and was a legal researcher for the Department of Finance, Canada.
ASSET SALES AND SECURED CREDITOR CONTROL IN RESTRUCTURING:  
A COMPARISON OF THE U.K., U.S. AND CANADIAN MODELS

Alfonso Nocilla

I. INTRODUCTION

Scholars on both sides of the Atlantic are noticing a trend towards the use of restructuring procedures to sell substantially all of the assets of insolvent companies. In the United Kingdom, these sales are carried out primarily by way of pre-packaged administrations (“pre-packs”) under the Enterprise Act 2002. Meanwhile, similar quick-sale procedures exist under s. 363 of Chapter 11 of the U.S. Bankruptcy Code (“363 sales”) and the Companies’ Creditors Arrangement Act in Canada (“liquidating CCAAs”). This paper compares these three procedures and assesses their appropriateness in light of the underlying goals of insolvency law and the empirical evidence to date on restructuring outcomes.

Part II of this paper sets out a basic formulation of the goals of insolvency law. Part III then compares pre-packs, 363 sales and liquidating CCAAs, suggesting that these procedures are functionally equivalent in that they facilitate swift recoveries for secured creditors through sales. In particular, I argue that these procedures may give too much control over the restructuring process to senior secured creditors, thereby encouraging rent-seeking and other value-destructive behaviour, and potentially undermining the fundamental goals of insolvency law.

II. WHAT SHOULD CORPORATE INSOLVENCY LAW DO?

Thomas Jackson’s well-known account holds that insolvency law’s primary goal is to resolve a common pool problem. Specifically, the law imposes a collective and compulsory process on the creditors of an insolvent debtor in order to prevent them from racing to enforce their individual claims against the debtor’s assets, dismembering the insolvent enterprise piecemeal when the assets would have been worth more if they had been kept together. Jackson argues that the law is justified in imposing a collective resolution mechanism because preventing the creditors’ race preserves value for the creditors as a whole. Accordingly, any rationally self-interested creditor would have agreed to submit to the collective process if it had been given the chance to bargain with the other creditors from an appropriately defined ex ante position.

For a number of reasons, Jackson’s thesis falls short of offering a complete and coherent account of insolvency law. Firstly, there are fundamental problems with the way Jackson sets up the hypothetical “creditors’ bargain” model. In particular, Jackson’s creditors are not truly behind a Rawlsian “veil of ignorance” because they are well aware of their own individual characteristics at the time that they strike their bargain – they are not hypothetical characters who are equal in all respects, but real-world creditors with very important differences.

A central premise underlying this creditors’ bargain conceptualization is that a system of state law entitlements (including priorities among secured and unsecured creditors) is already in place and that parties know what their priority positions will be... If we assume that commercial parties are rational and self-interested, this hypothetical
bargain analysis provides indirect evidence of what real world parties would, in fact, agree to. The hypothetical bargain thus yields a normative criterion, grounded on principles of autonomy, for evaluating the legitimacy of the bankruptcy process.

Riz Mokal argues that this failure to place the creditors behind a true Rawlsian veil undermines both the explanatory and justificatory force of Jackson’s model. For example, it is difficult to see how creditors possessing very different relative resources, knowledge and abilities would ever agree to submit to a collective process. If they are self-interested, as Jackson posits, then the most powerful creditors will always prefer to enforce their claims individually rather than forbear on enforcing for the benefit of the group. Moreover, even if the creditors could reach some sort of agreement, that agreement would lack binding moral force because it would merely reflect the creditors’ individual preferences at the point in time in which the bargain was concluded. But there is nothing morally special about the _ex ante_ time at which the bargain is struck in Jackson’s model, so there is no reason why the creditors should not be able to renge on the deal when their individual preferences change. This points up the fact that Jackson’s model merely reflects, and does not correct for, the inequalities of the creditors at an arbitrary point in time.

On the other hand, David Carlson argues that Jackson’s model is highly problematic even if we assume that the creditors are all equal. In that case, the model becomes tautological because it merely tells us that parties that are equal in all respects will naturally agree to the imposition of a process that treats all of them equally. Accordingly, whether we conceive of the creditors as hypothetical and equal, or as real-world creditors with various inequalities, Jackson’s model fails to explain and justify the imposition of a collective insolvency process.

Secondly, Jackson’s model has been widely criticised for failing to acknowledge the distributional character of insolvency law. For example, Elizabeth Warren has argued that insolvency law is distinct from debt-collection law, the latter of which merely provides a collection mechanism outside insolvency. In insolvency, since the debtor’s assets are insufficient to meet all of its liabilities, the law necessarily decides how to distribute the assets and losses among the claimants. In this regard, Jackson’s model leaves out an important aspect of insolvency law:

The collectivism advocated by Jackson is treated as neutral but it begs distributional questions. By purporting merely to enforce pre-insolvency rights Jackson presupposes the defensibility of the state-determined collection scheme without further argument; by this process distributive elements are worked into his theory via the back door.

Setting aside the relative merits of Jackson’s and Warren’s respective accounts, they clearly emphasize two important and distinct goals of insolvency law. Firstly, insolvency law seeks to preserve and maximise the value of the insolvent estate. Secondly, insolvency law seeks to ensure a fair distribution of the assets among the claimants. The primary means by which the law pursues these goals is, as Jackson notes, through the imposition of a collective and compulsory process on all claimants. But whereas Jackson conceives of those claimants in narrow terms – essentially, they are the secured creditors of the insolvent debtor – there are good reasons to think that the law should adopt a broader view. Certainly, there is more normative appeal to a system that recognizes and responds to the adverse effects of insolvency on the most vulnerable stakeholders of an insolvent enterprise. At the
same time, considering the interests of a broader group of stakeholders is more likely to enhance value in a restructuring:\(^{14}\)

There is growing scholarship that recognizes that modern economies are made up of enterprises reflective of interests broader than traditional creditors and shareholders. This theoretical approach is not aimed at any particular outcome, but rather represents an effort to move away from the narrow view that the policy objective of bankruptcy law is to maximize value in the interests of asset claimants… This approach suggests that bankruptcy and insolvency law should have as both policy objective and key policy instrument the establishment of a forum where all the interests can be heard regarding the possible restructuring of the insolvent corporation. Suppliers, employees, customers, and local government may all have an interest in the workout, even if that interest cannot be translated into current capital claims.

In order to understand how the above is an economic justification for taking into account broader interests in insolvency, and not a moral or political justification, it is useful to distinguish here between financial and economic distress. A debtor is merely financially distressed when it is either cash-flow or balance-sheet insolvent but its underlying business remains viable. In such circumstances, the business has greater value as a going concern than it would if it were broken up and sold piecemeal, i.e. through a liquidation. In contrast, a debtor is economically distressed when its business is unviable – that is, its assets would be worth more if they were sold piecemeal than if the business continued to operate.\(^{15}\) To the extent that an insolvency regime permits economically distressed companies to continue to operate, the regime generates deadweight losses.\(^{16}\) Accordingly, an effective and efficient insolvency regime must: (a) encourage the reorganization of financially distressed debtors, thereby avoiding improvident liquidations that would destroy value; (b) encourage the liquidation of economically distressed debtors as quickly as practicable, so as to mitigate further losses and permit the redeployment of assets to more productive ends; and (c) provide mechanisms for easy conversion from reorganization to liquidation proceedings, if the insolvent debtor’s circumstances change.\(^{17}\)

The foregoing merely sketches out some of the broad principles that should inform an insolvency regime. But even within this limited framework, I would suggest that pre-packs, 363 sales and liquidating CCAAs are problematic. In order to see why this is the case, it is helpful first to examine how each of these procedures operates within its respective restructuring regime.

### III. THREE MODELS OF RESTRUCTURING

#### 1. Administration and Administrative Receivership in the U.K.

U.K. law provides a number of formal processes for resolving corporate insolvency. The main restructuring process is administration, which was first introduced in the Insolvency Act 1986 and later reformed in the Enterprise Act 2002. In an administration, an insolvency professional known as an administrator is appointed to manage the affairs of the insolvent company. The administrator may be appointed in two ways: (a) by court order upon application of the debtor, its directors or one or more of its creditors; or (b) out-of-court, either by the debtor or its directors, or by the holder of a qualifying floating charge over the debtor’s assets. Upon application to the court or the filing of a notice of intention to appoint an administrator, interim moratoria are imposed on most enforcement actions against the
debtor, giving the debtor breathing room in which to attempt a restructuring. The administrator effectively displaces incumbent management of the insolvent debtor and is tasked with either rescuing the company, if it is "reasonably practicable" to do so, or otherwise to wind-up the company. If neither of these objectives is reasonably practicable, and if doing so does not unnecessarily harm the interests of the creditors as a whole, the administrator may sell the debtor's assets and distribute the proceeds to the secured or preferential creditors.

It is important to understand the context in which the Enterprise Act reforms were introduced. Although the Insolvency Act 1986 contained administration provisions, these differed significantly from the current regime. Firstly, administration under the Insolvency Act was not a stand-alone process, as any restructuring plan that was developed had to be implemented through some other statutory procedure. Usually, this meant either a Company Voluntary Arrangement (CVA) under the Insolvency Act, a scheme of arrangement under the Companies Act 1985, or liquidation. Secondly, as a court-supervised process, administration under the Insolvency Act was seen as more expensive and time-consuming than other procedures. Thirdly, although administration under the Insolvency Act imposed moratoria on most types of enforcement actions, it did not prevent floating charge holders from appointing an administrative receiver. In addition, the petition to appoint an administrator could not be approved unless all floating charge holders consented to it. This was a major shortcoming of the regime, as it significantly curtailed an administrator's abilities and arguably created a conflict of interest:

Since an administrator can only be appointed if debenture-holders agree, this procedure cannot be viewed as offering the debtor protection from impatient creditors... Since the administrator himself has to meet with the approval of creditors we may expect that the administrator will, if appointed, like an administrative receiver, act in the interests of the creditors although nominally an agent of the creditors and the firm.

Moreover, since the administrator had no power to make distributions to creditors, floating charge holders had an additional incentive to favour receivership over administration.

All of these factors discouraged the use of administration as a restructuring tool. In 1986, however, this was not seen as a problem. Rather, the Cork Committee, which recommended the 1986 administration process, thought that administrative receivership should be the primary mechanism for resolving corporate insolvency – administration was only designed to supplement receivership. Specifically, the Cork Committee recognized that not every insolvent company would have a creditor with a floating charge and sufficient resources and incentives to appoint a receiver, which meant that some companies would miss out on the purported benefits of receivership. The 1986 administration provisions were designed to extend the “benefits” of receivership to such companies.

The distinction between administration and administrative receivership is critical. A receiver’s primary duty is to the chargee – he is under no explicit obligation to attempt a restructuring, and creditors other than the chargee remain free to enforce their claims. In short, the receivership model prima facie encourages the liquidation of insolvent companies even if reorganization would generate more value. It is for this reason that the Enterprise Act reforms aimed at replacing receivership with a more robust administration mechanism. The Act sought to “tip the balance firmly in favour of collective insolvency proceedings.”
Government ministers echoed these sentiments when the Act was introduced in Parliament:

Company rescue is at the heart of the revised administration procedure. We want to make sure that viable companies do not go to the wall unnecessarily. That is why we are restricting administrative receivership and revising administration to focus on rescue and to make it more accessible to companies as well as their creditors. That is not just good for the companies themselves; it is also good for their suppliers, customers and employees.

Having said this, most insolvency scholars and practitioners continued to view receivership favourably and opposed its abolition. For example, Armour and Frisby argued that by concentrating control in the hands of a single creditor, receivership had the potential to reduce monitoring and enforcement costs, to the benefit of all creditors. Seen in this light, receivership is paradigmatic of Jackson’s model of insolvency law: it reflects the sort of bargain that creditors of unequal power would likely reach if they were to negotiate ex ante for an insolvency process. As such, receivership is open to many of the same criticisms levelled against Jackson’s account. In particular, we might argue that by allowing the most powerful creditors to control the process, receivership merely reflects, and does not correct for, the arbitrary inequalities of stakeholders in insolvency. Insofar as such a model is unlikely to treat all stakeholders fairly, it lacks normative appeal.

In addition, receiverships may well create perverse incentives for oversecured creditors to prefer fire sales. When a creditor is oversecured, it has an incentive to seek to liquidate the distressed company’s assets as quickly as possible, regardless of whether doing so maximises the value of the assets. Since the receiver is primarily responsible to the chargee, he would have no interest in maximising the value of the debtor’s assets beyond what is required to ensure a full recovery for the chargee. In fact, the empirical evidence suggests that the holders of floating charges, typically banks, are oversecured in most cases. In addition, receivers and chargees may have perverse incentives to act in value-destructive ways even in cases where chargees are undersecured. Banks lending to small and medium-sized companies will often obtain personal guarantees from those companies’ shareholders and directors, in addition to a floating charge over the debtor’s assets. Accordingly, when a debtor becomes insolvent, the bank and its receiver need not seek to maximise the value of the insolvent enterprise. Rather, the receiver need only obtain net returns from the sale of the insolvent debtor’s assets that are equal to what the bank could recover in personal actions against the debtor’s directors and shareholders.

More recently, Armour, Hsu and Walters have presented data showing that while going concern sales under the Enterprise Act yielded greater returns on the whole than receivership sales, the costs of administration were also higher. These results suggest that administration may be no better than administrative receivership. But there are limitations to these findings. Firstly, the authors draw their data on administration sales from cases that commenced up to 31 December 2004. It is possible that administration costs were higher at that time because insolvency professionals were still familiarising themselves with the new regime – a possibility which the authors acknowledge in an earlier paper.

As with any study of this nature there are limitations. Our statistical data give a snapshot of procedures that were commenced up to the 31st December 2004. The finding of increased direct costs, while
statistically robust, might simply reflect the increased costs incurred as practitioners educate themselves about the way in which the new regime operates – if so, then we might expect costs to show a decline over time.

Secondly, the authors acknowledge the possibility of selection bias in their sample of post-Enterprise Act administration cases. Specifically, they note that secured creditors may be selecting the procedure that they expect will maximise their recoveries. The authors dismiss this concern on the basis that most administration sales occurred in cases where the creditors were oversecured. In other words, the creditors had no incentive to select administration over receivership in those cases because they would expect to obtain a full recovery regardless of the procedure used. But this overlooks an alternative explanation, namely, that creditors are concerned with factors other than just expected recoveries – they may also prefer processes that are faster, less risky, and offer the creditors greater control. In these regards, and significantly, the authors found that administrations were completed almost twice as quickly as receiverships. Accordingly, it is entirely possible that secured creditors have been using administration sales as speedy collection mechanisms. Given that pre-packs can be completed even faster than other types of administration sales, pre-packs are even more attractive as debt collection devices. All things being equal, oversecured creditors may prefer pre-packs even if the expected returns are lower than those of receiverships or full administrations because the additional costs will be borne by undersecured and unsecured creditors. Interestingly, while the authors acknowledge the possibility that creditors may find ways of “contracting around” the Enterprise Act in the future, they do not suggest that this may have happened already. But it is entirely possible that pre-packs represent this type of behaviour by creditors.

Without further empirical evidence, it is difficult to say for certain what is happening in administration sales. However, even if Armour et al. are correct that unsecured creditors are no better off under administration than receivership, this alone would not be sufficient reason to abolish the administration regime. Rather, there may be other benefits to administration that are not easily measured. I noted above the authors’ finding that administrations are typically completed much more quickly than receiverships. This in itself may make administrations generally preferable to receiverships because the longer a company remains in insolvency proceedings, the greater the indirect costs it is likely to incur as a result. Accordingly, the authors’ findings ought to encourage further investigation of the reasons why unsecured creditors are not faring any better in administration than they did in receivership.

2. Pre-packs

As noted earlier, the Enterprise Act permits the appointment of an administrator both by court order and out-of-court. In a pre-pack, a distressed company and its creditors agree to a sale of substantially all of the company’s assets prior to appointing an administrator out-of-court. The administrator then implements the pre-arranged deal. In this way, the pre-pack is an alternative to full, formal administration proceedings – it is an abridged process.

For several reasons, pre-packs are widely regarded as giving secured creditors “a high level of control and certainty.” Firstly, secured creditors are typically the only parties involved in negotiating the pre-pack with the insolvent debtor and appointing the administrator. Secondly, secured creditors usually will possess more information about the debtor than other stakeholders. Thirdly, as noted already, the pre-pack is an abridged process and can be completed much more quickly than other processes. Consequently,
most stakeholders will have limited opportunities to scrutinise and challenge the terms of pre-packs. As such, most stakeholders will depend on the administrator to ensure that the pre-pack is fair and maximises value. Yet the administrator’s hands are likely to be tied in most cases.\textsuperscript{46}

The danger is that when powerful creditors agree to a pre-pack such an agreement creates a momentum that is difficult for the administrator to upset... If this is the case, the pre-pack commits the administrator to a course of action that is agreed outside statutory procedures and it is extremely difficult for less powerful creditors to scrutinise the pre-pack and to renegotiate terms.

Indeed, we can go further and say that administrators will have strong incentives not to scrutinise or challenge the terms of pre-packs, for the same reasons that they would be strongly inclined to support senior secured creditors generally.\textsuperscript{47}

What is problematic here is that IPs would rightly expect most of their work (i.e. future appointments as administrators) to come from the banks. They would thus have strong incentives, in situations where the bank’s interests diverge from those of other creditors, of developing a reputation for favouring the former.

In short, pre-packs permit secured creditors to “dictat[e] the method and timing of asset realization, much in the same way that they previously used receivership.”\textsuperscript{48} In this sense, pre-packs represent a shift in U.K. insolvency law away from collective proceedings aimed at company or business rescue, toward a model focused on facilitating quick realizations.

Significantly, the Enterprise Act explicitly rejected the receivership model on the premise that it destroyed value, lacked transparency and accountability, and generally gave secured creditors too much power. For these reasons, the Enterprise Act sought to shift power from secured to unsecured creditors and to promote a collective administration process that differed fundamentally from administrative receivership.\textsuperscript{49} Accordingly, pre-packs \textit{prima facie} appear to undermine the stated goals of the Enterprise Act. Moreover, it is conceivable that the informational asymmetries between senior creditors and other stakeholders, coupled with the speed of the pre-pack process, may create incentives for rent-seeking through the undervaluing of businesses sold in pre-packs. If true, value that should be flowing to unsecured creditors would flow instead to purchasers. Meanwhile, fully secured creditors would be indifferent to this result so long as they were assured of a quick recovery.

Many of these concerns seem to be borne out in recent empirical studies of pre-packs. In 2014, the U.K. government commissioned a report by Theresa Graham to examine pre-pack outcomes. The Graham Report made several key findings. Firstly, it found that pre-packs now comprise a significant proportion of administrations: roughly 600 out of 2,365 administrations in 2013.\textsuperscript{50} At the same time, the number of administrations has increased dramatically since the Enterprise Act was introduced, rising nearly 300% between 2002 and 2007, while liquidations fell by 23% during the same period.\textsuperscript{51} Secondly, around two-thirds of pre-packs in 2010 – 316 out of 499 – involved sales to connected parties within the meaning of the Insolvency Act 1986.\textsuperscript{52} These findings are consistent with a recent study by the Insolvency Service which found that 79% of pre-packs in 2011 were to connected parties.\textsuperscript{53} Thirdly, the Graham Report found that pre-packs very rarely resulted in
distributions to unsecured creditors. When unsecured creditors recovered anything at all, median payments were 4.3% of total debt.\textsuperscript{54}

I was surprised at these low levels of payment for unsecured creditors, particularly in the pre-pack cases… This data shows that unsecured creditors in particular receive only a paltry benefit from a pre-pack administration. Secured and preferential creditors, as one would expect given the statutory order of priority, fare better than the unsecured creditors but if those classes of creditors are chiefly benefiting from the administration process, it is little different from the administrative receivership process that Enterprise Act 2002 style administration was supposed to supersede.

This finding is consistent with those of other studies that pre-packs tend to yield higher returns for secured creditors than other types of sales, at the expense of unsecured creditors.\textsuperscript{55} But the most striking finding is that returns to unsecured creditors are even lower in connected-party pre-packs, which now comprise the majority of pre-packs.\textsuperscript{56} Perhaps unsurprisingly, the Report also found that administrators did a poor job of marketing the assets in connected-party pre-packs:

My researchers found the standard of reporting very variable and too often only limited marketing was carried out including:

- Limited enquiries made within the insolvency practitioner firm but no external marketing occurring;
- Insolvency practitioners accepting the word of the directors that there is no ready market for the business outside themselves or other connected parties, with no evidence that this assumption had been tested.

Furthermore, the valuation methods used were opaque at best: most valuations were desktop only, and “there was rarely any explanation as to the valuation methods used by the valuers.”\textsuperscript{57} Meanwhile, businesses sold in connected-party pre-packs were much more likely to fail within 3 years compared to those that were sold to third parties – a failure rate of 29% compared to 16%.\textsuperscript{58} In short, the Graham Report found that most pre-packs involved sales to connected parties in which: 1) the administrator made negligible efforts to market the business; 2) the valuation and purchase price were hardly scrutinised; and 3) unsecured creditors recovered very little or nothing.

3. U.S. Chapter 11 and 363 Sales

The Chapter 11 process possesses several features that distinguish it from administration in the U.K. Firstly, it is only possible to enter Chapter 11 by filing a petition with the federal bankruptcy court. Filing triggers an automatic stay on the enforcement of any claims against the debtor that arose prior to the filing.\textsuperscript{59} This stay remains in effect until the reorganization is complete or the court lifts the stay. Secondly, perhaps the key feature of Chapter 11 is that upon filing, the debtor becomes a “debtor in possession” (DIP). The debtor remains in control of its business as it prepares a reorganization plan. In practice, the plan must establish different classes for all claimants, such as secured, preferred and general unsecured creditors, and equity claimants. Typically, the debtor has 180 days after entering Chapter 11 to obtain its creditors’ acceptance of the plan,\textsuperscript{60} meaning that creditors
holding at least two-thirds in value and more than one-half in number of the claims in each
class must accept the plan.\textsuperscript{61}

If a debtor has no intention of reorganizing, it can file instead under Chapter 7. Under
Chapter 7, the debtor ceases operations and a trustee is appointed to sell the debtor’s assets
and distribute the proceeds to its creditors. In this regard, the Code provides mechanisms
for converting from Chapter 11 to Chapter 7 proceedings if a reorganization plan fails. But
this is not the only way of liquidating an insolvent debtor’s assets. Chapter 11 also permits
plans that “provide for a sale of all or substantially all” of the debtor’s assets and the
distribution of the proceeds to claimants.\textsuperscript{62} Perhaps the most commonly used sale process
today is the so-called “363 sale”. Under section 363 of the Code, the debtor or its trustee
may sell its assets outside the ordinary course of business.\textsuperscript{63} While court approval of the
sale is not strictly required, it is common practice to seek court approval for the purchaser’s
benefit.\textsuperscript{64} In this regard, section 363 is rather skeletal – it does not set out guidelines for
courts to follow in deciding whether to approve a sale.\textsuperscript{65} Consequently, courts have
developed a large body of case law dealing with 363 sales.

There is significant controversy in the scholarship and the courts surrounding the
appropriateness and efficacy of Chapter 11 as a reorganization mechanism. For example,
Baird and Rasmussen have argued that the increasing use of insolvency contracting, as well
as changes in the nature of companies, have rendered traditional reorganizations “largely
unnecessary”.\textsuperscript{66} Moreover, they assert that “the days when reorganization law promised
substantial benefits are gone.”\textsuperscript{67} One of their key claims is that the market now reflects the
fact that traditional reorganizations are obsolete. That is, Chapter 11 is now used only to
sell assets or obtain judicial approval of pre-existing deals:\textsuperscript{68}

Even when a large firm uses Chapter 11 as something other than a
convenient auction block, its principal lenders are usually already in
control and Chapter 11 merely puts in place a preexisting deal. Rarely
is Chapter 11 a forum where the various stakeholders in a publicly held
firm negotiate among each other over the firm’s destiny.

Setting aside whether these claims are accurate, there are good reasons to think that
a private, contract-based insolvency system cannot and should not replace Chapter 11.
Firstly, proponents of a contract-based insolvency system have not demonstrated that such
a system would improve outcomes for stakeholders generally. In fact, many instances of
insolvency contracting appear to be motivated by rent-seeking rather than value-
maximisation.\textsuperscript{69}

Practitioners report extensive contracting for bankruptcy procedure in
two kinds of transactions: workouts and asset securitizations. Failure
of secured creditors to include unsecured creditors in the contracts for
stay waivers in workouts suggests that the contracting parties are
attempting to appropriate the expectancies of the unsecured creditors
rather than to maximize social welfare. Failure to protect the future
creditors of the originator in asset-securitization contracts suggests that
redistribution of wealth may be the motivating force in those
transactions as well.

This is unsurprising given that historically, Chapter 11 developed as a response to the
myriad problems with the equity receivership, which was itself a creature of contract.\textsuperscript{70}
Secondly, Warren and Jay Westbrook have found that Chapter 11 cases often include large
numbers of maladjusting creditors such as tort claimants, utilities, tax authorities, employees, and voluntary creditors. This suggests that a contract-based insolvency system would adversely impact a large group of Chapter 11 creditors by shifting the risks and costs of insolvency onto them:

The claims of efficiency for contract bankruptcy are seriously undermined by the presence of significant numbers of maladjusting creditors. Each maladjusting creditor represents the possibility of substantial inefficiencies; as their numbers grow, the likelihood increases that these inefficiencies will overwhelm any purported efficiency gains from a contract bankruptcy system.

Thirdly, even if a contract-based system of insolvency could be shown to improve outcomes for stakeholders under ideal free market conditions, this alone would not justify adopting such a system. Rather, proponents of such a system would have to show that it is superior to Chapter 11 in real-world imperfect markets:

Distinguishing the misery and cost inherent in dealing with failing businesses from the misery and cost added by the way Chapter 11 deals with such businesses is an important but often ignored issue... Reorganizing was costly before bankruptcy law even dealt with reorganizations, and it will remain costly if we modify bankruptcy law or remove the reorganization process from bankruptcy.

Indeed, there is a real concern that certain models of contract-based insolvency would only work in a very limited number of real-world cases.

In addition, there are reasons to think that Baird and Rasmussen's claims about how Chapter 11 is used may not entirely reflect current practice. LoPucki has produced quantitative data showing that, at least in 2001 and 2002, most large companies still used Chapter 11 to attempt traditional reorganizations:

Most firms that do liquidate in Chapter 11 did not file for that purpose. Only 20% of the 174 large public firms that filed for bankruptcy in 2001 and 2002 indicated at filing that their intent was to sell or liquidate their businesses. Only an additional 4% filed prepackaged cases intended “merely [to put] in place a preexisting deal.” Nearly all of the remaining firms filed for the purpose of reorganization and for at least some period of time “negotiated over the firm’s destiny.”

Although LoPucki’s study focused only on large companies, which do not represent most filers under Chapter 11, and which are more likely to attempt a reorganization than a liquidation, these results nonetheless rebut Baird and Rasmussen’s claim that “[g]iant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure.”

There are additional reasons for thinking that Chapter 11 remains an important restructuring tool generally. Warren and Westbrook have presented data suggesting that Chapter 11 is reasonably successful in facilitating reorganizations for those companies that file with the intention of actually reorganizing. Specifically, since Chapter 11 has a very low entry bar, it is often used by companies that have no realistic chances of reorganizing. This, in turn, leads to lower rates of reorganization plan confirmations when calculated as a
proportion of all filings. For example, in slightly more than half of the cases that Warren and Westbrook examined between 1994 and 2002, the debtor never filed a plan. But for the balance of the cases, in which the debtor did file a plan, roughly 65% in 1994 and 71% in 2002 resulted in plan confirmations.\textsuperscript{78} In other words, Chapter 11 actually serves a dual function: it filters hopeless debtors out of the system, while also providing breathing room for debtors who might successfully reorganize. Viewed in this light, Chapter 11 is actually quite successful.\textsuperscript{79}

More recently, LoPucki and Joseph Doherty have presented further data showing that reorganizations of large public companies under Chapter 11 yielded more than twice the returns of sales during the period 2000 through 2004:\textsuperscript{80}

We found that companies sold for an average of 35\% of book value and an average market capitalization value – based on post-reorganization stock trading – of 91\% of book value. Even controlling for the difference in prefile earnings of the two sets of companies, sale yielded less than half as much value as reorganization. These results suggest that creditors and shareholders can more than double their recoveries by reorganizing large public companies instead of selling them.

For a number of reasons, LoPucki and Doherty’s arguments have not settled the reorganization vs. liquidation debate. Other scholars have taken issue with the claim that courts and insolvency professionals favour sales because they have private agendas – there may be alternative and benign explanations for this phenomenon.\textsuperscript{81} In addition, there is disagreement regarding how best to value companies in Chapter 11, with some claiming that LoPucki and Doherty’s findings might be exaggerated.\textsuperscript{82} That said, the data still show that pronouncements on the demise of Chapter 11 are premature at best.

Notwithstanding the current stalemate in the U.S. debate, 363 sales warrant careful scrutiny. Where secured creditors are able to control the process, there is a risk that 363 sales will not maximise value. In particular, fully secured creditors will prefer a quick sale even if a longer sale process or a reorganization would result in higher returns, as the costs and risks to secured creditors rise the longer the process takes.\textsuperscript{83} In addition, the secured debt levels of U.S. companies are rising, and this appears to be correlated with significantly lower returns for unsecured creditors and equity holders in Chapter 11.\textsuperscript{84} In short, the concern is that senior secured creditors may have found ways to subvert the Chapter 11 process so as to enhance their own returns at other creditors’ expense.\textsuperscript{85}

The Chapter 11 process, as contemplated in 1978, has been overwhelmed by marginalization of the debtor-in-possession, expansion of creditor (particularly secured creditor) control, the increasing imposition of creditor designated chief restructuring officers (“CROs”), claims trading, more complex debt and organizational structures, short-term profit motivation and, of course, greed gratified by claims trading, acquisitions and litigation. Gordon Gekko is alive and well in the public and private markets, as well as in the benign environment of restructuring. As a consequence, the objective of a successful rehabilitation, the preservation of going concern value and the emergence of a rehabilitated stand-alone debtor has been eclipsed in most cases.
The rise of 363 sales increases the potential for abusive and value-destructive behaviour. Unlike in Chapter 7, there is no need to appoint a trustee for a 363 sale. Accordingly, the debtor often remains in possession, continuing to manage its own operations and conducting the sale process. In addition, there is no need to file a reorganization or liquidation plan in a 363 sale. Thus, while the court is usually still involved in approving the sale, the creditors do not vote on it. In effect, then, section 363 offers a quick realization tool for creditors by way of a sale made free and clear of all encumbrances, while bypassing the usual Chapter 11 process.

A secured creditor and a cooperative debtor will have various tools at their disposal in a 363 sale to vary the normal distributional priorities set out in the Code, thereby maximising returns for the secured creditor at the expense of other claimants.\footnote{The Bankruptcy Code provides a specific set of distributional priorities in section 507, with priority claimants (according to their rankings, \textit{inter se}) being awarded priority over general unsecured creditors. These can be varied only pursuant the Chapter 11 plan process. However, in secured creditor bankruptcies the debtor and secured party often seek to vary the priorities (as well as those among general unsecured creditors and equity interest holders) through gifting, carve-outs, or both. When successful, these private transfer schemes, unblessed and unregulated by Congress, serve to undermine the absolute priority rule or to unfairly discriminate, thereby returning the process to the bad old days of pre-absolute priority rule federal equity receiverships.}

Some have argued that it is appropriate for a secured creditor to control the sale process when it is undersecured since, in such cases, no other claimants will receive any distribution, and the secured creditor will have an incentive to obtain the best possible price for the assets so as to maximise its own returns.\footnote{However, as noted earlier, the secured creditor’s incentive to maximise its own recovery will only obtain in cases where it is truly undersecured – that is, where it does not also hold personal guarantees against persons or entities related to the debtor. Furthermore, even in cases where the secured creditor is truly undersecured, it may well prefer the speed and certainty of a quick realization to the uncertainty, time and cost involved in a reorganization, even if the latter carries the potential for greater returns.} However, more recent empirical studies suggest that 363 sales typically result in lower returns than other types of sales. In particular, a study comparing 363 sales with plan sales during the years 1996 to 2010 found that 363 sales generated significantly lower prices, even correcting for companies in especially poor health or in distressed industries. Significantly, the authors found that the principal reason for the lower prices in 363 sales was the diminished leverage of junior creditors relative to plan sales.\footnote{Our primary finding is that 363 sales are associated with lower sale prices compared with plan sales... These lower prices, however, are not due to the speed of the 363 sales which could reduce bidding activity or exacerbate fire sales, but appear to be associated with the diminished creditor negotiation leverage in 363 sales.}

The authors also found that 363 sales are now the dominant method for selling substantially all of the assets of insolvent companies in the U.S.\footnote{The authors also found that 363 sales are now the dominant method for selling substantially all of the assets of insolvent companies in the U.S.} For the purposes of comparing these results with pre-packs in the U.K., it should be noted that this study – the first of its kind –
only focused on companies valued at more than $50 million, whereas pre-packs tend to involve much smaller companies. Nonetheless, the 363 and pre-pack processes are very similar in function. In addition, the fact that both processes appear to result in lower recoveries for unsecured creditors lends weight to the theoretical concerns raised here regarding secured creditor control, transparency and accountability.

4. Liquidating CCAAs

Insolvent corporations in Canada may attempt a reorganization through two principal mechanisms: commercial proposals under Part III of the Bankruptcy and Insolvency Act (“BIA”), and the CCAA. In both cases, reorganization is a court-supervised process. Under the BIA, the debtor files a proposal or a notice of intention to file a proposal with the court. This filing automatically triggers a stay of proceedings against the debtor by all secured and unsecured creditors, with some exceptions, prior to any court hearing. In practice, a debtor typically files a notice of intention first, as this gives it more time to prepare a proposal. Although the debtor remains in control of its assets and operations during this time, it must appoint a trustee to act as a monitor for the benefit of its creditors, and must meet various deadlines to file a cash flow statement and a proposal. The proposal must be approved by a majority of creditors in each class present and voting at the creditors’ meeting, and representing at least two-thirds in value of the claims in each class. Failing this, the debtor is automatically assigned to bankruptcy.

Compared to the CCAA, the BIA’s commercial proposal regime is quite rule-driven and rigid. In particular, the deadlines under the CCAA are much more flexible. Under the CCAA, an insolvent debtor with debts exceeding $5 million, or its trustee in bankruptcy, liquidator or creditors, may file an initial application with the court for protection. The initial application must include a projected cash-flow statement and copies of financial statements prepared in the last year. The application can be filed without notice to the creditors, or with notice only to certain creditors, if it is impracticable to notify all of them. Upon filing, the court typically will grant an initial stay of proceedings effective against all creditors, not to exceed 30 days, and will schedule a “comeback hearing” during which the creditors can present any objections they may have. The initial order will also authorize the debtor to appoint a monitor to assist it in preparing a reorganization plan. The debtor can apply for any number of extensions to the stay of proceedings, and the court usually will approve these provided that the creditors do not object and the debtor has demonstrated progress toward preparing a plan. Once a plan is filed, it must be approved by a majority in number of creditors representing two-thirds of the value of debt held by each class, calculated based on the number of creditors who actually vote. Unlike under the BIA, if the creditors reject the plan, the debtor remains under CCAA protection and can seek to negotiate a new plan.

Canadian insolvency law also provides several different mechanisms for liquidating insolvent corporations on either a piecemeal or going concern basis. These mechanisms include receivership, pursuant either to a general security agreement or a court order under the BIA, as well as liquidation by a trustee in bankruptcy. Given this range of liquidation tools, traditionally the CCAA has been used for reorganizations. This traditional use is reflected in recent statements by the Supreme Court of Canada:

Unlike the BIA, the CCAA contains no provisions for liquidation of a debtor’s assets if reorganization fails. There are three ways of exiting CCAA proceedings. The best outcome is achieved when the stay of proceedings provides the debtor with some breathing space during which solvency is restored and the CCAA process terminates without
reorganization being needed. The second most desirable outcome occurs when the debtor’s compromise or arrangement is accepted by its creditors and the reorganized company emerges from the CCAA proceedings as a going concern. Lastly, if the compromise or arrangement fails, either the company or its creditors usually seek to have the debtor’s assets liquidated under the applicable provisions of the BIA or to place the debtor into receivership.

These statements, however, do not entirely reflect current practice. While it is clear from the structure and history of the CCAA that it was designed to facilitate reorganizations, the reality today is that many insolvent debtors use the CCAA to sell substantially all of their assets, without preparing a formal restructuring plan. These “liquidating CCAAs” are increasingly used as an alternative to receivership or liquidation under the BIA. This trend appears to have accelerated following the introduction of section 36 of the CCAA in amendments to the Act in 2009. Section 36 provides that an insolvent debtor under CCAA protection may sell its assets outside the ordinary course of business if it obtains court approval to do so. Many courts have interpreted these provisions to include liquidating CCAAs – that is, the sale of substantially all of the assets of an insolvent corporation, in the absence of a plan that is presented to the creditors. However, liquidating CCAAs are not universally accepted, and some courts have expressed skepticism:

I query whether the court should grant a stay under the CCAA to permit a sale, winding up or liquidation without requiring the matter to be voted upon by the creditors if the plan of arrangement intended to be made by the debtor company will simply propose that the net proceeds from the sale, winding up or liquidation be distributed to its creditors.

Although there are no data on returns to creditors from liquidating CCAAs, there are reasons to be concerned about these types of procedures. Firstly, liquidating CCAAs may represent a very attractive collection mechanism for secured creditors because they are often quicker than bankruptcy or receivership sales. Secondly, liquidating CCAAs can eliminate troublesome liabilities that would survive in receiverships, such as successor employer liability, and courts have broad discretionary powers under the CCAA to eliminate other liabilities as well. Thirdly, as with a pre-pack, there is a sense in which the liquidating CCAA may be presented to creditors as a fait accompli, thus precluding other options. In short, liquidating CCAAs run counter to the basic objectives of the Act. In this regard, one senior Canadian restructuring lawyer has made the following observations:

The historic objectives of the CCAA, needless to say, had nothing to do with creditor realizations, and a purposive approach to statutory interpretation does not support the idea that the CCAA was intended to be a creditor’s tool of choice for realizing on its security. The remedial nature of the CCAA was never intended to be employed to further creditors’ remedies. Over the last decade… the statute has become a realization tool.

Although proponents of liquidating CCAAs argue that they are more likely to enhance value than other procedures, such as receiverships, they have not yet presented any evidence to support this claim. Indeed, liquidating CCAAs appear functionally equivalent to receiverships, suggesting that they are less about maximising value than appropriating it. At the same time, there is at least anecdotal evidence to suggest that liquidating CCAAs
benefit secured creditors at the expense of unsecured creditors, compared with traditional restructurings.\textsuperscript{115}

5. Conclusions Regarding Pre-packs, 363 Sales and Liquidating CCAAs

Despite the overall differences between their respective insolvency regimes, pre-packs, 363 sales and liquidating CCAAs are strikingly similar. Each of these procedures facilitates quick sales of substantially all of the assets of insolvent debtors under the auspices of restructuring legislation. In addition, there is little question that these procedures primarily benefit secured creditors, potentially at the expense of other stakeholders. Effectively, pre-packs, 363 sales and liquidating CCAAs may simply be forms of “receivership lite”. If this analysis is correct, pre-packs may well undermine the aims of the Enterprise Act, a problem which is compounded by a general lack of understanding of the nature of the Enterprise Act reforms among many insolvency professionals, who continue to prefer the old administrative receivership model.\textsuperscript{116} This is especially concerning given the Graham Report’s findings that pre-packs are typically made to connected parties, yield very low returns to unsecured creditors, and often result in repeat business failures. Similarly, Chapter 11 was designed to replace equity receiverships, while the CCAA was designed for reorganizations and not sales.

The analysis here suggests that a broader trend toward secured creditor-driven insolvency processes may be emerging on both sides of the Atlantic. While this trend may not be problematic in itself, its manifestations in the forms of pre-packs, 363 sales and liquidating CCAAs appear to threaten the basic goals of insolvency law identified in Part II of this paper. There are good reasons to think that wider stakeholder involvement is likely to be value-enhancing in most restructurings, and that “chances for successful reorganizations are enhanced where participants achieve common ground and all stakeholders are treated as advantageously and fairly as the circumstances permit.”\textsuperscript{117} Accordingly, to the extent that pre-packs, 363 sales and liquidating CCAAs lack transparency and limit the ability of weaker stakeholders to negotiate and scrutinise the deal, they may well interfere with insolvency law’s goals of maximising value and ensuring fair distributions to claimants.

IV. CONCLUSION

Ongoing reform efforts in the U.K., U.S. and Canada will undoubtedly provide policymakers with opportunities to consider the appropriate balance of rights between different stakeholders in restructuring. In doing so, they should be especially mindful of the potential for abusive behaviour when certain stakeholders are able to control the collective restructuring process. It may be too easy for some stakeholders to further their individual interests at the expense of the group. This paper has argued that pre-packs, 363 sales and liquidating CCAAs represent a shift toward secured-creditor driven procedures, a shift which may well give secured creditors too much control. If this conclusion is correct, then these procedures threaten to undermine not only the aims of the U.K., U.S. and Canadian restructuring regimes, but also the fundamental goals of insolvency law to preserve and maximise the value of insolvent enterprises and to ensure fair distributions to all stakeholders.

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1 2002 Ch 40 (Eng).
2 11 USC 101, et seq.
3 RSC 1985, c C-36.
5 ibid 13.
15 Mokal (n 7) 195.
16 ibid.
17 UNCITRAL (n 13) 18.
18 Insolvency Act 1986, sch B1, paras 42-44.
19 ibid paras 1(1), 59 and 69.
20 ibid para 3(1)(b).
21 ibid paras 3(1)(c) and 3(4).
25 Finch (n 11) 369.
26 ibid 368.
28 ibid 336.
29 Webb (n 24) 144.
31 ibid 2.5.
34 Mokal (n 7) 41-43.
35 Sarra (n 14) 52.
36 Mokal (n 27) 364.
37 ibid 365.
40 Armour, Hsu and Walters (n 38) 130.
41 ibid 131.
42 ibid 131.
43 While the authors’ study revealed that roughly 40% of administrations resulted in going concern sales, they did not distinguish between pre-packs and full administrations. See 116 (Table 5).
44 Finch (n 11) 455.
46 Finch (n 11) 471-472.
47 Mokal (n 27) 387. There are also significant obstacles to judicial scrutiny of pre-packs: see John Armour, “The Rise of the Pre-Pack: Corporate Restructuring in the UK and Proposals for Reform” in RP Austin and Fady JG Aoun (eds) Restructuring Companies in Troubled Times: Director and Creditor Perspectives (Ross Parsons Centre 2012) 22.
49 Insolvency Service (n 30) 2.5.
51 ibid 5.14.
52 ibid 7.50. The relevant provisions of the Act are found in s 249.
54 Graham Report (n 50) 7.4-7.6.
55 See Sandra Frisby, A Preliminary Analysis of Pre-Packaged Administrations: Report to the Association of Business Recovery Professionals (University of Nottingham 2007) 67.
56 Graham Report (n 50) 7.54.
57 ibid 7.80-7.81.
58 ibid 7.56.
59 11 USC § 362(a).
60 ibid. The court can extend this deadline, see § 1121(d).
61 ibid §1126(c).
62 ibid §1123(b)(4).
64 Alan N Resnick and Henry J Sommer (eds) Collier on Bankruptcy (16th edn, LexisNexis 2013) 363.02[1].
65 That said, § 363(f) sets out requirements to be met if the assets are to be sold “free and clear” of existing encumbrances. In particular, the secured creditor whose rights will be impaired must consent to the sale.
67 ibid 789.
68 ibid 752.

ibid 1235.

Eisenberg (n 70) 633-4.


Baird and Rasmussen (n 66) 751.


Charles W Mooney, Jr, “The (Il)Legitimacy of Bankruptcies for the Benefit of Secured Creditors” (2015) U Ill L Rev 735, 754. Note that the author is not expressing his own views, but merely stating key objections that have been made to giving secured creditors control over insolvency processes.

RSC 1985 c B-3.

For purposes of meeting this threshold, the debts of the debtor’s affiliates are included. See CCAA (n 3) ss 2(1), 3(1).
The classification of creditors for voting purposes requires court approval. See ss 4-6.

See s 22.

ibid s 243.


Cliffs Over Maple Bay Investments Ltd v Fisgard Capital Corp 2008 BCCA 327 (BC CA) para 32.


See Wood (n 83).


ibid 233.

Mokal (n 27) 392.

Century Services (n 105) para 70.
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Ways forward for secured creditors when insolvency strikes

Andreea Hlihor

It is widely known that position of the secured creditor is better within the insolvency proceeding among other creditors and, most of the times, this category of creditors proves to partially or entirely satisfy their claims.

Law no. 85/2014 regarding the prevention proceedings before the opening of the insolvency proceedings and the insolvency proceedings (hereinafter referred to as the “Insolvency Law”) regulates specific mechanisms for enforcement of real guarantees depending on the object of the security.

Although, a secured creditor can satisfy its claim prior to other categories of creditors, the conditions imposed by the law are quite restrictive and the practice in this respect is yet to be defined.

[I] The stay of other court claims and enforcement measures against the debtor

Whenever the insolvency proceedings are initiated, the rule provided under the Insolvency Law is that there will be a stay of all the court requests, extra judicial and enforcement measures, submitted/initiated for the sole purpose of recovering any receivables against the debtor.

The aforementioned effect is a European principle embraced by a large number of member states, as it is intended to be a clear objective of any insolvency proceeding. The report on the harmonisation of insolvency proceedings at the EU level reveals that national legislations of member states include specific provisions that expressly prohibit creditors to pursue their debts outside the insolvency procedure.

This effect is only natural given that, at least from the Romanian perspective, the insolvency proceeding is collective, equal for all of the creditors and of course, run through a courthouse.

In addition, as a consequence of the aforementioned stay, the only possibility left for the creditors to recover their receivables is to submit the relevant statement of claims and register it within the debtor’s estate. Failure to do so prohibits them to take any action involving the recovery of their claim from the debtor, as submitting such claim after the insolvency proceeding is opened will be ruled as inadmissible by the syndic judge.

Given the above, it goes without saying that if any enforcement of the securities prior to the opening of the insolvency proceeding was still in progress, a stay of these actions will occur, in accordance with the herein mentioned rule.
II. One way of enforcing the security during the insolvency proceedings

Re-iterating, under the Insolvency Law, a stay of all actions having as purpose the satisfaction, outside the insolvency procedure, of the creditors’ claims, including enforcement of the securities, will occur. However, as an exception to the rule, a creditor having a secured claim can request the syndic judge, the lifting of such stay, followed shortly by the sale of the object of the guarantee, if certain conditions are met.

Even though a secured creditor can satisfy its claim prior to the closing of an insolvency procedure, the conditions regulated within the Insolvency Law bear certain restrictions.

II.1 Generic aspects

When? Where? By whom?

The Insolvency Law does not provide for a specific moment when the secured creditor should file such claim, meaning that whenever the conditions for such action are fulfilled, the secured creditor may successfully submit it with the court.

Although the stay operates *ope legis*, (i) the lifting request of such stay is subject to the approval of the syndic judge and (ii) the creditor entitled to submit such request is the secured creditor, registered within the debtor’s estate. In other words, the syndic judge is the only one in power to rule over such request and the only one who will dismiss such request as submitted by a person without the capacity to stand trial, if the secured creditor failed to register within the preliminary table.

Controversies related to the persons entitled to file such claims are whenever there are multiple creditors, which have guarantees over the same assets of the insolvent debtor. Part of our doctrine, envisages that for the success of the request, the prior consent of all the guaranteed creditors is mandatory. However, in practice, there were cases when the syndic judge ruled in favor of one of the secured creditors, which filled such claim, although not followed by the other secured creditors.

Of interest, related to the person benefitting from such action, is the following scenario.

There are different securities of different ranks over the same asset pertaining to the insolvent debtor and only the creditor having a second rank security decides to submit with the court a request regarding the lifting of such stay. The question that arises is who benefits from the success of such action?

On one hand, the struggle in court will be carried out by the second rank creditor, as such, one may consider he/she is the person entitled to benefit from any distributions to be made pursuant to the sale of the guaranteed asset. On the other hand, the more diligent creditor who succeeded in carrying out all the required formalities in order to be the first one registered with the relevant public registries may be prejudiced.

Although the creditor with a former security did not participate in the litigation concerning the lifting of the stay, it will not be removed from any distributions. The Insolvency Law and the Civil Code...
provide that the distributions need to respect the order established by the ranks of the securities, namely the first creditor registered within the Land Book or the Electronic Archive for Security Interests in Movable Property (the Romanian public registries attesting any securities) is the one entitled to receive any payments. Nonetheless, whenever the amount to be recovered further to the sale exceeds the claim held by the first secured creditor, the rest will be distributed to the next secured creditor standing in line.

There is no doubt that this request may be submitted only during an ongoing insolvency proceeding, otherwise, the ordinary judge may rule it as inadmissible.

**Procedure**

Whenever invested with such a claim, the syndic judge summons the Creditors’ Committee, the special administrator of the insolvent debtor and the insolvency practitioner. The reason for the participation of the aforementioned parties consists in the acknowledgement of the procedure and a better view of the course of the procedure.

The success of such request also depends on the involvement of the insolvency practitioner, who needs to prior perform an analysis whether such claim is justified, looking in perspective of the entire debtor’s business. Of course, if in the context of the insolvency process this measure is appropriate, the insolvency practitioner will observe the provisions regulating the liquidation of the assets, namely:

(i) to ensure the maximization of the total value of the debtor’s patrimony by promoting it in an adequate manner and by making it public in every possible way;

(ii) to perform all the mandatory formalities required by the Insolvency Law with respect to the evaluation of the debtors’ assets;

(iii) to proceed with the distribution of the payment received to the guaranteed creditor, but only after covering the expenses incurred with the procedure.

**II.2 Specific aspects**

**II.2.1 Granting such request**

There are two situations when a guaranteed creditor’s request may prove to be successful in court, namely:

**II.2.1.1** The value of the secured asset is at least comparable to the creditor’s claim in favour of which the guarantee is instituted doubled by the fact that:

i. The secured asset is not relevant for the success of a reorganization plan or

ii. The secured asset is part of a functional system and its detachment may cause a value depreciation of the remaining assets.

It is widely known that, usually, creditors, in order to obtain a better satisfaction of their claims, require the debtor to institute a real guarantee over the core assets of its business. Needless to say that, in case the sale of such assets is encouraged, this might trigger imminent bankruptcy.
II.2.1.2 There is no equivalent protection of the secured claim as opposed to the value of the secured object due to:

i. The depreciation of the secured asset or the imminent danger of depreciation that the asset faces;

ii. The depreciation of the total value of the secured claim, lower ranked within the public registry than another secured claim, considering the high-accrued interest or penalties that the latter bears.

Given the aforementioned rules, it seems that the legislator’s intention is to protect the debtor’s business by ensuring the maximum protection of its assets and by increasing the chances for a reorganization plan.

Should the aforementioned conditions be met, the main effect consists in the liquidation of the assets. Therefore, the insolvency practitioner, with the prior consent of the Creditors’ Committee, will appoint on behalf of the debtor, an evaluator, establishing its fee.

The evaluation report will be submitted with the court and an announcement and excerpt regarding such will be published in the insolvency bulletin, in order for the creditors to analyse and acknowledge its content.

Furthermore, the insolvency practitioner will convene the Creditors’ Assembly within 15 days as of the submission of the evaluation report with the court, for the approval of the sale regulation of the asset.

Another important effect of such admission implies the minimization of the debts with that part that shall be recovered by the guaranteed creditor, as a result of the sale.

II.2.2 Dismissal of such request

Art. 78, second paragraph, of the Insolvency Law, regulates the premises for denying the guaranteed creditor’s request, namely when the insolvency practitioner/ the insolvent debtor engages in one of the following:

i. the periodical payments in favour of the guaranteed creditor for covering the depreciation of the value of the secured object or of the guaranteed claim;

ii. the periodical payments in favour of the secured creditor for (i) the satisfaction of the interests, penalties or any of such related, (ii) for reducing the principal debt so that the guarantee does not suffer any depreciation or (iii) for reducing that part of the debt that is secured by a second rank guarantee;

iii. the novation of the obligation to secure the creditor’s claim by executing a new real/personal guarantee or by substitution of the initial object of the guarantee with another one.

Mention should be made that the above alternatives, which hinders the approval of the liquidation of certain guaranteed assets, regard only the situation envisaged under section II.2.1.2 above.
Should the insolvency practitioner or the debtor prove that one of the aforementioned situations offer the guaranteed creditor an equivalent protection of its claim, the syndic judge might deny the creditor’s right to enforce its initial guarantee.

As for the first situation, not providing the payment on time, grants the possibility to the secured creditor to submit a new request.

As for the situation that regards the novation, one may consider that this is a real interference within the initial agreement between the parties, but altogether, one should be reminded that this measure may prove more appropriate in the context of the insolvency proceeding which is meant to be collective and equal for all the creditors. Nonetheless, there is obviously also in the debtor’s interest to maintain the assets of the company, increasing its chances for a successful reorganisation.

Besides the aforementioned situations, there is also the common case of rejecting the relevant claim whenever the generic and specific conditions for the admission of such request are not met and the interested party (the debtor, the insolvency practitioner/liquidator) proves such.

[III] Another way of enforcement

Another way of enforcing a security is taking over the secured asset into the claim’s account.

Such mechanism is often approached due to the fact that secured creditors consider this a safer way and a better protection of their secured asset. Therefore, creditors prefer to ensure the conservation of the asset and to seek further sale methods, which may in the end prove to be more satisfying.

III.1 When?

As previously mentioned, the imminent danger facing the secured claim or the secured asset grants the creditor the right to immediately file a request to the syndic judge and try lifting the stay that prevents him to further sale the secured assets, request to be made anytime during the insolvency proceeding. Whenever the conditions to cancel the stay are not met, any other measure to be undertaken with respect to enforcement of the security (as the one herein presented) may be envisaged only throughout a reorganisation plan or whenever the bankruptcy proceedings are initiated.

III.2 How?

The consent of the secured creditor

First of all, for such mechanism to be implemented, the consent of the guaranteed creditor to such proposal is mandatory, given that in most cases it is very likely that the total value of the claim to overcome the current value of the secured asset.

Secondly, this mechanism incurs certain expenses, namely those related to the taxes owed to the Romanian authorities, the fees of the evaluator and the insolvency practitioner, the fees owed to the insolvency found, etc. that need to be paid with priority. In addition, after the adjudication process, there are conservation, administration and protection costs.
Moreover, any amount recovered as a result of the sale will be used to pay the amounts owed to the guaranteed creditors who have a senior rank or the same rank, creditors that did not manifest any intention in respect of adjudicating the secured asset.

Thus, turning to this way of enforcement should be subject to a thorough assessment of the guaranteed creditor.

**The evaluation procedure and the sale regulation**

As in other cases, the insolvency practitioner needs to perform all the mandatory formalities required by the Insolvency Law with respect to the evaluation of the debtors’ assets in order to assure transparency and the best ways to obtain an accurate estimate value of the secured asset.

In terms of next steps, the sale regulation of the aforementioned secured asset shall be subject to the vote of the Creditors’ assembly. The sale regulation shall include the recommendation of the insolvency practitioner, which in this particular case are usually public auctions.

The interested guaranteed creditor shall participate to the auctions and shall publicly announce its intention to take over the secured asset in the account of the claims registered within the debtor’s estate. The price that needs to be offered by the creditor is the one mentioned within the evaluation report, this being an imperative rule established by the Insolvency Law.

Should the creditor which instituted a guarantee over the same asset make a better offer within the public auction, then, he will be entitled to receive that respective asset, however, bearing in mind the costs to be incurred related to the other privileged creditors.

The adjudicating minutes of the public auction shall be considered the property title for the asset and whenever so required by the law, the insolvency practitioner shall execute the sale-purchase agreement based on the aforementioned minutes in front of the public notary.

**[IV] Particularities of certain securities**

**IV.1 Enforcement of pledges over bank accounts**

The Insolvency Law provides certain derogatory ways for the enforcement of the securities instituted over the existent amounts deposited in the debtors’ bank accounts, without running through the whole procedure described under the above sections.

As such, at the simple request of the secured creditor, the insolvency practitioner or the liquidator releases all the amounts deposited in the debtor’s account.

**IV.1.1 When?**

The Insolvency Law does not expressly provide a term or a period when such request may be addressed by the secured creditor, however it would be advisable to proceed as soon as there are any amounts in the debtors’ accounts. The insolvency practitioner is required to release the amounts within 5 days as of the creditor’s request.

**IV.1.2 How?**

The release of the amounts is subject to the following conditions:
i. the existence of a security, registered within the public registry;

ii. the recognition of the secured creditor by its registration as such within the debtor’s preliminary table;

iii. the aforementioned security should be instituted over the amounts within the bank accounts pertaining to the insolvent debtor;

iv. the claim of the secured creditor needs to be certain, liquid and payable.

In consequence, the insolvency practitioner will perform all the required verifications before releasing the amount requested by the secured creditor.

However, as an exception to the exception, the insolvency practitioner can make use of the amounts in the guaranteed bank accounts, with the prior consent of the creditor, whenever they are needed for assuring the necessary resources for the current business of the debtor.

There are, of course, high chances that the guaranteed creditor will refuse the aforementioned measure, in which case, the insolvency practitioner/liquidator shall address this matter to the syndic judge, who may authorise the use of the amount in the benefit of the debtor.

However, the Insolvency Law stipulates that, in this case, the secured creditor shall be offered an equivalent protection, corresponding to the measures that may be undertaken described in section II.2.2 above.

It is hard to see in practice how this article will be applied in favour of the guaranteed creditors as it is often proved that liquidities, especially when insolvency strikes, are vital for the sustenance of the debtor’s activity. Undoubtable, it is hard to offer an equivalent protection to the guaranteed creditors. In such case, what better protection it may be then a security over money?

IV.2 Enforcement of pledges over shares/stocks

The Insolvency Law does not particularly mention the enforcement of the guaranteed instituted over shares/stocks, however, there are certain aspects concerning the possibility of creditors to convert their claims held against the debtor into shares/stocks to the insolvent company.

Thus, being the case and bearing in mind the aspects described above, one may consider enforcing such guarantees by taking over the shares/stocks into the claims’ account, meaning a conversion.

IV.2.1 When?

No matter if we talk about the appropriation of the shares/stocks in the claims’ account or about the conversion of the claim into stocks/shares, both procedures imply amendments to the company’s articles of association. In this respect, such reference is made only in the section dedicated to the reorganisation of the debtor’s activity, namely, that a plan will expressly provide information about any amendment brought to the articles of association.

Supplementary, in a ruling of the High Court of Cassation and Justice of Romania, it has been decided that changes that may occur in the shareholders/stockholders structure of the
insolvent company shall conduct to the amendment of the articles of association and the reorganisation plan needs to reflect such aspects.

IV.2.2 How?

Undoubtedly, the consent of the guaranteed creditor is mandatory. Furthermore, the Insolvency Law provides that the creditor who will acquire part of the shares/stocks needs to provide its confirmation of this operation in writing prior to expressing a vote with respect to the reorganisation plan.

The increase of the share/stock capital occurs as of the confirmation of the reorganisation plan by the syndic judge.

The reorganisation plan shall nevertheless include details regarding the amount used for the increase of the share/stock capital, the part of the claim “transformed” into shares/stocks, the number of the issued shares/stocks etc.

Mention should be made that the amendment brought to the articles of association is possible without the consent of the initial shareholders/stockholders, thus being a derogatory provision from Law no. 31/1990 on trading companies.
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Protection of Small Businesses Facing Debtors' Insolvency: The Italian Way

Eugenio Vaccari

Cross-border insolvency scholarship appears to be driven by two key ideals: harmonization and universalism. These goals have been persuasively supported by international institutions and organizations. Current debate is consequently investigating the best means to achieve these purposes.

With reference to the statutory preferential treatment of selected creditors, pursuance of these goals implies reducing the number and the extent of exceptions to the pari passu principle. Unsecured creditors should share rateably, unless there is a ‘strong case’ for a different solution. The exceptions should also be the same in every country.

But who or what is to determine when a strong case exists? Which criteria should be applied?

This lack of agreement among commentators results in only employees’ preferential treatment enjoying a wide (but far from unanimous) support. In the mainstream view, small and medium enterprises (hereinafter, SMEs) should not benefit from particular consideration in insolvency matters, at least in their role as creditors. Nevertheless, since priorities mirror domestic public policies (and politics) and legal cultures, some jurisdictions do grant special statutory protection to these claimants. Do SMEs ‘deserve’ such preferential treatment?

Given the dearth of empirical data on this specific subject, this note analyses the Italian preferential mechanism granted to certain types of SMEs called artisan enterprises (“imprese artigiane”). It concludes that, by reason of the way in which it is structured, it falls short of achieving the envisaged policy goals.

It would be reassuring to conclude that failure to single out the restricted category of creditors reinstated the general understanding that legislatures should refrain from introducing new, preferential treatments in insolvency law. However, this paper rejects this line of thinking.

It therefore determines that what evidence proves is the opportunity for reframing the existing legislation. This could be done by narrowing down its scope, clarifying the terms employed, and recognizing appropriate discretion to judges and insolvency practitioners (hereinafter, IPs). Not necessarily for abolishing the preferential status of (certain) creditors.

This paper argues that such an approach could be applied as an alternative to substantive harmonization in insolvency law. However, for those who consider that harmonization should be the only legitimate objective of this area of scholarship, the proposed mechanism nevertheless represents an improvement over the existing situation. In other words, it may also work as a step towards substantive harmonization.
Introduction

Although one of the fundamental goals of insolvency law\(^1\) is to provide equal treatment for creditors\(^2\), domestic rules for the distribution of the assets of the insolvent estate make it clear that some claimants are more ‘equal’ than others. National laws are governed by intricate systems of statutory priorities\(^3\), which favour beneficiaries over general unsecured (and sometime, even secured) creditors.

If insolvency law was (as it has been the case for several centuries) primarily a mechanism to settle disputes among local creditors, this topic would hardly rise to the attention of the international academic community. However, given the over-reaching relevance of cross-border insolvencies\(^4\) (vouched for ongoing international harmonization efforts\(^5\)), scholars advocate repealing or reducing the preferential treatments recognized by domestic statutes as far as possible. Harmonization and universalism have become the key words in insolvency practice\(^6\).

It may therefore appear that empirical data, which demonstrates the inefficiencies of an enforceable mechanism of statutory priorities, could not be anything other than supportive to the universalist, pro-harmonization approaches towards the abolition or reduction of these measures\(^7\). The study described in this note provides evidence for this. However, the author disagrees on the above-mentioned, mainstream interpretation.

Had there been the opportunity (in terms of time and space), the writer would also have demonstrated the validity of other assumptions that underlie this paper. Due to the inescapable existence of these constraints (which, thankfully, should prevent me from committing too many crimes against my mother tongue, as a distinguished scholar suggested\(^8\)), the validity of the following claims should be assumed.

First, it is argued that, for international cooperation to be effective, there is no need to have the same law in each country. Neither substantive harmonization, nor getting rid of priorities are essential steps for running trans-national cases efficiently\(^9\). Secondly, priorities are to the state legislature to be decided, and always will, because their determination is inherently linked to domestic practice and culture. It is a matter of national policy (and politics). Insolvency scholars may influence the debate and discuss the rationale of certain choices (or lack thereof). Nevertheless, other factors play a more relevant role in the eyes of the legislature, than international compliance and comity when it comes to a decision as to whether to introduce or retain a priority system in insolvency.

So what is left to the academics to debate? Is the discussion over the opportunity to introduce or amend existing priorities precluded? Not necessarily. However, since it is hardly possible to agree on a uniform system of priorities, debate should shift toward how domestic policies can be accommodated to reach the national goals whilst not hampering - or, ideally, while enhancing - international co-operation in cross-border cases.

Similar conclusions have been reached by the World Bank. In delivering the “Principles and Guidelines for Effective Insolvency and Creditor Rights Systems”\(^10\), the international organization recommended that domestic insolvency systems should recognize the rights and priorities of creditors (including secured ones) established prior to insolvency under commercial law. It also suggested keeping the number of priority classes to a minimum. It did not advocate, however, for a complete abolition of this system. On the contrary, it argued that “rules of priority should support incentives to manage credit efficiently”\(^11\).

These issues are addressed empirically by systematically analysing a wide range of liquidation cases in order to make an explanatory inference on the basis of the accumulated data. Methodology is described in greater details in section III of this contribution. Priorities
that exist or might exist by virtue of special mechanisms such as retention of title, setoffs or subordination claims fall outside the scope of this article.

This paper is divided in three substantive sections, followed by a general conclusion. Section I describes in very broad strokes the existing scholarly debate on statutory priorities. Particular attention is given to the argument surrounding the recognition of a preferential status to certain SMEs\textsuperscript{12}. Section II focuses on the Italian statutory preference accorded to certain SMEs, called ‘artisan enterprises’. After having determined the purpose that the legislature wanted to achieve in setting up this statutory preference, the section provides the accepted notion of artisan enterprise, and it clarifies the difference between this concept and that of SME. Section III introduces the study, describes its methodology, and illustrates its results.

Given the widely acknowledged circumstance that priorities are primarily influenced by domestic factors, the article does not advocate for repealing the preferential treatment. On the contrary, it recommends amendments to the existing legislation. Accordingly, this note concludes by contending that, whenever a legislature wants to introduce a preferential treatment for selected creditors, it should not follow the existing 'Italian way'. It should clearly identify, and strictly adhere to, the envisaged policy goals. It should then provide the IPs and the judiciary with an appropriate discretion to evaluate the single cases.

This article assumes that, if existing priorities are reframed at national level by adopting these recommendations, they would benefit only those claimants for which they are truly intended. Additionally, co-operation in cross-border cases would not be affected, but possibly enhanced.

This article does not underestimate the risks that may follow by a more discretionary approach towards statutory priorities. Risks include abusive and fraudulent behaviour, and the reduction of \textit{ex ante} predictability. These arguments are legitimate ones. However, it contends not only that the recommended approach is preferable to the \textit{status quo}, but also that it may be beneficial for the proposed substantive harmonization of insolvency practice. In fact, even though the latter is perceived as the only goal that should drive insolvency scholarship (a theory rejected by the writer), a ‘modified priority’ mechanism can well represent an intermediate step towards pure, fully-fledged universalism and harmonization of insolvency practice.

\section*{I. Preference/Priority Debate}

The relative merits of a unified treatment of statutory priorities, alongside the reduction in their scope, have been the subject of heated and extensive debate. The arguments marshalled by the proponents of this line of thought, are sophisticated, complex, and operate at macro-level. The following paragraphs try to summarize them.

‘Common pool’/claimants’ wealth maximization theorists\textsuperscript{13} reject the idea that priorities should be recognized in the law, since parties would never agree \textit{ex ante} on their recognition and enforcement. “\textit{Commercial law must establish the appropriate sequence in which creditors of a debtor must primarily bear the consequences of his insolvency}”\textsuperscript{14}. 
These commentators argue that losses “have to be shouldered by parties regardless of their relative blameworthiness”\(^{15}\). They fear that creditors enjoying state-created priorities may have incentives for initiating a liquidation process, or may demand similar priority treatment outside insolvency\(^{16}\). They conclude that “the protection of non-creditor interests of other victims of corporate decline, such as employees, managers, and members of the community, is not the role of insolvency law”\(^{17}\).

Their recommendations have been adopted in some jurisdictions\(^{18}\).

It is interesting to observe that also proponents of communitarian and multi-value visions (proceduralists) - which otherwise disagree with the above-mentioned commentators on the key principles and purposes of insolvency law - have reached similar conclusions on this particular subject. Because they adopt a principle-driven approach to insolvency law, they recognize the paramount role of the *pari passu* rule\(^{19}\). They therefore contend that rateable distribution among unsecured creditors should remain the default praxis, unless there are good reasons to depart from it\(^{20}\).

The problematic aspect is that decades of scholarly debate brought no agreement on how to identify the ‘good reasons’ or “persuasive justifications”\(^{21}\) to justify those statutes, which prefer selected creditors to other contributors.

Things do not improve if we analyse the academic contributions, which focused on the preferential treatment of SMEs. In addition, proposals that recommended extending the priority to small claims\(^{22}\) rather than SMEs have been dismissed, since there is no proof that the lower the amount of the loan, the more vulnerable the creditor. Finally, empirical studies demonstrated that even IPs do not support the introduction of new priorities, or retention of existing ones\(^{23}\). The only classes of creditors who seem to have a stronger case for priority treatment are employees, revenue authorities, tort creditors, and environmental clean-up costs.

There have been, however, dissenting opinions.

Alan Schwartz, for instance, argued in favour of the adoption of “corrective justice” mechanisms that should benefit those creditors (including small trade claimants) that are either unaware or unable to react to security. However, he concluded that advocating for a change in the priority list, which would favour those creditors, may cause more harm than good, and eventually dismissed his own proposal\(^{24}\).

Jacob S. Ziegel argued that priority treatment is justified only with reference to those small trade creditors that do not have enough customers to spread the risk around\(^{25}\). Vanessa Finch herself adopted an ambivalent approach on the subject, contending that “the English system of borrowing combines with corporate insolvency law’s priority regime to discriminate against small companies”\(^{26}\), and advocating for a move from ‘lifeline’ towards ‘facilitative’ and ‘risk-distribution’ approaches.

Since this topic has been extensively debated in parliamentary discussions and reform commissions, it may appear that this paper has little to add to the current discourse. Unless the very premises upon which this debate has been conducted up to now are questioned. And this is what this note attempts at doing.

Substantially all of the above-mentioned contributions adopted a similar way of proceeding. They tried to theoretically justify the recognition of these preferences by means of abstract criteria or pervasive principles. The underlying question has always been: do these creditors ‘deserve’ a priority treatment? More generally, do we need priorities in insolvency law?
However, if we assume (as this note does) that priorities should not be tested against the same principles and standards that apply to other areas of insolvency law, we could focus on different enquiries, and stop questioning the very existence of priority creditors. After all, their existence dates back to the creation of insolvency law as a separate branch of law.

But how can we discard decades of theoretical analysis on the subject with a stroke of pen? Surely, there must be steadier grounds than simple observance to prior practice. This ground exists. It consists of the observation that priorities are essential means to solve some of the distributional issues faced in insolvency.

Few commentators recognized the importance of the distributional question in insolvency law. This article adopts this line of thought and sheds some light (i.e. empirical evidence) on this debate. As a result, focus should shift toward analysing whether priorities mirror the existing, domestic legal culture, whether they work, and/or how they could work better. Whether a creditor ‘deserves’ a priority treatment in insolvency is a matter that cannot only be determined in the library of a Law School.

Prior scholars advocated for radical changes in the system of insolvency priorities because the measure (ex post statutory priority) was proven ineffective, incapable of achieving the expected goal. This paper acknowledges that the more priorities are granted by law, the more preferential creditors will go unpaid. However, it also argues that if the mechanism is ineffective, we should investigate alternative ways to improve it and achieve the goal, without necessarily getting rid of the ‘mechanism’ itself.

As for the goal, this is not represented by the protection of a selected category of creditors. On the contrary, it consists in promoting distributional equality in accordance with domestic legal culture. This objective cannot be ignored, even though other instruments can be employed to reach the same outcome. Accordingly, advocating for a repeal of the statutory system of priorities in national insolvency law may be legitimate only if alternative, more efficient protections are envisaged.

In accordance with these premises, the study analyses the Italian statutory mechanism for granting a preferential treatment to certain SMEs. It explains why it has been enacted, whether its existence mirrors the existing legal culture, and whether it achieves the expected goals. Since evidence proves the existence of serious shortcomings in the way by which the mechanism is structured, this note proposes amendments to the existing law. Finally, it concludes by contending that similar approaches can be implemented with reference to the other priorities recognized by the law, in each and every country.

II. The Italian Way

Italian legislation is characterized by its peculiar attention towards small entrepreneurs, who represent the backbone of Italian economy. Throughout the years, the legislature has consistently granted additional protection to certain small entrepreneurs. The legislative favour went toward businesspersons, professionals and autonomous workers that found themselves in a situation largely comparable to that of employees and salaried workers.

Italian governments, irrespective of their political affiliation, have consistently tried to entrench their rights and their relevance in national economy. It may therefore be argued that protection and development of SMEs has been a policy goal of both the First and the
Second Republic, and that such a purpose is consistent with the Italian legal and business culture.

The ‘modern’ root of this protection is laid out in the Constitution. Article 35(1) clarifies that “The Republic protects work in all its forms and practices”\textsuperscript{29}, while pursuant to article 45(2) “The Law safeguards and promotes artisanal work” (emphasis added)\textsuperscript{30}.

Neither the Constitution nor the Civil Code clearly define the notion of ‘artisan’. This profession has always been associated with the making of art (it. “artefatto”, lat. arte + factu, made in an artistic fashion) and hand works (it. “manufatto”, lat. manu + factu, made by hand). The Italian legislature developed the legal notion of ‘artisan’ against this background. Therefore, it comes with no surprise that the first legal understanding of ‘artisan’ was closely related to the commonly accepted belief of this labourer as a craftsman, who primarily made his living in a workshop, relying mainly on manual work.

Since the approval and enactment of the Constitution (1948), several years passed before special legislation on artisanal work received the \textit{imprimatur} of the Parliament. First, a priority ranking in insolvency has been granted to salaried workers (law no. 153/1969). It took another six years for the Members of the Parliament to extend the protection to other, similarly placed creditors. Law no. 426/1975 was finally enacted, and the extension of priority treatment in insolvency to artisan enterprises was recognized by adding an article (art. 2751 \textit{bis}) to the Italian Civil Code (royal decree no. 262/1942)\textsuperscript{31}.

According to article 2751 \textit{bis} (5) of the Civil Code, “[a] general privilege on movable property is granted to claims relating to […] claims of an artisan enterprise [as defined by the law] and of cooperative societies or institutions for production and work, for the compensation of services rendered and the sale of manufactured products”\textsuperscript{32}.

The question we should now investigate is whether the law truly safeguards ‘artisanal work’. The empirical study described in the next section should provide enough “food for thought” on the subject. At the same time, it is preliminarily appropriate to verify if the ‘artisan entrepreneurs’ mentioned in the 1975 legislation are the same as the ‘artisans’ mentioned in the pre-war body of laws, which the Constitution was committed to protecting. In other words, is the existing priority status, recognized to artisan enterprises, consistent with the constitutional goals, as well as the existing legal and business culture?

Law no. 426/1975 granted the priority treatment to “i crediti dell’impresa artigiana” (the credits of the artisan enterprise). The concept of ‘artisan enterprise’ was, in itself, relatively new. It was not until law no. 860/1956 that the term appeared in official legislation on the topic of artisanship.

Before then, the legislature mainly employed the notion of ‘artisans’. This term was used to make reference to workers, who exercised their craft in an artistic workshop, mainly alone or with the exceptional assistance of a salaried apprentice, and with the occasional use of ‘mechanical means’ (law no. 830/1925)\textsuperscript{33}. The Constitution never mentions the expression ‘artisan enterprise’. Equally, article 2083 of the Civil Code (enacted in 1942) defines the category of small entrepreneurs as formed by “farmers who personally cultivate the land, artisans, small tradesmen and those who engage professionally in an activity organized mainly with their own work and that of the members of their families”\textsuperscript{34}.

The pre-1956 notion of ‘artisan’ adopted by that legislation was narrow, but not excessively narrow. Mechanical instruments were expensive, people tended to live in small villages in the country, and Italy was still in the early stages of industrialization. It is therefore safe to assume that a relevant part of autonomous workers was included within the adopted notions
of ‘artisan’ and ‘small businessman’. Things rapidly changed in the aftermath of the Second World War.

Economic progress and industrialization meant that even craftsmen started using tools that were more sophisticated. While large enterprises undertook mass-production of goods, small entrepreneurs tried to compete on the market by applying the principles of serial production. Artisans - or, more appropriately, craftsmen - were pushed outside the market, or relegated to its high-ends.

Had the legislature followed the Constitutional rationale in its statutory production, not very many ‘autonomous workers’ would have been worthy of additional consideration. To avert this risk, the economic community lobbied to adopt a more encompassing notion of artisan entrepreneurs. The legislature replied to these calls by means of law no. 860/1956, which recognized the industrialization of the artisan practice. Entrepreneurs could then incorporate themselves in some of the existing corporate forms, employ a limited number of salaried workers, make use of more sophisticated mechanic tools to not only produce goods, but also provide services, and still be qualified as ‘artisans’. This word became increasingly synonymous with “piccola impresa di qualità” (small quality industry)35.

The legislature further expanded the notion of ‘artisan entrepreneurs’. Notably, law no. 443/1985 included the production of semi-finished products among the output of their activity, and cancelled the requirement of ‘artistic production’ for a company to be considered artisan. Furthermore, laws no. 133/1997 and no. 57/2001 conceded that artisans could incorporate their workshops and activities in limited liability companies, even with more than one shareholder.

All these amendments distance the artisan entrepreneur from the commonly accepted notion adopted by the legislator in the 1920s, and which represented the context in which the Constitutional protection was recommended in the 1940s. Can the owner of a limited liability company with 10 or more employees (even up to 40 in certain circumstances) be in the same, shaky position as a salaried worker when it comes to claim back his/her credits from an insolvent estate?

To sum up, the Italian legislature moved towards a notion of ‘artisan entrepreneur’ that goes far beyond the scope and rationale of the Constitutional protection as mirrored in the 1942 version of the Civil Code. Originally, emphasis was placed on the size of the enterprise (small) and on the activity (artistic or at least manual, with prevalence placed upon the entrepreneur’s work over other elements). Nowadays, the legislator anchored the notion to formal criteria, such as the number of employees (up to 40 for certain, non-serial productions), and the registration into the artisan section of the companies’ register (“albo”). This approach has recently been reinstated by means of law no. 35/2012, which amended art. 2751bis (5) of the Civil Code to specify that the artisan enterprise is only that which matches the criteria set out in the law (“definita ai sensi delle disposizioni legislative vigenti”)36.

Had the judiciary followed the statutory suggestions, it could be argued that this study is not about the priority ranking of ‘artisans’ or SMEs, but of selected businesses that match the formal criteria set out in the law. Final recommendations would have focused on mechanisms to improve the efficiency of the priority ranking, and on revising the existing policy goals.

Unfortunately - apart from some isolated cases37 (backed by some commentators38) - the Supreme Court39 and the majority of lower courts40 have been consistent in ruling that only those ‘artisan enterprises’ which possess both the qualitative criteria set out in the Civil Code...
and the quantitative criteria set out in the special legislation (law no. 443/1985) are entitled to the priority ranking\(^4\).

The latter, prevailing interpretation is more consistent with the original rationale of art. 2751 bis of the Civil Code, whose main goal was to translate into enforceable rules the principles set out in the Constitution\(^2\). However, such a line of thinking is clearly at odds with the purpose of the more recent legislator. Law no. 860/1956 held that the offered definition should have been valid “for all the purposes of the law” (art. 1)\(^3\). Furthermore, the 2012 act, introduced to improve predictability in insolvency law, suggested applying only the criteria of law no. 443/1985 to determine the nature of the claimant. Because of the recent amendments, courts may change their prevailing opinion, and conclude that the notion of artisan enterprise is determined only with reference to the criteria included in law no. 443/1985\(^4\).

This interpretation would be consistent with the rationale of the 2012 law, and the parliamentary debate. However, law no. 443/1985 does not apply to the whole national territory\(^5\). Therefore, it is problematic to argue that - despite the legislative intention - a law that is not even applicable to the whole territory of the Italian Republic, and which was conceived for different purposes, may become the sole yardstick to determine which companies are eligible for priority treatment in insolvency.

Recently, the Supreme Court reasserted this view, and remarked one more time the judiciary’s different approach to artisan enterprises\(^6\). It held that the final goal of art. 2751 bis of the Civil Code is to recognize a preferential treatment to those claims that arise from personal, physical or intellectual work that is substantially similar to that of salaried labourers. No reference was made to the need for this accomplishment to have an artistic nature to be considered artisanal.

It follows that there are currently two concentric concepts of ‘artisan’\(^7\). One, wider in scope, determined by the special law, which is valid for obtaining subsidies and benefits at the regional level. The other, narrower, determined by the complimentary application of the criteria set out in the Civil Code and in the special law, which shall be used to determine who is eligible for the priority treatment in insolvency. Despite being the clear intention of the legislator, as it emerged from the preparatory works, it is still not possible to determine if the 2012 amendments changed the situation\(^8\).

In other words, it appears that for a company to be ‘artisan’ it is not enough for it to respect the dimensional requirements prescribed by the special law, and to be listed in the appropriate section of the companies’ register in the local Chamber of Commerce. It is also necessary to demonstrate that the work of the owner and his family prevails over the work of other salaried workers, and over the assets\(^9\). Furthermore, this predominance has to last from the moment in which the credit emerged to the moment in which the creditor filed its claim in the insolvency proceeding\(^10\).

To determine if the claimant meets those requirements, courts and insolvency practitioners demand the exhibition of several fiscal and financial documents\(^1\). Marginal attention is paid to the nature of the contract between the creditor and the debtor\(^2\). This, as judicial practice proves, results in courts reaching no consistency in determining if a claimant can be qualified as artisan. The scope of the notion of artisan, both for insolvency and for civil law purposes, is still debated\(^3\).

This brief analysis made it clear that the commonly accepted definition of ‘artisan entrepreneur’ bears little resemblance to both the European notion of small entrepreneur\(^4\).
and the original concept of ‘artisan’ as codified in the Constitution and in the Civil Code in 1940s (art. 2083)\textsuperscript{55}. To make things worse, statutory recommendations have not been adopted to the full extent in the courtrooms.

It follows that there is a remarkable uncertainty in defining in advance, with a reasonable degree of predictability, whether a claimant can be qualified as an artisan entrepreneur or not, should one of his debtor file an insolvency proceeding. It is therefore not surprising that commentators criticize the \textit{status quo} for offering blurred definitions of ‘artisan’ and ‘artisan entrepreneur’\textsuperscript{56}, and that this thorny issue has been commonly addressed as “\textit{il più noto dei puzzle legali}” (the best known legal conundrum)\textsuperscript{57}.

As a result, even before embarking on the analysis of the results of the empirical study, it is possible to assert that lack of clarity on the scope of art. 2751 \textit{bis} (5) of the Civil Code negatively affects the beneficial effects that this priority may produce on the recipients.

\textbf{III. What the Study Reveals}

Despite recurrent complaints on the dearth of empirical evidence in legal scholarship\textsuperscript{58}, several studies have gathered data on the effect of harmonization policies\textsuperscript{59} and statutory preferential mechanisms\textsuperscript{60} in recent years.

This research, however, adopts a novel approach and perspective. It was carried out in Italy from June to August 2014, and it analysed 1,193 liquidation procedures closed in the years 2013 and 2014 in seven law districts\textsuperscript{61} within four different regions\textsuperscript{62}. Districts were chosen for their proximity to my residence - hence their prevalent collocation in the Northern part of the country -, and for their willingness to provide data and cooperate with the researcher\textsuperscript{63}.

This study is entirely replicable. It is based upon reports and legal documents uploaded by IPs and judges on a privately-owned web platform called Fall.co. The use of this system - which has since been replaced by a state-owned, purposefully developed platform - was voluntary, even though those courts, which relied on it, strongly encouraged IPs and civil servants to make use of it.

Apart from those district courts, which did not rely on this informatics platform - and could not therefore be considered for the purposes of this study - the researcher did not include large districts (such as Bologna, Milan or Venice) in his sample. This was due to the number of procedures to analyse (which would have been overwhelming for a study carried out by a single person), and because the evidence otherwise obtained would have largely prevailed in number over that gathered from the other circuits. Geographical variety has been preferred to the analysis of a larger number of cases in order to counteract possible biases arising from local practices.

Finally, the research covers almost two years (procedures closed in 2013 and up to July 2014), in order to verify if results changed markedly from one year to the following one. It was considered - and it would have been preferable – to gather data from procedures closed in less recent years, to compare recent results with older findings. Unfortunately, the possibility was dismissed due to the impossibility to gather such evidence\textsuperscript{64}.

The study focused on the dividend rate paid to artisan entrepreneurs in liquidation proceedings. First, this note describes the aggregate recovery rate, and then it analyses the differences within the considered circuits and the national dividend rate for preferred
creditors in general. Then it highlights how these results relate with the duration of the procedures, and it offers some additional considerations on the treatment of priority claims under Italian law. Finally, some of the limits of this investigation are discussed.

Data. The study evidenced a simple average recovery rate (‘mean’ value) for artisan enterprises in all the considered districts and for liquidations closed in both years of 33.05% (33 cent per euro). This value is not dissimilar to the average dividend rate for preferential creditors (28.97%) experienced at national level.

It is also significantly higher than the recovery rate SMEs experience in other countries, where they are listed among unsecured creditors. A closer analysis of the collected data, however, highlights mixed results.

In particular, the study evidences that:

- 89.7% of procedures where artisans were among the claimants ended with either no payment (59.92%) or with artisans’ integral satisfaction (29.78%);

- The most frequently occurring value (‘mode’ figure) was 0% (nihil); the second most recurring figure was 100% (integral) recovery. Incidence of each value varies depending on the year and the district considered, as well as on the duration of the procedure;

- Dividend rate varied sensibly between law circuits.

Time-Factor. Another relevant aspect that has been considered throughout this study is how long it took to obtain the above-mentioned dividend/recovery rate.

It was not possible to determine in each procedure the exact date in which partial or integral payment of the dividend rate was processed. As a matter of fact, proceeds are generally distributed when all or the vast majority of the assets have been sold, the administration expenses covered and the secured creditors entirely paid. This generally occurs a few weeks before the court certifies the termination and closure of the liquidation procedure.

Therefore, the study considered the closing date of the liquidation as the moment in which artisan creditors were paid. It is acknowledged that there are cases in which this
approximation is rough. However, this is the best possible estimation given the available data. According to the gathered evidence:

- 61.34% of cases which resulted in distribution of proceeds to artisan entrepreneurs lasted more than 5 years, 36.22% lasted between 2 and 5 years, and only 2.44% less than 2 years;
- 76.2% of cases which resulted in artisans’ integral payment lasted more than 5 years, while no integral payment was granted in liquidations closed within 2 years from their opening.

It is apparent, therefore, that the shorter the liquidation lasts, the fewer the assets available for distribution, and the lower the dividend. Furthermore, despite the quasi unscientific approach used to determine the payment date, it is clear that it is a matter of years before artisans receive at least a partial payment for the goods or services they provided.

As for the average duration of Italian insolvency proceedings, the most recent available data show that those concluded in 2015 have lasted 7 years and 5 months, down 8 months from the 2014 average, arguably because of the amendments introduced in August 2015. These figures however refer to all insolvency proceedings (including rescue ones, which were not considered for the purposes of this study), and do highlight a wide geographical variance. Finally, they do not distinguish - as this study has done - the duration of procedures, which end up in a distribution to creditors from those, which have no or little assets, and where distribution to claimants is not granted.

Additional considerations. Even in the cases where claimants are rewarded with integral payment, this is restricted to the “naked value” of the claim. This is despite the law extends the priority status to interest rates. Time is money, and an interpretation of insolvency provisions which denies compensation for the time value is “as a matter of statutory construction, strained, if not clearly wrong”.

Furthermore, creditors have to pay direct and indirect taxes on the debts admitted to the insolvency procedure, the possibility of retrieving them being subject only to its conclusion when all or part of the credit has not been repaid.

Limits. A few limitations of the data set should be noted. Some of them have already been discussed: these include the geographical distribution of the cases, the limited timeframe of the sample, and the approximation for the determination of the date of the distribution of proceeds.

Another characteristic of this study is that it focused only on liquidation cases (“fallimenti”). Consequently, the reported distribution rate to artisans may be lower than that experienced in alternative rescue procedures, such as concordato preventivo. However, such a choice was determined by the circumstance that rescue procedures may not (and usually do not) end with a distribution of assets and proceeds to creditors. More importantly, data for these proceedings was not collected on Fall.co or on other digital platforms at the time of the study.

Another limit is represented by the size of the sample. Data was gathered only with reference to 1,193 liquidation proceedings closed over a period of one year and a half, while 14,269 companies filed for liquidation in 2013 alone. It follows that they represent only a marginal portion of the liquidation procedures closed in Italy in the considered timeframe.

Finally, it was not possible to cross-reference the digital documents uploaded on Fall.co with the archived papers. Liquidation booklets are stored in archives, which are located in separate buildings from the main courthouse, sometimes not even in the same city or region. Consultation of these documents is, therefore, highly problematic and time-consuming. It
would also require the constant assistance of a member of the archive, in a period in which courthouses are seriously undermanned.

Nevertheless, lack of cross-referencing should not be as problematic as it seems. Many of the documents consulted on Fall.co are computer scans of papers and reports signed by the judge responsible for the case. Therefore, it is likely that any official document, which replaced another one previously valid and enforceable, has been uploaded. Consultation of paper archives would have allowed for data to be gathered on those proceedings where no or insufficient information was available on Fall.co.

Overall, incomplete information in the above-mentioned areas does not substantially affect the implications of the suggested findings. In fact, there is no evidence of any likelihood that radically different results could be observed had all the procedures from the considered districts been considered. Similarly, it does not appear that extending the research to the remaining legal districts would have significantly affected the final findings.

While the study showed that the average dividend rate reconciled with artisan entrepreneurs is significant and in line with similar rates experienced by other preferential creditors under Italian law, it also evidenced several problems. These include an all-or-nothing tendency, a direct link between the duration of the procedure and the likeliness of obtaining a dividend, and lack of recognition and payment of interest rates.

These issues add up to those highlighted in section II, namely uncertainty on the notion of ‘artisan entrepreneur’ and a mismatch between the original purposes of the envisaged protection and the current beneficiaries of the priority treatment.

Qualitative interviews with entrepreneurs and practitioners, as well as case analysis and literature review, evidenced further matters of concern. Artisan entrepreneurs demonstrated a reliance more on quasi-immediate fiscal benefits (such as tax deductibility for write-offs) over distribution rates and insolvency law protection.

To sum up, what the study proves is that the priority treatment envisaged by the legislator falls short not only of achieving the (Constitutional) statutory goals, but also of meeting business demands. In other words, it mirrors neither the existing legal culture nor the current corporate expectations.

The Italian experience also shows that the judgment on the size and qualification of an enterprise as ‘artisan’ cannot be based merely on accounting data. The valuation should be discretionary oriented.

Conclusion

To determine what this study wants to illustrate, I must first clarify what it is not about. Hopefully, this would help to understand the purpose of the study while avoiding me naivety.

This study is not about valuating the Italian preferential treatment of artisan enterprises. Laws may change, different jurisdictions recognize different priorities, or may apply the same priorities in different ways. Equally, this note was not about determining if artisan entrepreneurs (or some of them) ‘deserve’ particular consideration in the distribution of the insolvent’s assets and proceeds. This is a political evaluation, which exceeds the scope of this contribution.
This article focused on the process by which the legislator singled out a group of creditors, and awarded them with a preferential position in the distribution of assets and proceeds. It proved that the legislative approach to the matter should be reconsidered.

To efficiently allocate priorities to only those claimants that should be entitled to them (according to the political evaluation, which underpins their recognition), this study suggests a purpose-based approach, as detailed below.

Whenever the group of beneficiaries is sufficiently restricted in number - which is not the case of ‘artisan entrepreneurs’ as described by law no. 443/1985 - the legislator may consider establishing a priority in insolvency law. Otherwise, alternative mechanisms should be considered, and preferred.

As a result, if the Italian legislator wanted to restrict the priority treatment to those small artisans that find themselves in a situation substantially similar to that of unskilled salaried workers, it may reframe art. 2751 bis (5) of the Civil Code as follows:

“Hanno privilegio generale sui mobili i crediti riguardanti: […] (5) i crediti dell’artigiano (…) che esercita un’attività professionale con il lavoro proprio e dei componenti della famiglia, per i corrispettivi dei servizi prestati e della vendita dei manufatti”

“A general privilege on movable property is granted to credits relating to […] claims of an artisan (…) who engages professionally in an activity organized mainly with his/her own work and that of the members of their families, for the compensation of services rendered and the sale of manufactured products”

This study also demonstrated that, whenever a priority rule is introduced, it should be sufficiently flexible to allow both judiciary and practitioners to exercise adequate discretion in its implementation. The more detailed the criteria set out in the law, the more mechanic its application, the less likely the goal is achieved.

As a result, the Italian legislator may explore the opportunity of introducing in its insolvency framework a provision similar to 11 U.S. Code §.105(a), according to which:

“L’autorità giudiziaria competente può adottare ogni ordinanza, decreto o sentenza che appaia necessario o appropriato per implementare le disposizioni [della presente legge]”

“The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions [of this law]”.

Similar solutions have been enacted in other countries. This conclusion bears several similarities with the ‘pragmatic’ approach to the distributional question advocated in a recent contribution by José M. Garrido. Unlike the latter, the writer adopts a more positive attitude towards this vision.

We live in an (insolvency) world where harmonization and universalism appear to be the lodestars of the academic debate. This paper did not entirely reject these assumptions. However, it observed that, with reference to some insolvency issues, it is better to give adequate (if not prominent) consideration to local peculiarities.
Ill-conceived statutory priorities may hinder cooperation in cross-border cases. Risks include abusive and fraudulent behaviour, and the reduction of ex ante predictability. These arguments are legitimate ones.

However, if legislatures “learn” from the Italian experience and follow the above-mentioned criteria in defining when and to which extent recognizing preferential treatment to selected claimants, uncertainty and unpredictability may be reduced. Whether a ‘modified priority’ mechanism represents an interim step in the process of substantive harmonization of insolvency practice, or a final haven, is a matter worth for further consideration.

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1 Depending on the jurisdiction, there are different understandings of the meaning of ‘insolvency law’. Out of respect of the venue of this Colloquium, this paper adopts the English version of the notion. Therefore, the term ‘insolvency law’ is used to refer to corporate practice, while the term ‘bankruptcy law’ is relegated to cases dealing to individuals. Occasionally, in direct quotations from other Authors, this distinction may not be respected.


3 A part from Italy, other jurisdictions recognize a patchwork of different types of priority and preferential claims. Examples include the United States [11 U.S.C. §.507(a)], and Belgium. In Canada, different priorities are recognized depending on the procedure; and not only by federal, but also by provincial statutes. The Russian’s Federation Federal Insolvency Law 2002 also recognizes different priorities depending on the business, which filed for insolvency protection. In addition, the country adopts a tiered system for the payment of claimants.

Another jurisdiction with a long list of preferential creditors is France, even though in the last decade the position of non-preferred creditors has improved. France is one of the very few jurisdictions where secured creditors may not satisfy their claims over the secured assets in priority to all other claims.

Mexico provides special protection for labour claims, while Dutch insolvency legislation recognizes a priority status to certain tax claims [art. 21(1) of the Tax Collection Act 1990], and salary and social security premiums [art. 3:288(e) of the Civil Code]. Further priorities have also been recognized by special statutes.

Recent reforms in Poland (2015) have abolished the priority ranking of tax claims. Nevertheless, other pre-commencement creditors, such as employees and farmers for supplies of products from their own farms, enjoy a priority treatment under the revised legislation.

Finally, South Korea and Spain recognize priority status to - respectively - certain claims from SMEs or natural persons for work personally done. For a comprehensive analysis of the system of priorities in the considered jurisdictions, see Dennis Faber et al, Ranking and Priority of Creditors (OUP 2016).

4 Not only cases like BCCI, Maxwell, Enron, Parmalat/Eurofood, Yukos, Lehman Bros., Nortel, General Motors and Chrysler - just to cite a few - have world-wide implications. There is an increasing line of proceedings involving medium and even small corporations, either individually or as part of a corporate group, which make use of the existing legal framework to move their assets and places of incorporation on the eve of insolvency. A practice commonly referred as ‘forum shopping’.

5 Reference is made to soft-law measures such as the UNCITRAL Model Law on Cross-Border Insolvency (issued in 1997, and since then enacted in several jurisdictions, including the U.S. and the U.K.), the 1995 Cross-Border Insolvency Concordat, the 2001 World Bank’s Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, etc. With reference to binding measures, the most renowned is the Regulation (EC) No. 1346/2000 as replaced from June 2017 by Regulation (EU) No. 848/2015. See also the EU Recovery and Resolution Directive No. 2014/59/EU, as well as to the Insolvency Initiative, Inception Impact Assessment Report of 02/03/2016, <http://ec.europa.eu/justice/civil/files/insolvency/impact_assessment_en.pdf> checked 30 March 2016. Trans-national treaties include the OHADA Uniform Act (1998/2015), the Montevideo Treaties (1889/1940), the Nordic Bankruptcy Convention (1933), etc.


7 The most strenuous supporter of universalism in insolvency matters is Jay L. Westbrook. For an analysis of its position on the priority treatment of creditors, see ‘Universal Priorities’ (1998) 33 Texas International Law Journal 27, and ‘Breaking Away: Local Priorities and Global Assets’ (2011) 46 Texas International Law Journal 601. In the latter contribution, he recognizes that - a part from limited priorities, such as wages, securities and taxes - it is unlikely a
mutual understanding on the treatment of other claims could be achieved at the international level. Therefore, Westbrook argues that, while universalism should remain the preferred approach, exceptions could be envisaged.


9 As observed by José M. Garrido, “[h]armonization or unification of the law in this area is extremely unlikely, precisely because of the political nature of numerous priorities” in ‘No Two Snowflakes the Same: The Distributional Question in International Bankruptcies’ (2011) 46 Texas Int’l L. J. 459, at 482.


11 ibid. The same document, however, asserts that “[l]egislators should resist the temptation to create a proliferation of priority classes based on special interests rather than solidly endorsed and widely embraced social policies” (p. 44, §.148 - emphasis added). It also recommends restricting priority treatments to selected tax and employees’ claims.

12 In this paper, the terms ‘priority’, ‘preferred’ and ‘preferential’ creditors are used as synonyms, to indicate any creditor receiving a preferential right to payment upon the debtor’s insolvency under applicable insolvency laws.

13 Among the most widely acknowledged law and economics scholars are Thomas H. Jackson and Douglas G. Baird. They argue that insolvency law’s essential role is to provide collectivized machinery for the administration of the debtor’s estate. In their view, this area of law should not be used as a proxy to redistribute pre-insolvency property rights, which should be governed by traditional commercial rules. See Thomas H. Jackson, The Logics and Limits of Bankruptcy Law (Harvard University Press 1986); and Douglas G. Baird, Elements of Bankruptcy (6th edn, Foundation Press 2014).


17 Vanessa Finch, Corporate Insolvency Law (2nd edn, CUP 2002) at 28.

18 For instance, in Austria the Insolvency Law Reform Act (IRÄG) 1982 introduced the ‘class-less’ insolvency. As a result, no priority treatment - other than that of secured creditors - is recognized by the law. Limited exceptions to this general rule result from special fields, such as the Pension and Insurance Law.

Germany has abolished all categories of priority creditors from its Insolvenzordnung, so it sits in a position similar to the Austrian one. However, following the financial crisis and calls for re-introducing the privilege for tax claims, some pre-commencement tax claims have been labelled as ‘administration claims’, thus payable in preference to other unsecured creditors ($55 para 4 InsO). In addition, the financial industry managed to make close-out netting agreements insolvency-proof, thus obtaining a de facto priority treatment over them.

As for England, after the abolition of the Crown preference by means of the Enterprise Act 2002, priorities are restricted to certain sums owing to employees, and certain levies on coal and steel production (sch. 6, para 15A, Insolvency Act 1986). However, the United Kingdom cannot be defined as a priority-free jurisdiction if we consider the effect on pari passu distribution of the “prescribed part” (sub n 25).

For a comprehensive analysis of the ranking of insolvency claims in each of the considered jurisdictions, see Faber et al (n 3).

19 As Vanessa Finch observes, “in considering exceptions to pari passu, it is the relative cases for preferring the different types of creditors that are at issue” (emphasis as in the original contribution); Finch (n 17) at 627.

20 Paul Heath, ‘Preferential Payments on Bankruptcy and Liquidation in New Zealand: Are They Justifiable Exceptions to the Pari Passu Rule?’ (1996) 4 Waikato Law Review 24. By reinstating the paramount relevance of the pari passu principle, the author questions even the opportunity of the employee preferential status. He observes that “[w]hen assessing whether priority should be given to employees, one must also bear in mind the consequences of excluding the wider class of claimant of this type and also the danger of according priority to a class of creditor which naturally includes working shareholders who function in a management role and who also have a contract of employment”, at 43.

21 Christopher F. Symes, Statutory Priorities in Corporate Insolvency Law - An Analysis of Preferred Creditor Status (Ashgate 2008) at 1.


23 According to Professors Andrew Keay and Peter Walton, 97% of practitioners responding to a survey in the United Kingdom indicated they would not advocate the introduction of any other new class of priority creditors; Andrew Keay and Peter Walton, ‘Preferential Debts: An Empirical Study’ [1999] Insolvency Lawyer 112, at 116.


Nevertheless, a similar mechanism was implemented by means of s.176A of the Insolvency Act 1986 thanks to the proposal having been enforceable at the time of his study, the average unsecured creditors’ return would have increased from 5% to 6.7%. In his words, “hardly enough to bring joy to a creditor’s heart”, at 804.  


37 Among the notable exceptions, see José M. Garrido, ‘The Distributional Question in Insolvency: Comparative Aspects’ (1995) 4 International Insolvency Review 25. He argued that “the most important flaw in Jackson’s otherwise brilliant construction is that it is isolated from social and economic reality”, at 27. Equally - and, somehow, unexpectedly - Thomas H. Jackson observed that while discharge “may well be the motivating cause of a majority of bankruptcy cases, most of the process is in fact concerned with creditor-distribution questions”, in Thomas H. Jackson, ‘Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain’ (Apr. 1982) 91(5) The Yale Law Journal 857, at 857. Finally, Federico M. Mucciarelli observed that creditors’ priorities both have a distributive impact on creditors and high political relevance, in Federico M. Mucciarelli, ‘Not Just Efficiency: Insolvency Law in the EU and Its Political Dimension’ (2013) 14(2) European Business Organization Law Review 175.

38 According to a recent study published by Cerved S.p.a., SMEs make up more than one-fifth (22%) of all Italian companies that submitted valid financial statements in 2013, the last year in which figures are available; <https://know.cerved.com/en/study-and-analysis/2015-cerved-smes-report> accessed 14 June 2016.


40 It is interesting to observe that in the first draft of the bill (no. 146/1972) only professionals and agency workers should have enjoyed a privileged treatment in insolvency. Preparatory debates show that it was not until farmers were included in the list that agreement could be reached on the extension of this priority to “the credits of the artisan enterprise”. Political turmoil, social unrest and economic difficulties made the recognition of this priority treatment both compelling and highly controversial. It was only when both parties at the table could score a point, and present it as a victory to their electorate, that the amendment to the Civil Code was approved. This example clearly proves the pivotal role of politics in determining insolvency policies.

41 For an analysis of the preliminary evolution of the legislation on artisans, see F. Cavazzuti, ‘Le Piccole Imprese’ in F. Cavazzuti (ed), La Costituzione Italiana (Strenna Utet 2007) at 451.

42 The term “cooperative societies” is better understood as “cooperative companies”.

43 It is in fact concerned with creditor-distribution questions
2751 bis (5) does not apply to insolvency procedures filed before 2012 (see Cass. SS.UU. no. 5685/2015 cited above). As such, the Supreme Court has not yet had the opportunity to clarify if the 2012 amendments modified the commonly accepted criteria for determining whether a company is ‘artisan’ or not.


41 In other words, the prevailing opinion in the judiciary is that – for the purposes of art. 2751 bis (5) of the Civil Code - ‘artisans’ should be small entrepreneurs whose work (and that of the members of their family) prevails over the work of any other employee and on the assets (as per art. 2083 of the Civil Code). Additionally, their company should meet the criteria set out in law no. 443/1985.


43 This is the translation in English of the Italian text made by the author of the present note.

44 This is what the Court of Ravenna clearly stated in a judgment issued on 23 December 2014, published in Redazione Giuffré 2014. On that occasion, the bankruptcy section of the court held that, because of the 2012 amendments, priority in insolvency has to be granted to those enterprises, which respect only the criteria set out in law no. 443/1985. In the view of the Court, the previous prevailing interpretation - supported by the Supreme Court - is no longer valid. How this interpretation can be conciliated with the Supreme Court’s vision on the purposes of the privilege (sub n 46) is a matter for further consideration.

45 According to art. 13 of law no. 443/1985, some regions (“regioni a statuto speciale”) and administrative territories (“province autonome”) hold the right to set different criteria to determine which enterprises can be considered artisanal.


48 However, according to G. Cian and A. Trabucchi, Commentario Breve al Codice Civile (11th edn, Cedam 2014), “nowadays there is no doubt that the above-mentioned privilege refers only to the credits of the artisan enterprise which abides to the criteria set out in law no. 443/1985” at 3684. This is the translation in English of the Italian text made by the author of the present note.

49 How to evaluate whether this ‘predominance’ of personal labour over alien contributions and assets is another, much debated issues. Traditionally, courts look at both quantitative and qualitative standards, even though some judgments suggest that the distinction between artisans and commercial entrepreneurs lies in the goal of their activities. In their view, artisans seek ‘earnings’ (“guadagno”), while commercial entrepreneurs seek ‘profits’ (“profitto”) - see Fall. Stendardo c. Stendardo, C. Cass. no. 11039/1994, in Fall., 1995, 649.


51 For an updated list, see the decree published by the Court of Verona - Bankruptcy Section file:///C:/Users/acnp426/Downloads/Privilegio_artigiano-Tribunale_di_Verona%20(1).pdf, accessed 15 June 2016. However, local courts and IPs may require additional documents, even though best (harmonized) practices have been suggested by the Italian association of chartered accountants (which represents the vast majority of IPs in Italian insolvency procedures).


54 According to the EU Recommendation no. 2003/361, a business can be classified as “small” if it employs less than 50 workers and if its turnaround or its balance sheet total is less than € 10 million. These ceilings apply to the figures for individual firms only.

55 G. Nicolini, La Nuova Impresa Artigiana (Giuffré, 1986) at 17.

European Parliament, PE 432.766.


The considered districts were Ancona, Cremona, Mantova, Padua, Piacenza, Reggio nell’Emilia e Vicenza.

The considered regions were Emilia-Romagna, Marche, Lombardy and Veneto.

Access to the data stored in the Fall.co web platform was only possible from local courthouses, using credentials provided to either local judges or civil servants working in the district. Use of these credentials allowed the researcher to view and download material only from cases filed and closed in that district. Access to the online platform had to be pre-emptively authorized in writing from the President of the courthouse. Requests were sent to thirty-five courthouses: only twelve replied. Out of them, four did not use the Fall.co platform (hence, they could not be considered for the purposes of this study) and one denied the permission to carry out the research.

The more we go back in time, the less documents are uploaded on the platform.

Results are reported in deeper details in the tables attached to this paper.

This aggregate figure refers to the return to preferential creditors in general. Artisan entrepreneurs are among those preferential creditors but, because in Italy priorities are graduated, they rank after salaried workers, professionals and representatives (but before cooperative corporations). The 28.67% figure dates back to 2007, the last year in which the National Institute of Statistics gathered this evidence at national level: see table 9, <http://giustiziaincifre.istat.it/jsp/dawinci.jsp?q=pl09-0010013000&an=2007&ig=1&ct=212&id=1A|13A> accessed 16 June 2016.

Overall, the cases in which no payment was granted to priority creditors represented 59.92% of the sample in which artisan entrepreneurs submitted a claim.

From 8.49% (Reggio Emilia, 2014) to 50% (Cremona, 2014).

That goes without considering the period of time that has elapsed between the moment in which the creditor provided the goods or services and the time in which the debtor was admitted to an insolvency proceeding.


In the most ‘efficient’ circuits, insolvency procedures last on average between 3 and 4 years, while in the slowest ones, they may take 15 years on average.

Pursuant to art. 54, 55 of the Italian insolvency Law (royal decree no. 267/1942), bank interests on the credit enjoy the same preferential treatment of the main claim. However, a series of technicalities, limits, and lack of effective remedies resulted in none of the considered procedures having paid any amount for this purpose.


Paper documents duly signed and notified to all parties are the only ones which have legal value, according to the Italian law.

Similar conclusions were reached by Pecoraro (n 53).

According to the European standards set out in the EU Recommendation no. 2003/361.

This is the translation in Italian of the English text made by the author of the present note.

Pursuant to Art. 132 (1) of the South Korean Debtor Rehabilitation and Bankruptcy Act 2005, in a rehabilitation procedure, “[w]hen a small- and medium-sized businessman who is a transaction partner of the debtor is feared to face hardship in the continuation of his/her business unless he/she receives the payment of a small-sum claim that he/she holds, the court may grant permission to pay back the whole or part of such small-sum claim to him/her upon receiving an application filed by any custodian, any preservative custodian or the debtor even before it decides to

Garrido (n 9).

### SUMMARY OF THE STUDY

**No. of liquidation procedures analysed: 1,193**

- **a)** closed for reasons unrelated with payment of creditors
  - 54 (4.52%)

- **b)** closed for distribution of assets/money
  - 450 (37.72%)
    - within 730 days (2 years): 11 (2.44%)
    - between 730 and 1,825 days (2 to 5 years): 163 (36.22%)
    - over 1,825 days (> 5 years): 276 (61.34%)

- **c)** closed for lack of assets/money
  - 303 (25.39%)
    - within 730 days (2 years): 101 (33.33%)
    - between 730 and 1,825 days (2 to 5 years): 136 (44.88%)
    - over 1,825 days (> 5 years): 66 (21.68%)

- **d)** closed for integral payment of creditors
  - 4 (0.33%)

- **e)** unable to establish the reasons
  - 382 (32.04%)

**No. of procedures sub (b), (c) and (d): 757 (63.45%)**

- without artisan enterprises or similar creditors: 475 (62.74%)
- with artisan enterprises or similar creditors: 282 (37.26%)

- average distribution rate: **33.05%**

  - integral payment
    - within 730 days (2 years): 0
    - between 730 and 1,825 days (2 to 5 years): 20 (23.8%)
    - over 1,825 days (> 5 years): 64 (76.2%)

  - no payment
    - within 730 days (2 years): 19 (11.24%)
    - between 730 and 1,825 days (2 to 5 years): 84 (49.7%)
    - over 1,825 days (> 5 years): 66 (39.06%)

  - distr. rate between 0% and 50%
    - 21 (7.44%)

  - distr. rate above 50%
    - 8 (2.86%)
ANCONA [OVERALL]

No. of liquidation procedures analysed: 128

a) closed for reasons unrelated with payment of creditors
   3 (2.34%)

b) closed for distribution of assets/money
   39 (30.46%)
   (of whom)
   • within 730 days (2 years)
     0
   • between 730 and 1,825 days (2 to 5 years)
     17 43.58%
   • over 1,825 days (> 5 years)
     22 56.42%

c) closed for lack of assets/money
   39 (30.46%)
   (of whom)
   • within 730 days (2 years)
     15 38.46%
   • between 730 and 1,825 days (2 to 5 years)
     21 53.84%
   • over 1,825 days (> 5 years)
     3  7.7%

d) closed for integral payment of creditors
   0

e) unable to establish the reasons
   47 (36.74%)

No. of procedures sub (b), (c) and (d): 78 (60.94%)

- without artisan enterprises or similar creditors
  52 (66.67%)
- with artisan enterprises or similar creditors
  26 (33.33%)

- average distribution rate: 38.67%

  - integral payment
    10 (38.46%)
    ▪ within 730 days (2 years)
      0
    ▪ between 730 and 1,825 days (2 to 5 years)
      3 30%
    ▪ over 1,825 days (> 5 years)
      7 70%
  - no payment
    15 (57.69%)
    ▪ within 730 days (2 years)
      3 20%
    ▪ between 730 and 1,825 days (2 to 5 years)
      7 46.66%
    ▪ over 1,825 days (> 5 years)
      5 33.34%
  - distr. rate between 0% and 50%
    1 (3.85%)
  - distr. rate above 50%
    0
No. of liquidation procedures analysed: 102

a) closed for reasons unrelated with payment of creditors 2 (1.96%)

b) closed for distribution of assets/money 28 (27.45%)
   (of whom)
   • within 730 days (2 years) 0
   • between 730 and 1,825 days (2 to 5 years) 10 35.71%
   • over 1,825 days (> 5 years) 18 64.29%

c) closed for lack of assets/money 33 (32.35%)
   (of whom)
   • within 730 days (2 years) 11 33.33%
   • between 730 and 1,825 days (2 to 5 years) 19 57.57%
   • over 1,825 days (> 5 years) 3 9.1%

d) closed for integral payment of creditors 0

e) unable to establish the reasons 39 (38.24%)

No. of procedures sub (b), (c) and (d): 61 (59.8%)

- without artisan enterprises or similar creditors 40 (65.57%)
- with artisan enterprises or similar creditors 21 (34.43%)

- average distribution rate: 38.35%
  - integral payment 8 (38.09%)
    • within 730 days (2 years) 0
    • between 730 and 1,825 days (2 to 5 years) 2 25%
    • over 1,825 days (> 5 years) 6 75%
  - no payment 12 (57.14%)
    • within 730 days (2 years) 2 16.66%
    • between 730 and 1,825 days (2 to 5 years) 5 41.67%
    • over 1,825 days (> 5 years) 5 41.67%
  - distr. rate between 0% and 50% 1 (4.77%)
  - distr. rate above 50% 0
**ANCONA [2014]**

No. of liquidation procedures analysed: **26** (up to 24 July 2014)

a) closed for reasons unrelated with payment of creditors
   1  (3.84%)

b) closed for distribution of assets/money
   11  (42.3%)
   (of whom)
   - within 730 days (2 years) 0
   - between 730 and 1,825 days (2 to 5 years) 7  63.63%
   - over 1,825 days (> 5 years) 4  36.37%

c) closed for lack of assets/money
   6  (23.07%)
   (of whom)
   - within 730 days (2 years) 4  66.67%
   - between 730 and 1,825 days (2 to 5 years) 2  33.33%
   - over 1,825 days (> 5 years) 0

d) closed for integral payment of creditors
   0

e) unable to establish the reasons
   8  (30.79%)

No. of procedures sub (b), (c) and (d): **17** (65.38%)

- without artisan enterprises or similar creditors 12  (70.58%)
- with artisan enterprises or similar creditors 5  (29.42%)

- average distribution rate: **40%**

  - integral payment 2  (40%)
    - within 730 days (2 years) 0
    - between 730 and 1,825 days (2 to 5 years) 1  50%
    - over 1,825 days (> 5 years) 1  50%
  - no payment 3  (60%)
    - within 730 days (2 years) 1  33.33%
    - between 730 and 1,825 days (2 to 5 years) 2  66.67%
    - over 1,825 days (> 5 years) 0
  - distr. rate between 0% and 50% 0
  - distr. rate above 50% 0
CREMONA [OVERALL]

No. of liquidation procedures analysed: 44

a) closed for reasons unrelated with payment of creditors 1 (4.34%)

b) closed for distribution of assets/money 7 (30.43%)
   (of whom)
   • within 730 days (2 years) 0
   • between 730 and 1,825 days (2 to 5 years) 2 28.58%
   • over 1,825 days (> 5 years) 5 71.42%

c) closed for lack of assets/money 5 (21.73%)
   (of whom)
   • within 730 days (2 years) 3 60%
   • between 730 and 1,825 days (2 to 5 years) 1 20%
   • over 1,825 days (> 5 years) 1 20%

d) closed for integral payment of creditors 0

e) unable to establish the reasons 31 (43.5%)

No. of procedures sub (b), (c) and (d): 12 (27.27%)

• without artisan enterprises or similar creditors 8 (66.67%)
• with artisan enterprises or similar creditors 4 (33.33%)

• average distribution rate: 50%

  □ integral payment 2 (50%)
    • within 730 days (2 years) 0
    • between 730 and 1,825 days (2 to 5 years) 0
    • over 1,825 days (> 5 years) 2 100%
  □ no payment 2 (50%)
    • within 730 days (2 years) 1 50%
    • between 730 and 1,825 days (2 to 5 years) 0
    • over 1,825 days (> 5 years) 1 50%
  □ distr. rate between 0% and 50% 0
  □ distr. rate above 50% 0
**CREMONA [2013]**

**No. of liquidation procedures analysed: 21**

a) closed for reasons unrelated with payment of creditors 0

b) closed for distribution of assets/money 0
   (of whom)
   - within 730 days (2 years) 0
   - between 730 and 1,825 days (2 to 5 years) 0
   - over 1,825 days (> 5 years) 0

c) closed for lack of assets/money 0
   (of whom)
   - within 730 days (2 years) 0
   - between 730 and 1,825 days (2 to 5 years) 0
   - over 1,825 days (> 5 years) 0

d) closed for integral payment of creditors 0

e) unable to establish the reasons 21 (100%)

**No. of procedures sub (b), (c) and (d): 0**

- without artisan enterprises or similar creditors 0
- with artisan enterprises or similar creditors 0

- average distribution rate: unknown

  - integral payment 0
    - within 730 days (2 years) 0
    - between 730 and 1,825 days (2 to 5 years) 0
    - over 1,825 days (> 5 years) 0
  - no payment 0
    - within 730 days (2 years) 0
    - between 730 and 1,825 days (2 to 5 years) 0
    - over 1,825 days (> 5 years) 0
  - distr. rate between 0% and 50% 0
  - distr. rate above 50% 0
**CREMONA [2014]**

**No. of liquidation procedures analysed: 23** (up to 21 July 2014)

- **a) closed for reasons unrelated with payment of creditors**
  - 1 (4.34%)

- **b) closed for distribution of assets/money**
  - 7 (30.43%)
    - within 730 days (2 years)
      - 0
    - between 730 and 1,825 days (2 to 5 years)
      - 2 (28.58%)
    - over 1,825 days (> 5 years)
      - 5 (71.42%)

- **c) closed for lack of assets/money**
  - 5 (21.73%)
    - within 730 days (2 years)
      - 3 (60%)
    - between 730 and 1,825 days (2 to 5 years)
      - 1 (20%)
    - over 1,825 days (> 5 years)
      - 1 (20%)

- **d) closed for integral payment of creditors**
  - 0

- **e) unable to establish the reasons**
  - 10 (43.5%)

---

**No. of procedures sub (b), (c) and (d): 12 (52.17%)**

- without artisan enterprises or similar creditors
  - 8 (66.67%)
- with artisan enterprises or similar creditors
  - 4 (33.33%)

- average distribution rate: 50%

  - **integral payment**
    - 2 (50%)
      - within 730 days (2 years)
        - 0
      - between 730 and 1,825 days (2 to 5 years)
        - 0
      - over 1,825 days (> 5 years)
        - 2 (100%)
  - **no payment**
    - 2 (50%)
      - within 730 days (2 years)
        - 1 (50%)
      - between 730 and 1,825 days (2 to 5 years)
        - 0
      - over 1,825 days (> 5 years)
        - 1 (50%)
  - **distr. rate between 0% and 50%**
    - 0
  - **distr. rate above 50%**
    - 0
Cremona Law Circuit
Dividend Rate

Average Dividend Rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Cremona</th>
<th>Italy</th>
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<tbody>
<tr>
<td>2007</td>
<td>50.01%</td>
<td>28.67%</td>
</tr>
<tr>
<td>2013</td>
<td>50.00%</td>
<td>34.77%</td>
</tr>
<tr>
<td>2014</td>
<td>50.00%</td>
<td>29.02%</td>
</tr>
</tbody>
</table>
**MANTOVA [OVERALL]**

**No. of liquidation procedures analysed: 135**

a) closed for reasons unrelated with payment of creditors 5 (3.7%)

b) closed for distribution of assets/money 53 (39.25%)
   (of whom)
   - within 730 days (2 years) 3 5.66%
   - between 730 and 1,825 days (2 to 5 years) 34 64.15%
   - over 1,825 days (> 5 years) 16 30.19%

c) closed for lack of assets/money 40 (29.62%)
   (of whom)
   - within 730 days (2 years) 16 40%
   - between 730 and 1,825 days (2 to 5 years) 22 55%
   - over 1,825 days (> 5 years) 2 5%

d) closed for integral payment of creditors 1 (0.74%)

e) unable to establish the reasons 36 (26.69%)

**No. of procedures sub (b), (c) and (d): 94 (69.62%)**

- without artisan enterprises or similar creditors 54 (57.44%)
- with artisan enterprises or similar creditors 40 (42.56%)

- average distribution rate: 31.71%

  - integral payment 12 (30%)
    - within 730 days (2 years) 0
    - between 730 and 1,825 days (2 to 5 years) 6 50%
    - over 1,825 days (> 5 years) 6 50%
  - no payment 26 (65%)
    - within 730 days (2 years) 2 7.69%
    - between 730 and 1,825 days (2 to 5 years) 18 69.23%
    - over 1,825 days (> 5 years) 6 23.08%
  - distr. rate between 0% and 50% 1 (2.5%)
  - distr. rate above 50% 1 (2.5%)
MANTOVA [2013]

No. of liquidation procedures analysed: 101

a) closed for reasons unrelated with payment of creditors 5 (4.95%)
b) closed for distribution of assets/money 37 (36.63%)
   (of whom)
   • within 730 days (2 years) 2 5.4%
   • between 730 and 1,825 days (2 to 5 years) 26 70.27%
   • over 1,825 days (> 5 years) 9 24.33%
c) closed for lack of assets/money 34 (33.66%)
   (of whom)
   • within 730 days (2 years) 15 44.11%
   • between 730 and 1,825 days (2 to 5 years) 18 52.94%
   • over 1,825 days (> 5 years) 1 2.95%
d) closed for integral payment of creditors 0
e) unable to establish the reasons 25 (24.76%)

No. of procedures sub (b), (c) and (d): 71 (70.29%)

- without artisan enterprises or similar creditors 42 (59.15%)
- with artisan enterprises or similar creditors 29 (40.85%)

- average distribution rate: 31.2%
  - integral payment 9 (31.03%)
    • within 730 days (2 years) 0
    • between 730 and 1,825 days (2 to 5 years) 5 55.55%
    • over 1,825 days (> 5 years) 4 44.45%
  - no payment 19 (65.51%)
    • within 730 days (2 years) 2 10.52%
    • between 730 and 1,825 days (2 to 5 years) 14 73.7%
    • over 1,825 days (> 5 years) 3 15.78%
  - distr. rate between 0% and 50% 1 (3.46%)
  - distr. rate above 50% 0
MANTOVA [2014]

No. of liquidation procedures analysed: **34** (up to 14 July 2014)

a) closed for reasons unrelated with payment of creditors 0

b) closed for distribution of assets/money 16 (47.05%)  
   (of whom)
   • within 730 days (2 years) 1 6.25%
   • between 730 and 1,825 days (2 to 5 years) 8 50%
   • over 1,825 days (> 5 years) 7 43.75%

c) closed for lack of assets/money 6 (17.64%)  
   (of whom)
   • within 730 days (2 years) 1 16.67%
   • between 730 and 1,825 days (2 to 5 years) 4 66.66%
   • over 1,825 days (> 5 years) 1 16.67%

d) closed for integral payment of creditors 1 (2.94%)

e) unable to establish the reasons 11 (32.37%)

No. of procedures sub (b), (c) and (d): 23 (67.64%)

- without artisan enterprises or similar creditors 12 (52.17%)
- with artisan enterprises or similar creditors 11 (47.83%)

- average distribution rate: **33.07%**
  - integral payment 3 (27.27%)
    - within 730 days (2 years) 0
    - between 730 and 1,825 days (2 to 5 years) 1 33.33%
    - over 1,825 days (> 5 years) 2 66.66%
  - no payment 7 (63.63%)
    - within 730 days (2 years) 0
    - between 730 and 1,825 days (2 to 5 years) 4 57.14%
    - over 1,825 days (> 5 years) 3 42.86%
  - distr. rate between 0% and 50% 0
  - distr. rate above 50% 1 (9.1%)
## No. of liquidation procedures analysed: 375

<table>
<thead>
<tr>
<th>Category</th>
<th>No.</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) closed for reasons unrelated with payment of creditors</td>
<td>6</td>
<td>(1.6%)</td>
</tr>
<tr>
<td>b) closed for distribution of assets/money</td>
<td>161</td>
<td>(42.93%)</td>
</tr>
<tr>
<td>(of whom)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• within 730 days (2 years)</td>
<td>2</td>
<td>1.24%</td>
</tr>
<tr>
<td>• between 730 and 1,825 days (2 to 5 years)</td>
<td>48</td>
<td>29.81%</td>
</tr>
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<td>• over 1,825 days (&gt; 5 years)</td>
<td>111</td>
<td>68.95%</td>
</tr>
<tr>
<td>c) closed for lack of assets/money</td>
<td>98</td>
<td>(26.13%)</td>
</tr>
<tr>
<td>(of whom)</td>
<td></td>
<td></td>
</tr>
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<td>• within 730 days (2 years)</td>
<td>26</td>
<td>26.53%</td>
</tr>
<tr>
<td>• between 730 and 1,825 days (2 to 5 years)</td>
<td>44</td>
<td>44.98%</td>
</tr>
<tr>
<td>• over 1,825 days (&gt; 5 years)</td>
<td>28</td>
<td>28.49%</td>
</tr>
<tr>
<td>d) closed for integral payment of creditors</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>e) unable to establish the reasons</td>
<td>110</td>
<td>(29.34%)</td>
</tr>
</tbody>
</table>

### No. of procedures sub (b), (c) and (d): 259 (69.06%)

- without artisan enterprises or similar creditors: 169 (65.25%)
- with artisan enterprises or similar creditors: 90 (34.75%)

- average distribution rate: 37.67%
  - integral payment: 31 (34.44%)
    - within 730 days (2 years): 0
    - between 730 and 1,825 days (2 to 5 years): 5 (16.12%)
    - over 1,825 days (> 5 years): 26 (83.88%)
  - no payment: 51 (56.66%)
    - within 730 days (2 years): 5 (9.8%)
    - between 730 and 1,825 days (2 to 5 years): 26 (50.98%)
    - over 1,825 days (> 5 years): 20 (39.22%)
  - distr. rate between 0% and 50%: 5 (5.55%)
  - distr. rate above 50%: 3 (3.35%)
No. of liquidation procedures analysed: 267

a) closed for reasons unrelated with payment of creditors 5 (1.87%)

b) closed for distribution of assets/money 123 (46.06%)
   (of whom)
   - within 730 days (2 years) 2 1.62%
   - between 730 and 1,825 days (2 to 5 years) 34 27.64%
   - over 1,825 days (> 5 years) 87 70.74%

c) closed for lack of assets/money 71 (26.59%)
   (of whom)
   - within 730 days (2 years) 15 29.41%
   - between 730 and 1,825 days (2 to 5 years) 35 49.29%
   - over 1,825 days (> 5 years) 21 21.3%

d) closed for integral payment of creditors 0

e) unable to establish the reasons 68 (25.48%)

No. of procedures sub (b), (c) and (d): 194 (72.65%)

 without artisan enterprises or similar creditors 126 (64.94%)
 with artisan enterprises or similar creditors 68 (35.06%)

 average distribution rate: 40.25%

  ▪ integral payment 26 (38.23%)
     within 730 days (2 years) 0
     between 730 and 1,825 days (2 to 5 years) 4 15.38%
     over 1,825 days (> 5 years) 22 84.62%
  ▪ no payment 36 (52.94%)
     within 730 days (2 years) 1 2.77%
     between 730 and 1,825 days (2 to 5 years) 19 52.77%
     over 1,825 days (> 5 years) 16 44.46%
  ▪ distr. rate between 0% and 50% 5 (7.35%)
  ▪ distr. rate above 50% 1 (1.48%)
No. of liquidation procedures analysed: 108 (up to 15 July 2014)

a) closed for reasons unrelated with payment of creditors 1 (0.94%)

b) closed for distribution of assets/money 38 (35.18%)
   (of whom)
   - within 730 days (2 years) 0
   - between 730 and 1,825 days (2 to 5 years) 14 (36.84%)
   - over 1,825 days (> 5 years) 24 (63.16%)

c) closed for lack of assets/money 27 (25%)
   (of whom)
   - within 730 days (2 years) 11 (40.74%)
   - between 730 and 1,825 days (2 to 5 years) 9 (33.33%)
   - over 1,825 days (> 5 years) 7 (25.93%)

d) closed for integral payment of creditors 0

e) unable to establish the reasons 42 (38.88%)

No. of procedures sub (b), (c) and (d): 65 (60.18%)

- without artisan enterprises or similar creditors 43 (66.15%)
- with artisan enterprises or similar creditors 22 (33.85%)

- average distribution rate: 29.7%
  - integral payment 5 (22.73%)
    - within 730 days (2 years) 0
    - between 730 and 1,825 days (2 to 5 years) 1 20%
    - over 1,825 days (> 5 years) 4 80%
  - no payment 15 (68.18%)
    - within 730 days (2 years) 4 26.66%
    - between 730 and 1,825 days (2 to 5 years) 7 46.68%
    - over 1,825 days (> 5 years) 4 26.66%
  - distr. rate between 0% and 50% 0
  - distr. rate above 50% 2 (9.09%)
### Padua Law Circuit

#### Dividend Rate

- Integral Payment: 2014 - 38.23%, 2013 - 7.35%
- Payment Between 0.01% and 49.99%: 2014 - 1.48%, 2013 - 9.09%
- No Payment: 2014 - 68.18%, 2013 - 52.94%

### Average Dividend Rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Padua</th>
<th>Italy</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>19.54%</td>
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<tr>
<td>2013</td>
<td>40.25%</td>
<td>34.77%</td>
</tr>
<tr>
<td>2014</td>
<td>29.70%</td>
<td>29.02%</td>
</tr>
</tbody>
</table>
PIACENZA [OVERALL]

No. of liquidation procedures analysed: 93

a) closed for reasons unrelated with payment of creditors 1 (1.07%)
b) closed for distribution of assets/money 31 (33.33%)
   (of whom)
   • within 730 days (2 years) 1 3.22%
   • between 730 and 1,825 days (2 to 5 years) 12 38.7%
   • over 1,825 days (> 5 years) 18 58.08%
c) closed for lack of assets/money 28 (30.1%)
   (of whom)
   • within 730 days (2 years) 6 21.42%
   • between 730 and 1,825 days (2 to 5 years) 10 35.71%
   • over 1,825 days (> 5 years) 12 42.07%
d) closed for integral payment of creditors 1 (1.07%)
e) unable to establish the reasons 32 (34.43%)

No. of procedures sub (b), (c) and (d): 60 (64.51%)

- without artisan enterprises or similar creditors 39 (65%)
- with artisan enterprises or similar creditors 21 (35%)

- average distribution rate: 31.66%
  - integral payment 6 (28.58%)
    - within 730 days (2 years) 0
    - between 730 and 1,825 days (2 to 5 years) 3 50%
    - over 1,825 days (> 5 years) 3 50%
  - no payment 13 (61.9%)
    - within 730 days (2 years) 2 15.38%
    - between 730 and 1,825 days (2 to 5 years) 5 38.46%
    - over 1,825 days (> 5 years) 6 46.16%
  - distr. rate between 0% and 50% 1 (4.76%)
  - distr. rate above 50% 1 (4.76%)
PIACENZA [2013]

No. of liquidation procedures analysed: 69

a) closed for reasons unrelated with payment of creditors 1 (1.44%)

b) closed for distribution of assets/money 21 (30.43%)
   (of whom)
   • within 730 days (2 years) 1 4.76%
   • between 730 and 1,825 days (2 to 5 years) 7 33.33%
   • over 1,825 days (> 5 years) 13 61.91%

c) closed for lack of assets/money 20 (28.98%)
   (of whom)
   • within 730 days (2 years) 6 30%
   • between 730 and 1,825 days (2 to 5 years) 5 25%
   • over 1,825 days (> 5 years) 9 45%

d) closed for integral payment of creditors 1 (1.44%)
e) unable to establish the reasons 26 (37.71%)

No. of procedures sub (b), (c) and (d): 42 (60.86%)

• without artisan enterprises or similar creditors 28 (66.67%)
• with artisan enterprises or similar creditors 14 (33.33%)

• average distribution rate: 33.03%
  • integral payment 4 (28.57%)
    • within 730 days (2 years) 0
    • between 730 and 1,825 days (2 to 5 years) 2 50%
    • over 1,825 days (> 5 years) 2 50%
  • no payment 9 (64.28%)
    • within 730 days (2 years) 2 22.22%
    • between 730 and 1,825 days (2 to 5 years) 3 33.33%
    • over 1,825 days (> 5 years) 4 44.45%
  • distr. rate between 0% and 50% 0
  • distr. rate above 50% 1 (7.15%)
PIACENZA [2014]

No. of liquidation procedures analysed: 24 (up to 23 July 2014)

a) closed for reasons unrelated with payment of creditors 0

b) closed for distribution of assets/money 10 (41.66%)
   (of whom)
   • within 730 days (2 years) 0
   • between 730 and 1,825 days (2 to 5 years) 5 50%
   • over 1,825 days (> 5 years) 5 50%

c) closed for lack of assets/money 8 (33.34%)
   (of whom)
   • within 730 days (2 years) 0
   • between 730 and 1,825 days (2 to 5 years) 5 62.5%
   • over 1,825 days (> 5 years) 3 37.5%

d) closed for integral payment of creditors 0

e) unable to establish the reasons 6 (25%)

No. of procedures sub (b), (c) and (d): 18 (75%)

■ without artisan enterprises or similar creditors 11 (61.11%)
■ with artisan enterprises or similar creditors 7 (38.89%)

■ average distribution rate: 28.92%
   □ integral payment 2 (28.57%)
     ■ within 730 days (2 years) 0
     ■ between 730 and 1,825 days (2 to 5 years) 1 50%
     ■ over 1,825 days (> 5 years) 1 50%
   □ no payment 4 (57.14%)
     ■ within 730 days (2 years) 0
     ■ between 730 and 1,825 days (2 to 5 years) 2 50%
     ■ over 1,825 days (> 5 years) 2 50%
   □ distr. rate between 0% and 50% 1 (14.29%)
   □ distr. rate above 50% 0
Piacenza Law Circuit

Dividend Rate

Average Dividend Rate

<table>
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<tr>
<th></th>
<th>2007</th>
<th>2013</th>
<th>2014</th>
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<tbody>
<tr>
<td>Piacenza</td>
<td>20.31%</td>
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<td>Italy</td>
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<td>34.77%</td>
<td>29.02%</td>
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</table>

Map of Italy with indicators for Piacenza and other regions.
**REGGIO EMILIA [OVERALL]**

**No. of liquidation procedures analysed: 199**

a) closed for reasons unrelated with payment of creditors
   - 3 (1.5%)

b) closed for distribution of assets/money
   - 94 (47.23%)
     - within 730 days (2 years): 3 (3.19%)
     - between 730 and 1,825 days (2 to 5 years): 23 (24.46%)
     - over 1,825 days (> 5 years): 68 (72.35%)

c) closed for lack of assets/money
   - 62 (31.15%)
     - within 730 days (2 years): 19 (30.64%)
     - between 730 and 1,825 days (2 to 5 years): 27 (43.54%)
     - over 1,825 days (> 5 years): 16 (25.82%)

d) closed for integral payment of creditors
   - 0

e) unable to establish the reasons
   - 40 (20.12%)

**No. of procedures sub (b), (c) and (d): 156 (78.39%)**

- without artisan enterprises or similar creditors: 86 (55.12%)
- with artisan enterprises or similar creditors: 70 (44.88%)

- average distribution rate: **25.64%**

  - integral payment: 15 (21.42%)
    - within 730 days (2 years): 0
    - between 730 and 1,825 days (2 to 5 years): 2 (13.33%)
    - over 1,825 days (> 5 years): 13 (86.67%)

  - no payment: 44 (62.85%)
    - within 730 days (2 years): 3 (6.81%)
    - between 730 and 1,825 days (2 to 5 years): 17 (38.63%)
    - over 1,825 days (> 5 years): 24 (54.56%)

  - distr. rate between 0% and 50%: 10 (14.28%)
  - distr. rate above 50%: 1 (1.45%)
No. of liquidation procedures analysed: 151

<table>
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<tr>
<th>Type of Liquidation</th>
<th>No. of Procedures</th>
<th>Percentage</th>
</tr>
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<tr>
<td>a) closed for reasons unrelated with payment of creditors</td>
<td>3</td>
<td>(1.98%)</td>
</tr>
<tr>
<td>b) closed for distribution of assets/money</td>
<td>72</td>
<td>(47.68%)</td>
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<tr>
<td>(of whom)</td>
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<tr>
<td>• within 730 days (2 years)</td>
<td>2</td>
<td>2.77%</td>
</tr>
<tr>
<td>• between 730 and 1,825 days (2 to 5 years)</td>
<td>21</td>
<td>29.16%</td>
</tr>
<tr>
<td>• over 1,825 days (&gt; 5 years)</td>
<td>49</td>
<td>68.07%</td>
</tr>
<tr>
<td>c) closed for lack of assets/money</td>
<td>45</td>
<td>(29.8%)</td>
</tr>
<tr>
<td>(of whom)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• within 730 days (2 years)</td>
<td>14</td>
<td>31.11%</td>
</tr>
<tr>
<td>• between 730 and 1,825 days (2 to 5 years)</td>
<td>21</td>
<td>46.66%</td>
</tr>
<tr>
<td>• over 1,825 days (&gt; 5 years)</td>
<td>10</td>
<td>32.23%</td>
</tr>
<tr>
<td>d) closed for integral payment of creditors</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>e) unable to establish the reasons</td>
<td>31</td>
<td>(20.54%)</td>
</tr>
</tbody>
</table>

No. of procedures sub (b), (c) and (d): 117 (77.48%)

- without artisan enterprises or similar creditors: 64 (54.7%)
- with artisan enterprises or similar creditors: 53 (45.3%)

average distribution rate: 31.14%

- integral payment: 14 (26.41%)
  - within 730 days (2 years): 0
  - between 730 and 1,825 days (2 to 5 years): 2 (14.28%)
  - over 1,825 days (> 5 years): 12 (85.72%)
- no payment: 30 (56.6%)
  - within 730 days (2 years): 1 (3.33%)
  - between 730 and 1,825 days (2 to 5 years): 12 (40%)
  - over 1,825 days (> 5 years): 17 (56.67%)
- distr. rate between 0% and 50%: 8 (15.09%)
- distr. rate above 50%: 1 (1.9%)
No. of liquidation procedures analysed: 48 (up to 15 July 2014)

a) closed for reasons unrelated with payment of creditors 0

b) closed for distribution of assets/money 22 (45.83%)
   (of whom)
   • within 730 days (2 years) 1 4.54%
   • between 730 and 1,825 days (2 to 5 years) 2 9.08%
   • over 1,825 days (> 5 years) 19 86.38%

c) closed for lack of assets/money 17 (35.41%)
   (of whom)
   • within 730 days (2 years) 5 29.42%
   • between 730 and 1,825 days (2 to 5 years) 6 35.29%
   • over 1,825 days (> 5 years) 6 35.29%

d) closed for integral payment of creditors 0

e) unable to establish the reasons 9 (18.76%)

No. of procedures sub (b), (c) and (d): 39 (81.25%)

- without artisan enterprises or similar creditors 22 (56.41%)
- with artisan enterprises or similar creditors 17 (43.59%)

- average distribution rate: 8.49%
  
  - integral payment 1 (5.88%)
    - within 730 days (2 years) 0
    - between 730 and 1,825 days (2 to 5 years) 0
    - over 1,825 days (> 5 years) 1 100%
  - no payment 14 (82.36%)
    - within 730 days (2 years) 2 14.28%
    - between 730 and 1,825 days (2 to 5 years) 5 35.72%
    - over 1,825 days (> 5 years) 7 50%
  - distr. rate between 0% and 50% 2 (11.76%)
  - distr. rate above 50% 0
Reggio Emilia Law Circuit
Dividend Rate

Integrated Payment
Payment Between 50% and 99.99%
Payment Between 0.01% and 49.99%
No Payment

2013
2014

82.36%
56.60%
15.09%
1.90%
26.41%

Reggio Emilia
Italy

Average Dividend Rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Reggio Emilia</th>
<th>Italy</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>22.50%</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>31.14%</td>
<td>34.77%</td>
</tr>
<tr>
<td>2014</td>
<td>8.49%</td>
<td>29.02%</td>
</tr>
</tbody>
</table>
VICENZA [OVERALL]

No. of liquidation procedures analysed: 219

a) closed for reasons unrelated with payment of creditors 35 (15.98%)
b) closed for distribution of assets/money 65 (29.68%)
   (of whom)
   • within 730 days (2 years) 2 3.07%
   • between 730 and 1,825 days (2 to 5 years) 27 41.53%
   • over 1,825 days (> 5 years) 36 55.3%
c) closed for lack of assets/money 31 (14.15%)
   (of whom)
   • within 730 days (2 years) 16 51.61%
   • between 730 and 1,825 days (2 to 5 years) 11 35.48%
   • over 1,825 days (> 5 years) 4 12.91%
d) closed for integral payment of creditors 2 (0.91%)
e) unable to establish the reasons 86 (39.28%)

No. of procedures sub (b), (c) and (d): 98 (44.74%)

- without artisan enterprises or similar creditors 67 (68.36%)
- with artisan enterprises or similar creditors 31 (31.64%)

- average distribution rate: 32.19%

  - integral payment 8 (25.8%)
    • within 730 days (2 years) 0
    • between 730 and 1,825 days (2 to 5 years) 1 12.5%
    • over 1,825 days (> 5 years) 7 87.5%
  - no payment 18 (58.06%)
    • within 730 days (2 years) 3 16.66%
    • between 730 and 1,825 days (2 to 5 years) 11 61.11%
    • over 1,825 days (> 5 years) 4 22.23%
  - distr. rate between 0% and 50% 3 (9.67%)
  - distr. rate above 50% 2 (6.47%)
VICENZA [2013]

No. of liquidation procedures analysed: 135

a) closed for reasons unrelated with payment of creditors
   21  (15.55%)

b) closed for distribution of assets/money
   30  (22.22%)
   (of whom)
   • within 730 days (2 years) 0
   • between 730 and 1,825 days (2 to 5 years) 10  33.33%
   • over 1,825 days (> 5 years) 20  66.67%

c) closed for lack of assets/money
   20  (14.81%)
   (of whom)
   • within 730 days (2 years) 12  60%
   • between 730 and 1,825 days (2 to 5 years) 5  25%
   • over 1,825 days (> 5 years) 3  15%

d) closed for integral payment of creditors
   2  (1.48%)
e) unable to establish the reasons
   62  (45.94%)

No. of procedures sub (b), (c) and (d): 52 (38.51%)

• without artisan enterprises or similar creditors 39  (75%)
• with artisan enterprises or similar creditors 13  (25%)

• average distribution rate: 24.96%
  ▪ integral payment 2  (15.38%)
    ▪ within 730 days (2 years) 0
    ▪ between 730 and 1,825 days (2 to 5 years) 0
    ▪ over 1,825 days (> 5 years) 2  100%
  ▪ no payment 8  (61.53%)
    ▪ within 730 days (2 years) 1  12.5%
    ▪ between 730 and 1,825 days (2 to 5 years) 4  50%
    ▪ over 1,825 days (> 5 years) 3  37.5%
  ▪ distr. rate between 0% and 50% 2  (15.38%)
  ▪ distr. rate above 50% 1  (7.71%)
### Vicenza [2014]

**No. of liquidation procedures analysed:** 84 (up to 21 July 2014)

<table>
<thead>
<tr>
<th>Category</th>
<th>No.</th>
<th>Percentage</th>
</tr>
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<tbody>
<tr>
<td>a) closed for reasons unrelated with payment of creditors</td>
<td>14</td>
<td>16.66%</td>
</tr>
<tr>
<td>b) closed for distribution of assets/money</td>
<td>35</td>
<td>41.66%</td>
</tr>
<tr>
<td>• within 730 days (2 years)</td>
<td>2</td>
<td>5.71%</td>
</tr>
<tr>
<td>• between 730 and 1,825 days (2 to 5 years)</td>
<td>17</td>
<td>48.57%</td>
</tr>
<tr>
<td>• over 1,825 days (&gt; 5 years)</td>
<td>16</td>
<td>45.71%</td>
</tr>
<tr>
<td>c) closed for lack of assets/money</td>
<td>11</td>
<td>13.09%</td>
</tr>
<tr>
<td>(of whom)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• within 730 days (2 years)</td>
<td>4</td>
<td>36.36%</td>
</tr>
<tr>
<td>• between 730 and 1,825 days (2 to 5 years)</td>
<td>6</td>
<td>54.54%</td>
</tr>
<tr>
<td>• over 1,825 days (&gt; 5 years)</td>
<td>1</td>
<td>9.1%</td>
</tr>
<tr>
<td>d) closed for integral payment of creditors</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>e) unable to establish the reasons</td>
<td>24</td>
<td>28.59%</td>
</tr>
</tbody>
</table>

**No. of procedures sub (b), (c) and (d): 46 (54.76%)**

- without artisan enterprises or similar creditors: 28 (60.86%)
- with artisan enterprises or similar creditors: 18 (39.14%)

- **average distribution rate:** 37.41%
  
  - integral payment: 6 (33.33%)
    - within 730 days (2 years): 0
    - between 730 and 1,825 days (2 to 5 years): 1 (16.66%)
    - over 1,825 days (> 5 years): 5 (83.34%)
  - no payment: 10 (55.55%)
    - within 730 days (2 years): 2 (20%)
    - between 730 and 1,825 days (2 to 5 years): 7 (70%)
    - over 1,825 days (> 5 years): 1 (10%)
  - distr. rate between 0% and 50%: 1 (5.56%)
  - distr. rate above 50%: 1 (5.56%)
Personal insolvency and social costs in insolvency

Personal insolvency law and the financial crisis: bankruptcy abuse prevention and bank protection?
Dr Joseph Spooner, London School of Economics

Comparative legal aspects in consumer insolvency in Europe
Dr. Veronika Sajadova, University of Geneva

The German Period of Good Conduct as a Requirement for Debt Relief
Dr Katharina Möser, Birmingham Law School

The fresh start potential of bankruptcy in Australia; reality or hype?
Nicola Howell, Queensland University of Technology

A human rights approach to consumer credit
Associate Professor Chrystin Ondersma, Rutgers School of Law - Newark
Dr Joseph Spooner has been an Assistant Professor at the Law Department of the London School of Economics since 2013. He was awarded his PhD from University College London in 2014 for research on the contemporary role of consumer bankruptcy law in a debt-based economy. He obtained policy experience working on the World Bank’s *Report on the Treatment of the Insolvency of Natural Persons* (2013), as well as on the Law Reform Commission of Ireland’s project on personal debt management and debt enforcement (2008-2010).

Joseph researches household debt law and policy. He focuses particularly on policymaking in personal insolvency law and consumer credit regulation, and the role of bankruptcy law as a tool for addressing macro-economic problems generated by excessive household debt and over-indebtedness in a financialised society. He also studies the politics of household debt, with particular emphasis on conflicts between popular and private interests in influencing law reform.
Dr. iur. Veronika Sajadova holds a doctoral degree in International Law from the University of Latvia. In 2014–2015 she undertook a postdoctoral as a SCIEX Fellow at the University of Geneva (Switzerland) on a project ‘Consumer Insolvency Proceedings in Europe’.

She has lectured at the University of Latvia (2006–2009), Riga Technical University (Latvia, 2007–2008) and BA School of Business and Finance (Latvia, 2014). She undertook a number of researches on insolvency law for governmental and non-governmental organisations of Latvia. She is a member of different Latvian and international working groups on insolvency.
Comparative legal aspects in consumer insolvency in Europe

Dr. iur. Veronika Sajadova

The paper briefly introduces the main results of the comparative study on ‘Consumer Insolvency Proceedings in the European Union, Switzerland and Russia’. The study began as a SCIEX PostDoc research project between the University of Latvia and the University of Geneva. Now, the study has become multinational in scope and currently includes more than 40 representatives from 30 European countries. Contributors to this study comprise professors, judges and highly qualified insolvency practitioners. This study represents the largest report into consumer insolvency proceedings of its kind and reflects the latest developments in consumer insolvency regulation in the concerned countries.
Katharina Möser
Birmingham Law School, UK
k.moser@bham.ac.uk

Dr. Katharina Möser joined Birmingham Law School in January 2009. She teaches Company and Contract Law. Her research interests include company, personal insolvency and comparative law. Prior to joining Birmingham, she worked as a research assistant at the University of Dresden.

Dr. Möser qualified for the German legal profession with the First State Examination at the University of Marburg and the Second State Examination in Frankfurt am Main. She received her LLM from the University of Lancaster and her PhD from the University of Dresden.
Dr. Katharina Moser, Lecturer, Birmingham Law School

The German period of good conduct as a requirement for debt relief

Until 1999 German insolvency proceedings offered no option for debt relief at all. Being confronted with an ever-growing problem of consumer over-indebtedness the German legislature then grudgingly accepted that the debtor has a right to discharge, but only subject to stringent conditions. In particular, these include a period of good conduct, during which the debtor must either engage in reasonable gainful employment, or, if she is unemployed, must look for employment and is not allowed to reject reasonable opportunities. This period of good behaviour was originally seven years long, but was reduced to six years in 2001. The most recent reforms, which were implemented in June 2014, allow for a discharge after 3 years, if the debtor has paid off at least 25-% of his debts and for a discharge after five years, if the debtor has at least paid off the costs of the insolvency proceedings.

This paper suggests that German politicians and academics use five main reasons in order to justify the German approach. They argue that the period of good conduct provides (i) a fair balance between the interests of the debtor and her creditors, (ii) an efficient balance between ex ante incentives to honour credit obligations and ex post work incentives, (iii) a chance for the debtor to prove her honesty, (iv) a tool for debtor rehabilitation and, (v) that it reduces the burden imposed on courts, because it deters applications from debtors, who are not willing to fulfil the statutory requirements. The paper examines the practical experiences made in the last 15 years and concludes that the German period of good conduct is only partially successful in achieving these objectives. Nevertheless, it is preferable to other instruments, such as strict eligibility requirements, up-front fees or insolvency restrictions that other jurisdictions use to achieve similar aims.
Nicola Howell
Queensland University of Technology, Australia
nicola.howell@qut.edu.au

Nicola Howell is a Senior Lecturer in the School of Law, Queensland University of Technology (Brisbane Australia). Her research and teaching covers consumer law, consumer credit law, financial services law, personal insolvency law, commercial law and contract law. Recent publications have focused on the fresh start in bankruptcy, regulation of small amount credit contracts, and self-regulation through industry codes of practice.

Prior to her appointment at Queensland University of Technology, Nicola held the position of inaugural Director of the Centre for Credit and Consumer Law, based at Griffith University. Nicola is also long-time member of the executive of the Consumers’ Federation of Australia (CFA), and since 2014, she has been the CFA’s representative on the Consumer Advisory Panel established by the Australian Securities and Investments Commission.
Assessing the fresh start and rehabilitation potential of bankruptcy in Australia

Nicola Howell, Queensland University of Technology

In Australia, over 17,000 people entered bankruptcy in 2014-15, with most of these bankruptcies resulting from consumer debts. The Australian bankruptcy system has a ‘fresh start’ objective, with most debts discharged after the period of bankruptcy (currently a minimum of three years). The type of fresh start provided for in the Australian bankruptcy law can be described as a discharge-focused fresh start, one that provides at least a temporary reprieve for overcommitted debtors. However, the extent to which the bankruptcy system facilitates a broader concept of the fresh start, one that focuses on the opportunity for economic and social rehabilitation of debtors, is less clear. A recent report for the World Bank suggested three elements as being necessary for a debtor’s economic rehabilitation - debt discharge; freedom from discrimination; and avoidance of future over-indebtedness. Reviewing the extent to which Australia’s system provides these three elements shows that there are improvements that could be made. However, a comprehensive analysis is hampered by a lack of information on the ways in which debtors experience bankruptcy, and the extent to which deficiencies in the ‘law on the books’ stymie the achievement of economic and social rehabilitation. This paper will therefore examine the available information on the law on the books and the law in practice, and discuss the challenges and opportunities for delving more deeply into the experience of bankruptcy so as to better understand the reality of the fresh start in Australia.
Assessing the fresh start and rehabilitation potential of bankruptcy in Australia

Nicola Howell, Queensland University of Technology

Introduction

Like many other Anglo-American jurisdictions, Australia has a personal insolvency regime that provides for discharge of debt at the conclusion of a bankruptcy (currently a minimum of three years), leading to it being described by legislators, judges, and commentators as a ‘fresh start’ approach. However, the scope, boundaries and practical effect of the fresh start as provided by the Australian bankruptcy system has not been extensively studied. My earlier analysis of bankruptcy legislation, case law and explanatory material shows that the fresh start provided in Australia is more in the nature of a temporary reprieve from overwhelming debt. This is valuable and is a key component of an effective bankruptcy system for natural persons. However, this initial analysis also showed that the Australian system does little to more directly assist with economic and social rehabilitation of the debtor, so as to improve ongoing financial and general wellbeing.

In 2013, a report for the World Bank (‘the Working Group report’) suggested that economic rehabilitation of the debtor is one of the ‘principal purposes of an insolvency system for natural persons’. For such rehabilitation, the report argued that three elements are required:

First, the debtor has to be freed from excessive debt. . . . Second, the debtor should be treated on an equal basis with non-debtors after receiving relief (the principle of non-discrimination). Third, the debtor should be able to avoid becoming excessively indebted again in the future, which may require some attempt to change debtors’ attitudes concerning proper credit use.

Measuring the Australian system against these three criteria can help to further explore the extent to which bankruptcy in Australia addresses a debtor’s economic rehabilitation and provide the fresh start. For greatest validity, such an exercise should take account of both the ‘law on the books’ and the ‘law in action’, however, the latter has not been extensively studied in recent times, and there is a deficit of information on how debtors experience either the period of bankruptcy or the period after discharge from bankruptcy.

The Working Group report focuses on economic rehabilitation of the debtor, which it describes as ‘re-establishing a debtor’s economic capability’. However, debtor rehabilitation can and should also have a humanitarian dimension, and analysing the impact of bankruptcy on the debtor’s future financial and general wellbeing is also important for an assessment of the reality of the fresh start.

Freedom from excessive debt

The first element suggested by the Working Group report requires the system to provide for the debtor to be free of excessive debt. On this point, the Australian system is largely successful. In terms of the law on the books, once a person enters bankruptcy, unsecured creditors are prohibited from collecting their debts, and this prohibition remains for the
whole period of bankruptcy.\textsuperscript{vii} Immediately on discharge from bankruptcy, the debtor is discharged from all of their obligations in relation to the debts proved in the bankruptcy.\textsuperscript{viii}

However, the debt discharge is not comprehensive. There are some types of debts that are, for public policy reasons, either not provable in the bankruptcy or not discharged at the conclusion of the bankruptcy.\textsuperscript{ix} Further, the rights of secured creditors to collect and realise the secured property are unaffected by a bankruptcy.\textsuperscript{x}

Turning to the law in action, there is no reporting of the number or value of non-provable or non-dischargeable debts in bankruptcies. However, it seems likely that at least one category of such debts will rise in the future, that being tertiary education debts. The cost of tertiary education is rising,\textsuperscript{xi} and, at the same time, the number of students enrolled is increasing.\textsuperscript{xii} Ramsay and Sim have argued that bankruptcy is increasingly becoming a middle-class phenomenon,\textsuperscript{xiii} and if university education is a criterion for determining middle class status,\textsuperscript{xiv} the non-provability of tertiary education debts may impact on significant numbers of those considering bankruptcy, and reduce the achievement of rehabilitation in practice.

**Freedom from discrimination**

The second element that is suggested by the Working Group report as necessary for economic rehabilitation is freedom from discrimination. Reviewing the law on the books suggests that Australia can be ranked poorly here. There is no law that prohibits a current or previous bankruptcy from being used as a ground for discrimination in a range of settings. Specifically, there is no anti-discrimination clause in the *Bankruptcy Act 1966* (Cth), and bankruptcy or insolvency is not a prohibited ground of discrimination under any of the Commonwealth or State/Territory anti-discrimination laws. As a result, person who is, or has previously been, bankrupt could potentially have their bankruptcy status used against them in decision making about employment, business, housing, access to credit, and access to utilities, and in other areas of social and public life.

The potential for discrimination is also directly facilitated by the bankruptcy system and other laws. For example:

- Bankruptcy is permanently listed on a public database, which anyone can access, for any reason, on payment of a (small) fee;\textsuperscript{xv}
- Bankruptcy is listed on consumer credit reports for 5 years, and these reports can be used by creditor providers in making decisions about granting credit.\textsuperscript{xvi} Importantly, utility providers are included as creditor providers in this system,\textsuperscript{xvii} and thus have access to bankruptcy data;
- Persons seeking to obtain credit above the prescribed amount (currently $5,485), must disclose their bankruptcy status when seeking credit or to obtain goods or services on credit;\textsuperscript{xviii}
- There are numerous occupational restrictions imposed on persons who are, or have been bankrupt, across a range of fields of employment.\textsuperscript{xix}

Of course, there may be circumstances where a current or previous bankruptcy is genuinely relevant, so that discrimination may be justified. However, these circumstances should be specifically provided for.
Turning to the law in action, there is very little empirical evidence on the extent of discrimination in practice in Australia. Qualitative research undertaken in Melbourne, Victoria in 1987-88 was encouraging on this point in relation to employment, as it reported that only two (of seventy-six) respondents commented that they thought they had been rejected by a potential employer on the grounds of their bankruptcy. However, more recent experience from the United States suggests that bankruptcy and/or poor credit reports can have an adverse impact on employment outcomes in that jurisdiction, and more contemporary research is needed in Australia. Recent research with financial counsellors in Australia also raises concerns about the potential adverse impact of bankruptcy on access to housing and utilities, reinforcing the need for an assessment of the extent of any bankruptcy discrimination across a range of areas.

Avoiding future over-indebtedness

The third element identified in the Working Group report as being necessary for economic rehabilitation is that the debtor should be able to avoid becoming excessively indebted in the future. The report suggests that this may require attention to changing debtors' attitudes about credit use. However, the extent to which such attention will be universally relevant to debtors can be challenged, given the range of reported causes of bankruptcy.

In terms of the law on the books, the bankruptcy legislation does not impose any requirement for a debtor to participate in financial education or financial literacy programs, either before or during bankruptcy, in contrast to the approaches taken in some other jurisdictions. There is a requirement for potential bankrupts to be provided with information about bankruptcy and other insolvency options, but this is a minimal requirement that is met by providing the debtor with prescribed information in the debtor's petition document itself. Further, the prescribed information focuses on the impact of different insolvency options; it pays little attention to changing financial habits. Any educational benefit provided by bankruptcy may be serendipitous, rather than being explicitly provided for in the legislation.

However, preventing future over-indebtedness can also be facilitated outside the bankruptcy system. In Australia, consumer credit law now plays a key role, with the recent introduction of new responsible lending obligations for credit providers and credit assistance providers, as well as the introduction of a price cap for loans, which particularly impacts on the costs of small, or payday loans. These changes should reduce the risk of debtors becoming over-indebted as a result of poor lending decisions. Further changes have also been proposed to deal with minimising the risk of overcommitment on credit cards. Other protections are embedded through the statutory right of debtors to request a variation of a credit contract on the grounds of hardship, including the right to take such a request to the independent Ombudsman schemes or to a court if the credit provider refuses to make a change. Thus, the consumer credit law has an important role to play in preventing future over-indebtedness for all debtors, not just for those debtors who are, or have been, bankrupt.

Turning to the law in action, again, there is minimal empirical evidence of the extent to which debtors who have become bankrupt are able to avoid future over-indebtedness. One empirical measurement that is available is the extent of repeat bankruptcies. Statistics recorded by the regulator show that the level of repeat bankruptcies is relatively consistent, at around 15-16% of total bankruptcies each year. However, there is no
information reported on the number of persons who might use another insolvency option, or who become overcommitted again, but do not turn to a formal insolvency option.

In terms of the impact of consumer credit law, there is not yet conclusive evidence of the extent to which the responsible lending laws have improved lending decisions; however, many consumers have taken advantage of the ability to request a variation to their contract on the grounds of hardship. For example, the largest Ombudsman scheme (the Financial Ombudsman Service) reports that, in 2014-15, it received 4,134 disputes about financial difficulty, but that the number of such disputes has been falling in recent years. FOS suggests that the fall in disputes may be due, in part, to improvements in responses by financial services providers to consumers in financial difficulty.

As already noted, in Australia, there is no obligation for debtors to participate in a financial education program, either as a condition of bankruptcy, or as a condition of discharge from bankruptcy. In any case, the evidence of the effectiveness of such programs appears limited, whether considering the mandatory bankruptcy programs, or financial education programs more generally. Among other things, such programs may have little role to play where bankruptcy results from external shocks, rather than poor financial decision-making, as is the case for many bankruptcies in Australia.

It is true, however, that for some debtors, poor financial management may contribute to insolvency, and for these debtors, appropriate financial capacity-building programs may be of assistance. However, it is likely that, to be effective, something more than a generic, two-hour financial education program is needed. In Australia, more intensive and personalised financial capability programs have been made available as part of voluntary financial inclusion programs (for example, matched savings programs, and no or low interest loan schemes), and these have been successful in improving financial capacity. Similarly, financial counselling services have been shown to be effective in improving financial capacity. However, the demand for financial inclusion and financial counselling programs / services currently outstrips the supply.

It is also possible that the period of bankruptcy itself may improve financial capability, even without formal education programs. In his research with consumer bankrupts in 1987-88, Ryan reported that many bankrupts felt that they ‘learnt something’ from their bankruptcy, in terms of changing financial behaviour, including lessons around using credit wisely or not at all, and being more likely to use a budget compared to before their bankruptcy. Ryan suggests that it is the ‘time out’ from the credit economy that allows these learnings to occur. However, again, these findings are now quite dated, and do not reflect, for example, that the credit economy may not be closed to people in bankruptcy.

Thus, there is some evidence that the debtors in Australia have an opportunity to reduce the risk of further overcommitment after bankruptcy, but this is largely coincidental to the bankruptcy law, rather than being driven by those laws.

**Improved financial and general wellbeing**

As well as the factors suggested by the Working Group as necessary for economic rehabilitation, a broad concept of rehabilitation and the fresh start in a bankruptcy system should result in debtors having improved financial and personal wellbeing after bankruptcy. Again, the extent to which this is occurring in Australia is unknown. Ryan’s study found
that more than three-quarters of respondents reported that bankruptcy improved their financial situation, and most of the remainder found that their financial situation remained the same. And although the ability of respondents to access credit was reduced, most perceived this as a positive advantage, allowing some ‘time out’ from the credit economy.

Similarly, most respondents found that bankruptcy resulted in improvements in their personal wellbeing, with a majority reporting that their bankruptcy had improved their health (59%), improved their marriage (60% of those married), and had a positive effect on their family (82%).

However, this research is now quite dated. The findings with respect to financial wellbeing can also be contrasted with more recent studies from the United States; for example Porter and Thorne found that just over one-third of debtors surveyed reported that their financial situation had either stayed the same or worsened since bankruptcy. Given the economic, legislative and social changes in the Australian economy since Ryan’s research, more contemporary assessment is needed, of bankruptcy’s outcomes generally, and also of matters that pertain to the three elements identified in the Working Group report.

However, empirical bankruptcy research in Australia is challenging. It can be difficult to recruit participants for research, perhaps because of the stigma associated with bankruptcy, or perhaps because there is a general weariness of surveys. Practical issues with empirical research into bankruptcy also abound – bankruptcies are no longer reported in newspapers, making potential participants less easy to find; honorariums for participating in research may need to be considered as part of a debtor’s income; and most bankruptcies in Australia are initiated and completed through an administrative process, with no need for a court hearing or face to face interview with an insolvency professional. Also, there is also a small number of bankruptcies from which to recruit for research compared to much larger jurisdictions like the United States or United Kingdom. Despite these challenges, the costs, benefits and impact of bankruptcy are wide-ranging, and a concerted effort is needed to understand whether Australia’s personal insolvency regime is still meeting its objective to facilitate a fresh start for debtors.

Conclusion

Australia’s bankruptcy regime is a mature one, which provides at least a minimum of a discharge focused fresh start. However, assessing the Australian system against the three elements that have been suggested as necessary for a debtor’s economic rehabilitation - that is debt discharge; freedom from discrimination; and avoidance of over-indebtedness - shows that there is still much room for improvement in the law on the books. At the same time, a genuine assessment of the extent to which bankruptcy facilitates improvements in both financial and general wellbeing requires greater investment in empirical studies to better understand the law as it operates in practice.
Notes

i For example, the Explanatory Memorandum for the Bankruptcy Amendment Bill 2002 notes that ‘One key purpose of the bankruptcy system is to allow people in a hopeless financial position to rule a line under their debts and be given a fresh start’ (at 17).


iv Ibid, 117.

v Ibid 115.

vi For example, Karen Gross, Failure and Forgiveness: Rebalancing the Bankruptcy System (Yale University Press, 1997) 101.

vii Bankruptcy Act 1966 (Cth), s 58(3).

viii Bankruptcy Act 1966 (Cth), s153(1).

ix Bankruptcy Act 1966 (Cth), ss 82(2) – (3B); 153(2).

x Bankruptcy Act 1966 (Cth), s 153(3).

xi When the tertiary contributions scheme was introduced in 1989, the annual student contribution was $1,800 and by 2003, it had increased to $6,136 for the most expensive courses: Dr Kim Jackson, The Higher Education Scheme, (Australian Parliamentary Library E-Brief, updated 12 August 2003), available: http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/Publications_Archive/archive/hecs. In 2007, the average course fee was $20,579: NATSEM (2008) ‘What price the clever country? The costs of tertiary education in Australia (AMP-NATSEM Income and Wealth Report 21, November) 20. For 2016, a Bachelor of Laws (Honours) at QUT costs $42,400 ($5300 per 48 credit points, and a total of 384 credit points required to graduate): https://www.qut.edu.au/study/courses/bachelor-of-laws-honours.

xii In 2014, there were 1.37 million students enrolled in higher education institutions, an increase of 4.5% from 2013. This compares with 1.19 million students in 2010: student data available from http://www.education.gov.au/student-data.


xiv See discussion in Ramsay and Sim, ibid, 292.

xv Bankruptcy Regulations 1996 (Cth), pt 13.

xvi Privacy Act 1988 (Cth), s 20X.

xvii Privacy Act 1988 (Cth), s 6G(2).

xviii Bankruptcy Act 1966 (Cth), s 269.


xxiv Bankruptcy Act 1966 (Cth), s54D; Bankruptcy Regulations 1996 (Cth), reg 4.11.

xxv For example, National Consumer Credit Protection Act 2009 (Cth), ch 3.

xxvi National Consumer Credit Protection Act 2009 (Cth), Schedule 1 (National Credit Code), pt 2, divs 4, 4A.


xxviii National Consumer Credit Protection Act 2009 (Cth), Schedule 1 (National Credit Code) ss 72-74.


xxx Although it is not possible to enter into a Debt Agreement if a debtor has been bankrupt (or in another insolvency agreement) in the previous 10 years: Bankruptcy Act 1966 (Cth), s 185C(4)(a).


Of the self-assessed causes of non-business bankruptcy, only 19% report excessive use of credit facilities in 2013-2014: Australian Financial Security Authority, Non-business causes time series, available from https://www afsa.gov.au/resources/statistics/socio-economic-statistics/causes-1/causes-non-business-related. Other top causes are unemployment or loss of income (35%), domestic discord (12%), and ill health (9%).

Ali, O’Brien and Ramsay, above n xxii, 146.


Nicola Brackertz (2012) I wish I’d known sooner: The impact of financial counselling on debt resolution and personal wellbeing (Salvation Army).

Good Shepherd Microfinance (2014) Life changing loans at no interest, 37; Financial Counselling Australia, User-Pays Model to Fund ASIC Should Extend to Financial Counselling (Media Release, 21 April 2016).

Ryan, above n xx, 77-8.

Ibid 247.

For example, in the USA, see Katherine Porter (2010) ‘Life after debt: understanding the credit restraint of bankruptcy debtors’ 18(1) American Bankruptcy Institute Law Review 1.

Ryan, above n xx, 228.

Ibid 225.

Ibid 180.

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A Human Rights Approach to Consumer Credit

Chrystin Ondersma

Abstract

As consumer credit and its attendant problems have exploded around the globe, consumer protection has been the dominant, if not exclusive, framework for mitigating risks to the consumer. Historically, consumer protection work in the consumer credit context has focused on “leveling the playing field” between debtors and creditors by preventing fraud and ensuring proper disclosure. Certain types of loans are now subject to substantive restrictions, such as the new Dodd-Frank regulations requiring mortgage lenders to ensure that borrowers have the ability to repay high cost mortgages. Despite these important advances, some critical gaps remain. Predatory lending continues to be a significant problem. In addition, even in circumstances where there are effective disclosures and absent predatory behavior, consumers can find themselves financially distressed as a result of onerous debt obligations. In particular, the current approach does not effectively address situations in which a debtor’s desperation renders her willing to accept credit on whatever terms it is offered.

This paper suggests that a human rights framework can provide a complementary overlay to the consumer protection approach to consumer credit. Far from supplanting the consumer protection framework, human rights principles can bolster and complement consumer protection work. Human rights principles can establish a universal floor of protection that prevents a race to the bottom and cannot be circumvented on economic efficiency grounds. I propose a specific example of a consumer credit regulation based on human rights: namely, states should not enforce a consumer credit contract if, at the time of the contract, it was substantially likely that the contract would render the debtor unable to meet his or her basic needs.

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After Kevin lost his job, he put $7,000 on his Capital One credit card. When Kevin wasn’t able to pay his bill, Capital One obtained a judgment. By this time, the debt had ballooned, with 26% interest accruing in addition to $1200 in attorney’s fees. Capital One began garnishing 25% of Kevin’s wages (the maximum permissible under state and federal law), with the result that he paid $500 out of each paycheck until he had repaid a total of $6,000. However, even after paying $6,000, Kevin still owed $10,000.1 Although the U.S. is known for its generous debt relief laws, individuals, families, and communities continue to suffer as a result of onerous debt burdens. In the fall of 2013, 7.4% of consumer debt in the U.S. was past due.2

While foreclosures have decreased since the 2008 financial crisis, 4.3% of mortgage balances are also past due.3 Delinquencies on credit card debt have also fallen, but 9.4% of credit card balances were past due in fall 2012. Delinquency rates on student loans have increased dramatically, up to 11.8% in fall 2013.4 Stories of individuals struggling to escape from debt abound. One fifty-one-year-old home health care aid purchased a van for a loan amount that was nearly three times its value.5 The van, which she used to bring her wheelchair-bound father to medical appointments, often broke down. Part of the reason for the $13,778 loan amount was a life insurance policy that was added without her knowledge.6 In another case, a seventy-six year old widow who lived on social security was given a $12,473 loan to purchase a vehicle worth only half that amount—the lender falsified

3 Id.
4 Id.
6 Silver-Greenberg & Corkery, supra note 5.
her income on documents. She went on food stamps in order to afford payments, but the car was ultimately repossessed and she was sued for the deficiency.

Consumer protection advocates have worked tirelessly to achieve protection for Kevin and others like him, and can claim a number of important victories. The Consumer Financial Protection Bureau is now able to take action to address “unfair, deceptive, or abusive act[s] or practice[s],” that is, practices that are typically understood to be predatory. In addition to taking action against companies engaged in predatory practices, the CFPB issued regulations requiring lenders of high cost mortgages to scrutinize borrowers’ ability to repay before issuing mortgages. However, the CFPB’s powers are not sufficient to ameliorate the problems facing Kevin, or the home-health-aid worker, or the widow. The CFPB does not have jurisdiction over auto loans, for example, and new regulations only require credit card lenders to ensure borrowers’ ability to repay minimum balances, which can lead to excessive portions of income being devoted to debt servicing. Thus, even though important gains have been made, significant gaps in protection for debtors remain.

This paper argues that joining a human rights approach to the consumer protection approach can help us close these gaps in protection for consumer debtors. A human rights approach to regulating consumer credit would mean crafting regulations with an intention to comply with human rights principles. A consumer protection approach focuses on fairness for consumers and “leveling the playing field” between creditors and debtors. Both are appropriate and important goals, but a human rights approach guarantees a floor of protection for debtors that the existing consumer protection approach alone does not. The existing consumer protection approach does not adequately address the problems of consumer confusion and consumer desperation. The problems facing Kevin and others like him are not just problems of market inefficiencies and unfairness—they raise human rights concerns as well.

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7 Id.
8 Id.
10 15 U.S.C. § 1639(c) (Dodd-Frank Act § 1411) (Dodd-Frank Act § 1412) (Amendment to Regulation Z which implements TILA).
In my previous paper, I discussed the human rights concerns that arise in the consumer credit context and analyzed how nations’ responses to over-indebtedness might ameliorate these concerns. There are a number of ways in which human rights concerns can be triggered in the consumer credit context. Situations of severe over-indebtedness can render debtors unable to meet their basic needs, interfering with the debtor’s ability to access an adequate standard of living or healthcare. In addition, some debt repayment terms may raise debt peonage concerns (for example if the debtor faces imprisonment for failure to pay a debt and must devote all disposable income to servicing debt for prolonged periods). Other contract terms or conditions may be discriminatory. Collection methods may also interfere with the debtor’s right to privacy or human dignity; for example, creditors may intrude on a debtor’s property or harass the debtor by phone or in person. I also explained that insolvency regimes themselves can implicate human rights concerns, such as privacy concerns (when debtor information is not protected or when debtors’ homes are exposed to administrator scrutiny) or discrimination concerns (for example, where relief is not equally available to all, particularly when effective access to relief hinges on race).

In that paper, I stopped short of arguing that a human rights approach should inform nations’ responses to over-indebtedness. Instead, I reviewed the human rights obligations and standards applicable to situations of over-indebtedness and discussed how a human rights approach to treating over-indebtedness would differ from the status quo. This paper goes further. Here, I take the normative position that human rights principles should inform consumer credit regulation. I suggest that human rights principles should inform not just the resolution over situations of over-indebtedness, but the entire panoply of consumer credit regulation, including issues that arise at the time of contract formation. A human rights approach to consumer credit regulation offers a number of benefits: first, it offers a universally comprehensible rhetorical framework for addressing

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12 Id.
13 Id.
14 Id.
15 I also discuss creditors’ rights to property (explaining that debt relief generally will not interfere with property rights) and rights to process (explaining that insolvency proceedings generally will not interfere with process rights). Id. at [x].
consumer credit problems; second, it provides a fundamental floor of protection for debtors that cannot be circumvented based on economic efficiency concerns; third, because it applies universally, it prevents the “race to the bottom” whereby regulators and jurisdictions can compete to offer ever more lenient credit terms; fourth, it offers a powerful mechanism for changing lender behavior.

This paper proceeds as follows: Part II provides more detail regarding some fundamental problems with consumer credit. I focus on the problem of over-indebtedness, including problems associated with income shortfalls and onerous credit terms. I emphasize that many consumers enter into ultimately harmful consumer credit contracts either out of confusion or desperation; that is, problematic consumer credit contracts can arise even absent fraud or improper disclosure on the part of the lender. Part III discusses the ways in which these problems have historically been addressed under a consumer protection approach and explores some of the gaps in protection for debtors under that scheme. Importantly, the consumer protection approach has focused primarily on combating procedural unfairness and has largely accepted the propriety of considering economic efficiency concerns in evaluating proposed substantive regulations. I explain that this approach does not adequately address the problems of consumer confusion and consumer desperation and does not seek to identify any baseline level of protection for debtors from severe over-indebtedness. Part IV defines a human rights approach to consumer credit and argues that a human rights framework is a beneficial tool for the regulation of consumer credit because, among other benefits, it provides a powerful, universal floor of protection for consumer debtors that cannot be circumvented on economic efficiency grounds. To illustrate the benefits of a human rights approach more specifically, I make a human-rights-based consumer credit proposal: I suggest that contracts that are substantially likely to cause debtors to be unable to meet their basic needs should be unenforceable. Part V discusses how a human rights approach to consumer credit can be implemented: academics and policymakers can propose or consider consumer credit legislation that promotes human rights, and advocates can push for consumer credit reform that respects human rights. Part VI responds to some potential objections to a human rights approach to consumer credit.

II. CONSUMER CREDIT PROBLEMS
The purpose of this Part is to elucidate the nature of many of the problems associated with consumer credit. I will review the fundamental problems and current regulatory landscape as a means of reviewing shortcomings, then will proceed to discuss the current efforts to address these concerns, and finally explore the extent to which a human rights framework can address some of these shortcomings.

Perhaps the biggest consumer credit problem involves situations of severe over-indebtedness; that is, debt that interferes with an individuals’ ability to meet her basic needs. Severe over-indebtedness can be attributed to at least two significant, overlapping issues. First, credit is sometimes offered under unreasonably onerous terms. Onerous loan terms can come about for a variety of reasons. Sometimes, the problem is outright fraud. In other cases the loan is “predatory” even though it may fall short of being fraudulent—often the cost of the predatory loans is disproportionate to the credit risk that the debtor poses. Sometimes, though, the problem is a less nefarious market inefficiency, such as consumer confusion or lack of information. However, severe over-indebtedness can occur even absent predatory lending or consumer confusion. Due to flat or declining wages and reductions in the welfare state, more individuals than ever turn to credit to meet basic needs. That is, individuals or families face an income shortfall and rely on credit to fill the gap—which in turn often only increases that gap. The second problem then, is a problem of income shortfall and consumer desperation.

Often these two problems—onerous credit terms and income shortfalls—are related. Individuals turn to credit to meet basic needs, but the terms on which credit is offered ultimately makes it even harder for the individual to meet his or her basic needs. In other cases, individuals have income that is sufficient to meet basic needs, but extension of credit and the resulting cost of servicing that debt render them unable to meet their basic needs. It is important to note that these problems can arise without any fraud on the part of the lender, and even in cases where terms are adequately disclosed.

A. Income Shortfalls and Consumer Desperation

Individuals can become seriously over-indebted due to sudden or chronic income shortfalls, even when no predatory lending is
involved. Sometimes over-indebtedness is triggered by a sudden decrease in income or increase in expenses. Examples include incurring medical debt for a medical emergency or taking out a home equity loan or credit cards to cover emergency expenses (such as medical bills, funeral expenses, costs of covering basic needs after a job loss, or an unexpected tax bill). In situations of sudden and/or severe income shortfalls, individuals may be willing to borrow on unfair terms; the immediate need for the loan can outstrip the high risk of non-payment. A Pew Trusts study of over seven hundred payday loan borrowers found that 37% of borrowers found themselves in such a dire financial situation that they would have accepted the payday loan on any terms offered.\(^\text{16}\)

Other times, the income necessary to provide for basic needs is chronically insufficient, and credit is used in an attempt to close the gap—but ultimately only widens the gap. The costs of housing, transportation, health care, and education have all increased.\(^\text{17}\) In the education context, particularly higher education, individuals often incur substantial debt in an effort to obtain a degree.\(^\text{18}\) Unfortunately, many degrees increasingly do not pay a sufficient wage to allow the individual to both repay the education debt and provide for his or her basic needs.\(^\text{19}\)

In some cities, the cost of basic utilities has become unaffordable and residents have become severely indebted to utility companies as a result. Residents of Detroit face extremely high water bills that many cannot afford based on their current incomes.\(^\text{20}\) As a result of past-due bills, many residents had their water shut off, preventing them from cooking, bathing, or caring for the sick.\(^\text{21}\)


\(^{21}\) Violation of the Human Right to Water and Sanitation in the City of Detroit, Michigan. Submission to the Special Rapporteur on the Human Right to Safe
some cases the water was shut off even when payment attempts were made or the amount owed was in dispute.\textsuperscript{22} When residents were unable to pay, debt owed to utilities accrued and eventually the city cut off water to thousands of individuals.\textsuperscript{23} Detroit residents face critical health and safety risks as a result of the water shutoff. Some residents were required to pay more than 20\% of their income for water, and some had inexplicably high past-due bills. In the case of Nicole Hill, her bills were $200 per month, amounting to almost $6,000 in past-due charges. The city did not respond to her inquiries about why the cost of water was so high and aid organizations say they are unable to help her because she owes more than $2,500.\textsuperscript{24} In addition, overdue water bills were often added to property taxes, resulting in foreclosure when they were not paid.\textsuperscript{25} Some homes became uninhabitable as a result of cracked pipes.\textsuperscript{26}

Income shortfalls are not only a problem in the U.S. Scholars and policymakers have noted the rise of over-indebtedness internationally.\textsuperscript{27} Even in Europe, where social services have historically been robust, cuts in the welfare state have “transferred credit into necessity for many of the poor in order to balance their budget.”\textsuperscript{28} The expectation that credit can successfully fill gaps in income shortfalls has become an international phenomenon. Some

\begin{thebibliography}{99}
\bibitem{Drinking Water and Sanitation Regarding Water Cut-offs in the City of Detroit, Michigan at 3-5} Drinking Water and Sanitation Regarding Water Cut-offs in the City of Detroit, Michigan at 3-5 (hereinafter “Detroit Submission”).
\bibitem{22} Id.
\bibitem{23} Id. at 4.
\bibitem{25} Detroit Submission at 4.
\bibitem{26} Id. at 5.
\bibitem{28} BENÖHR, supra note 28 at 113.
\end{thebibliography}
policymakers abroad have begun to view credit as a panacea for social welfare problems. For example, government and private investment in micro-lending enterprises, which typically fund tiny entrepreneurial enterprises, has increased exponentially. Some scholars have suggested that funds that would have been directed toward fighting poverty by investing in research, education, and welfare programs, nations and private industry have been redirected toward the micro-lending industry.29

In sum, for many families and individuals, income shortfalls, whether short-term or chronic, result in the use of credit to close the gap. Reliance on credit has risen as increases in expenses have outpaced wage increases.30 In some cases individuals can successfully use credit to cope with short-term cash flow shortages. Unfortunately, as will be discussed in greater detail below, the terms of credit extension may be such that the income shortfall is only widened and entrenched. That is, the result of consumer credit contracts that consumers enter out of desperation is that individuals who, in many cases already struggled to meet basic needs, are faced with an even greater gap between their expenses and the income available to cover them.

29 See Harper (2007:258) Some Final Thoughts, in WHAT’S WRONG WITH MICROFINANCE? 28-29 (Thomas Dichter & Malcolm Harper, eds., 2007) (arguing that microfinance “offers to neoliberals a highly visible way of being seen to be addressing the issue of poverty, but in a way that offers no real challenge to the existing structures of wealth and power,” and explaining that microfinance “has been consciously positioned as the substitute for social welfare spending (and international donor support.”). According to Bateman and Change, “government officials are increasingly deflecting community demands to support better basic education and health services on the grounds that poor people ‘now have microfinance’ and should individually seek to purchase such services (albeit at high prices) from the private sector rather than through taxpayer-funded public provision.” Id. at 30. More forcefully, Bateman and Change posit that “[m]icrofinance offers to neoliberals the hope that informal sector activities backed up by microfinance will become universally embedded as the only legitimate exit route out of poverty for both the individual and the community, thereby also removing from the political and policy agenda a wide range of progressive policies. These include demands for constructive state intervention, robust social welfare programmes, quality public services accessible to all, income and wealth redistribution (including land reform), and all forms of state, collective and cooperative ownership.” Id. at 28.

B. Onerous Credit Terms

When individuals do turn to credit, whether to cover income shortfalls or simply to gain assets (such as a home or car), there are many instances in which credit is offered under onerous terms. Sometimes the individual understands that the terms are onerous but has no other option and accepts the extension of credit. In other cases, the individual does not understand the terms and perhaps would have been able obtain the credit under much more favorable terms.

While historically most lenders did not give loans that were unlikely to be repaid, loans are now given in many cases in which lenders realize that default is likely. This can occur in cases in which loans are being securitized or otherwise sold to third parties such that the loan originator no longer bears the credit risk, or it can occur when the fees and interest rate charges are such that the loan is more profitable when it is in default than when it is timely repaid.

Loan terms may be onerous whether or not the loan was made on terms that are considered predatory. Predatory lending practices include those that involve fraud, deception, and lack of transparency. Predatory lending does not always involve actionable fraud; lenders or brokers may also use aggressive sales tactics and/or take unfair advantage of borrowers’ lack of understanding of the loan terms. Predatory lending usually involves “rent seeking,” that is; the cost that the lender charges a borrower is greatly disproportionate to the risk of lending to that borrower. In other words, predatory loans often include fees that “far exceed what would be expected or justified on

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34 Curbing, supra note 34, at 3.
35 MCCOY, supra note 34, at 82; STURDEVANT & BRENNAN, supra note 34, at 38-39.
economic grounds."36 In some cases, predatory loans are "asset-based loans," which are loans made under circumstances where the borrower is clearly unable to repay—where the lender relies from the get-go on seizing equity upon foreclosure rather than repayment.37 But because of the changes in the economic structure of consumer loans, lenders often do not scrutinize the borrowers’ ability to repay loans even if the loan is not asset based.

Predatory practices and onerous terms are prevalent in the auto loan context.38 Given the relative ease with which auto loans can be securitized, there are currently “millions of Americans with shoddy credit who are easily obtaining auto loans from used-car dealers, including some who fabricate or ignore borrowers’ abilities to repay.”39 The targets of such loans are often the “most desperate, least financially sophisticated customers.”40 In a New York Times study of over one hundred bankruptcy cases, dozens of civil lawsuits against lenders, and hundreds of loan documents, loans often exceeded twenty percent interest and were “typically at least twice the size of the value of the used cars purchased, including dozens of battered vehicles with

36 Curbing, supra note 34, at 2. Some loan products or practices are nearly always predatory. For example, “loan flipping” is a predatory practice whereby lenders convince borrowers to refinance at frequent intervals (even several times in a single year). With each refinancing, penalties and refinancing fees are tacked onto the principle, and borrowers become trapped in negatively amortizing loans. McCoy, supra note 34, at 83; Curbing, supra note 34 at 2. Negative amortization means that the payment schedule is insufficient to cover interest, so the loan balance grows over time rather than shrinks, often making it impossible for borrowers to earn equity even with regular payments. McCoy, supra note 34 at fn 5; Curbing, supra note 34 at 91-92.

37 Curbing, supra note 34, at 2, 6. Another type of predatory loan folds debtors’ unsecured debt into their mortgage payments, stripping equity and making foreclosure a consequence of default on missed payments of what was previously unsecured debt. McCoy, supra note 34, at 83. Loans that refinance subsidized loans (such as Habitat for Humanity loans which charge no interest) often provide no economic benefit to the borrower tend to be predatory. McCoy, supra note 34 at 83. Credit related insurance products are also often sold predatorily—providing little or no benefit to the borrower and excessively increasing the total cost of the loan. For example, credit life insurance often takes the form of single-premium payment or lump sum, whereby the lender collects all premiums up front and adds the cost to the principal, greatly increasing both the loan balance and cost of insurance. Curbing, supra note 34 at 81, 86-88, n.85, 89, 91; see Sturdevant & Brennan supra note 34.

38 Jessica Silver-Greenberg & Michael Corkery, supra note 5.

39 Id.

40 Id.
mechanical defects hidden from borrowers.” 41 Recently bankrupt borrowers were common targets—their inability to file for bankruptcy again within eight years makes them attractive customers. 42 Fabrications on applications were common, such as displaying incorrect information about borrower income—many borrowers with income listed were in fact unemployed or were living on social security. 43 After default and repossession, many borrowers found themselves not only without a vehicle but also still deeply indebted, as lenders pursued collection actions for the remaining debt. 44 One bankruptcy lawyer explained that old car loans were often rolled into new loans, resulting in situations in which borrowers paid “$600 a month for a piece of junk.” 45

Payday loans are another example of a type of loan that tends to entrench its borrowers in debt and poverty. Interest rates of payday loans are typically between 400% and 600% annually, although some loans exceed 1,000% per year. 46 Most payday loan customers do not take out just one payday loan, but instead, being unable to repay the original loan, are forced to roll over these loans again and again, with ever increasing proportions of the repayment going to interest and fees. 47 Title lenders are another type of loan that is often predatory—over one third of title loan borrowers end up losing their car. 48

Recently, predatory lending has appeared in the education context. The CFPB recently sued ITT Educational Services Inc. for predatory lending, alleging that the school pushed students into high cost private loans, resulting in high odds of default. 49 The CFPB also sued Corinthian Colleges for a predatory lending scheme that involved

41 Id.
42 Id.
43 Id.
44 Id.
45 Id. supra note 5 (quoting bankruptcy lawyer Charles Juntikka).
46 Nathalie Martin, 1,000% Interest – Good While Supplies Last: A Study of Payday Loan Practices and Solutions, 52 ARIZ. L. REV. 563, 564 n.1 (2010).
47 Id. at 610.
pressuring students to take out private loans and illegally seeking to collect debt while students were still in school.\textsuperscript{50}

Sometimes the onerous contract terms or predatory practices relate to the collection of debt. In addition to the problem of the high cost of servicing debt, debtors face collection processes that threaten their wellbeing. Some lenders list borrowers’ possessions as collateral and then sell insurance on borrowers’ collateral that far exceeds its value. For example, CitiFinancial has listed as collateral and sold insurance on “fishing lures and tackle boxes, record albums, tents, sleeping bags, and lanterns,” even though it has acknowledged it would not seize the items in the event of default.\textsuperscript{51} In some cases, crucial services are suddenly cut off, as in the case of the water shut off in Detroit.\textsuperscript{52} Subprime auto lenders now disable vehicles for late payments, which may cut off transportation to work and children’s schools.\textsuperscript{53} As discussed in my previous paper, some collection methods interfere with debtors’ dignity and privacy.\textsuperscript{54} Lenders and third party debt collectors sometimes make innumerable harassing or invasive phone calls. An extreme example of offensive debt collection practices is the case in which a funeral home returned a body covered only in a sheet to the family’s front stoop when the family could not pay.\textsuperscript{55} In some cases, an individual’s debt is sold to more than one third party debt collector, and the individual continues to be harassed for repayment even after the debt has been repaid. In jurisdictions

\textsuperscript{50} CFPB Sues For-Profit Corinthian Colleges for Predatory Lending Scheme, CFPB (Sept. 16, 2014), http://www.consumerfinance.gov/newsroom/cfpb-sues-for-profit-corinthian-colleges-for-predatory-lending-scheme/.


\textsuperscript{52} Violation of the Human Right to Water and Sanitation in the City of Detroit, Michigan. Submission to the Special Rapporteur on the Human Right to Safe Drinking Water and Sanitation Regarding Water Cut-offs in the City of Detroit, Michigan.


\textsuperscript{54} See Ondersma, supra note 11.

without debt relief, individuals can be perpetually liable for mortgages and automobile loans even after the property has been repossessed; in Spain, for example, mortgage borrowers are saddled with the unpaid debt from their homes even after they lose their homes to foreclosure.\(^{56}\)

Finally, in some instances the onerous debt terms involve the mechanisms available for resolving problems with the consumer credit contracts. For example, mandatory arbitration clauses can cut off consumers’ ability to effectively challenge problematic credit terms.\(^{57}\) In addition, creditors may try to inappropriately collect debt, particularly when debt is sold to a third party that tries to collect debt after the statue of limitations has run, or even after the debt has been discharged in bankruptcy.\(^{58}\)

Although in some cases lenders conceal onerous terms or deliberately mislead borrowers, in other cases the terms are not hidden. Nevertheless, the consumer is unable to understand the terms, or simply does not notice the problematic terms. As has been discussed in greater detail below, it is becoming increasingly clear that consumers are subject to cognitive biases that make it difficult for them to adequately evaluate the risks of the contracts into which they enter.\(^{59}\)


III. THE CONSUMER PROTECTION APPROACH TO REGULATION OF CONSUMER CREDIT

Although some policymakers and nations in Europe have begun to view certain aspects of these problems as a human rights issue, this has not taken hold outside of Europe. In addition, no one has suggested that human rights be taken into consideration when crafting consumer credit regulation as a whole. Consumer protection has been the dominant framework for addressing concerns related to consumer credit.

Historically, the consumer protection approach has meant a focus on correcting market inefficiencies and combating predatory or unfair practices. Much of the reform sought in the consumer credit context has been designed to “level the playing field” between lenders and borrowers. These measures are most helpful in situations where predatory conduct is the sole or primary problem, but these measures

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60 As I begin to discuss in my previous paper, in some parts of the world, human rights language has already been invoked in the context of consumer credit. In Europe, policymakers have expressed a desire to incorporate human rights principles in responding to problems of over-indebtedness. Although there has not been explicit human rights work in the area of regulating consumer credit contracts, consumer rights have been “increasingly linked” to fundamental rights and human rights. BENÖHR, supra note 30, at 3 (citing A. Fagan, “Buying Rights: Consuming Ethically and Human Rights,” in J. Dine & A. Fagan (eds), Human Rights and Capitalism, A Multidisciplinary Perspective on Globalisation 115 (Cheltenham: Edward Elgar Publishing, 2006). Benöhr identifies a number of human rights as having implications for consumers, including the right to an adequate standard of living, the right to physical and mental health, the right to a fair trial, the right to freedom of expression, and the right to freedom of assembly. BENÖHR at 49-50. She discusses the right to an adequate standard of living in Art. 11(1) of the ICESCR, and the right to physical and mental health in Article 12 of the ICESCR, the right to fair trial in Article 6 of the ECHR, the right to freedom of expression in Article 10 of ECHR, and the right to freedom of assembly in Article 11 of the ECHR. As Benöhr argues, human rights can serve as a “counterweight” to the “predominantly economic- and market-based concept of integration of the EU.” BENÖHR at 53.

do not adequately mitigate problems associated with consumer desperation or consumer confusion. These reforms have been particularly non-responsive to situations in which debtors’ distress is caused by a combination of income shortfall and onerous terms, at least when the onerous terms are not predatory. Although there have been meaningful substantive reforms recently, these measures do not cover all consumer credit products everywhere. There has not yet been sustained insistence that all consumer credit contracts be scrutinized to ensure that they do not imperil debtors’ ability to meet his or her basic needs. In part this is because consumer protection advocates often feel compelled to defend substantive, protective regulation on economic efficiency grounds; that is, even if a proposed reform would help more individuals meet their basic needs, it would be rejected if overall wealth is reduced, even if under the proposal more individuals would be able to meet basic needs.

A. Consumer Credit Regulation Historically

Although many consumer credit regulations emerged from a consumer protection impulse,\(^{62}\) the protection of the market has been at least as salient in the development of consumer credit regulations as

has protection of the consumer. For example, although the Federal Trade Commission is charged with “protecting America’s consumers,” its mission is also overtly tied to protecting market efficiency. Its stated mission is to: “prevent business practices that are anticompetitive or deceptive or unfair to consumers; to enhance informed consumer choice and public understanding of the competitive process; and to accomplish this without unduly burdening legitimate business activity.” The FTC describes its function as “pursu[ing] the development of an international market-based consumer protection model, which focuses on protecting consumers from significant harm while maximizing economic benefit and

63 International consumer protection efforts are also tied to market concerns. On April 9, 1985 the Assembly of the United Nations adopted Resolution 39/248 establishing general principles for consumer protection, including protection from health and safety hazards, protection of economic interests, access to adequate information, consumer education, access to redress, and freedom to form consumer orgs and present views. G.A. Res. 39/248, § 2(3), U.N. Doc. A/RES/39/248 (April 16, 1985); see also E.S.C. Res. 1995/70, U.N. Doc. E/1995/70 (May 24, 1995). The United Nations later issued guidelines for consumer protection. Department of Economic and Social Affairs, United Nations Guidelines for Consumer Protection (2003), available at http://www.consumersinternational.org/media/33866/consumption_en.pdf. The statement of objectives preceding the guidelines makes clear that economic efficiency is a paramount concern: Objectives include “encourag[ing] development of market conditions which provide consumers with greater choice at lower prices,” Guidelines at I.1.(g), and “further[ing] international cooperation in the field of consumer protection.” Guidelines at I.1.(f). The general principles of the guidelines include protecting consumers from health and safety hazards, “the promotion and protection of the economic interests of consumers,” consumer access “to adequate information to enable them to make informed choices according to individual wishes and needs,” consumer education, access to effective redress, freedom to organize, and “the promotion of sustainable consumption patterns.” Guidelines at II. The guidelines include that admonition that for consumer protection is that “due regard should be given to ensuring that they do not become barriers to international trade and that they are consistent with international trade obligations.” Guidelines at III.10. The guidelines also focus on consumer education, promoting programs that “enable people to act as discriminating consumers, capable of making an informed choice of goods and services, and conscious of their rights and responsibilities.” Guidelines at III. 34.


consumer choice.”66 The FTC’s vision for the U.S. economy is one “characterized by vigorous competition among producers and consumer access to accurate information, yielding high-quality products at low prices and encouraging efficiency, innovation, and consumer choice.”67 The overall message is that consumers will be protected by 1) fraud prevention and 2) education/information, and protective steps will not be a burden to businesses. Many of its proposed solutions to consumer credit problems in the U.S. focused on “increase[ing] the amount of disclosures that consumers receive before each credit transaction.”68 There is little room in the mission of the FTC for substantive regulations that would prevent over-indebtedness caused by confusion or income shortfalls, and economic efficiency can trump concerns about fairness.

Indeed, specific FTC regulations focus on protecting the “reasonable” consumer, and expressly provide that unfair practices may be permissible if they serve the greater economic good. Section 5(a) of the FTC Act prohibits “unfair or deceptive acts or practices in or affecting commerce.” 69 Deception includes a “material representation, omission, or practice that is likely to mislead a consumer who is acting reasonably under the circumstances.” 70 Unfair practices are “those which cause, or are likely to cause, reasonably avoidable and substantial injury to consumers without any offsetting countervailing benefits to consumers or competition.”71 In other words, if a practice harms some consumers but benefits the

67 About the FTC, supra note 66.
70 Consumer Protection in the United States: An Overview, supra note 70, at 2; FTC Act 5(a).
71 Id. at 2; FTC Act 5(a).
In economy as a whole, such injury is acceptable. In addition, the “reasonably avoidable” condition suggests that if consumers could have avoided the harm by, for example, carefully reading the contract and opting out, no unfairness would be found.\textsuperscript{72} The FTC’s specific regulations evince this approach, as FTC Regulations such as Regulation Z and the Truth in Lending Act focus on increasing disclosures to consumers, and assume that consumers actually makes decisions based on review of the terms of various credit offers.\textsuperscript{73}

Beyond the FTC, consumer financial education was also viewed as a solution. The Office of Financial Education “develops and implements ‘initiatives intended to educate and empower consumer to make better informed financial decisions.’”\textsuperscript{74}

Prior to the passage of Dodd-Frank, there was limited regulation of even high cost, subprime loans. The Home Ownership Equity Protection Act of 1994 (HOEPA) did provide regulation for some subprime mortgages, but only institutions that were under the Federal Reserve (rather than the OCC or OTS) and even then only those institutions engaged in a “pattern or practice” of ignoring borrowers’ ability to repay were regulated.\textsuperscript{75}

Consumer protection advocates have also relied on common law contract law principles to mitigate hardship caused by consumer credit contracts, but common law principles are also designed primarily to challenge only procedural unfairness such as fraud or


\textsuperscript{73} See S. Blocklieb, R. Weiner, J.A. Cantone, & M. Holtje, Disclosure as an Imperfect Means for Addressing Overindebtedness, in CONSUMER CREDIT DEBT AND BANKRUPTCY: COMPARATIVE AND INTERNATIONAL PERSPECTIVES (Niemi, Ramsay, & Whitford, eds. 2009).

\textsuperscript{74} Consumer Protection in the United States: An Overview, supra note 70, at 16.

misrepresentation. Unconscionability—a contract common law doctrine that limits enforcement of contracts that are extremely unfair—is an exception, but most courts nevertheless require both both procedural and substantive unconscionability before declining to enforce a contract according to its terms.

Thus, consumer protection in the consumer credit context was historically focused primarily on the prevention of fraud, the improvement of disclosures to consumers, and enhancing consumer education. Regulation was designed primarily to reduce information asymmetries and insist on full disclosure; if consumers wish to make “bad” economic decisions after full disclosure, they were free to do so. The underlying assumption seemed to be that if consumers understood the terms, they would be sufficiently protected. That is, if they enter into a harmful contract but were aware of the risk of harm at the time they entered into the contract, then no regulation is necessary—presumably the consumer was adequately compensated (at least felt herself to be adequately compensated) for undertaking the risk. As a result (and as discussed in greater detail in subsection D) regulations and common law principles can do little to help consumers whose debt burdens are caused primarily by confusion or income shortfalls.

**B. Expansion of Substantive Regulation**

As widespread abuses in the subprime loan sector came to light, the Fed, OCC, OTS, and National Credit Union Administration agreed to accept new “Interagency Guidelines on Subprime Lending.” As John Pottow has noted, this regulation initially was

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78 See *Curbing Predatory Home Mortgage Lending*, supra note 34.

justified only to the extent such loans posed risks to the safety and soundness of banks. In the early 2000s, the OCC began cautioning their institutions against giving mortgages without analyzing borrowers’ ability to repay—however, such loans were not prohibited. Finally, the Fed issued regulations that prohibited issuance of mortgages without consideration of borrower ability to repay. However, the rule initially applied only to depository institutions and subsidiaries—not to other originators and affiliates. At the same time, more robust state regulation was preempted. Only in 2008, after home prices collapsed, did the Fed pass regulation expressly banning high-cost (prime plus 1.5%) loans made without consideration of borrowers’ ability to repay.

After the financial crisis, more robust, substantive regulation of consumer credit was achieved with the passage of Dodd-Frank and the Card Act of 2009. The crowning consumer protection achievement was the creation of The Consumer Financial Protection Bureau (CFPB), charged with protecting consumers of credit. The CFPB is responsible for conducting financial education programs; collecting, investigating, and responding to consumer complaints; collecting, researching, monitoring, and publishing information relevant to the functioning of markets for consumer financial products and services to identify risks to consumers and the

80 70 Fed. Reg. 77250 (Dec. 29, 2005) (proposed guidance) (“[O]ur concern is elevated with nontraditional products due to the lack of principal amortization and potential accumulation of negative amortization. The Agencies are also concerned that these products and practices are being offered to a wider spectrum of borrowers, including some who may not otherwise qualify for traditional fixed-rate or other adjustable-rate mortgage loans, and who may not fully understand the associated risks.”); Pottow, supra note 76.
84 Id. at 1908-11.
proper functioning of such markets; supervising covered persons for compliance with Federal consumer financial law; and issuing rules, orders, and guidance implementing Federal consumer financial law."86

The CFPB may “take any action allowable under the statute ‘to prevent a covered person or service provider from committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer.’”87

The scope of practices that the CFPB may challenge is very similar to practices prohibited by the FTC Act. For example, unfair practices are limited to those “likely to cause substantial injury to consumers which is not reasonably avoidable by consumers” and “such substantial injury is not outweighed by countervailing benefits to consumers or to competition.”88 Thus, harm is permissible so long as it is offset by sufficient countervailing benefit. “Abusive” practices are those which 1) “materially interfere with the ability of a consumer to understand a term . . . ” and 2) take “unreasonable advantage” of consumers’ lack of understanding, inability to protect their own interests, or reasonable reliance on the person who offered the product.89

In addition to establishing the CFPB and Office of Housing Counseling, the Dodd-Frank Act, with its “Mortgage Reform and Anti-Predatory Lending Act,” is designed to prevent predatory lending with a variety of new regulatory provisions. Mortgage originators now owe a duty of care to borrowers.90 Lenders must consider borrowers’ ability to repay91 (based on income, future income, and

91 Pottow, supra note 76, at n.183. As Pottow notes, this kind of “paternalistic” regulation is not at all foreign to U.S. law—securities agencies have long been required to analyze the “suitability” of investments for investors and are only permitted to recommend “suitable” investments. Conduct Rules, FINRA, available at http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/ConductRule
credit history among other factors) before issuing a home loan unless the mortgage is a “qualified mortgage.” Qualified mortgages must 1) have regular, substantially equal payments, 2) be term of under 30 years, 3) be underwritten using the maximum interest rate in first five years, 4) be income verified, 5) leave borrower with a debt-to-income ratio of less than 43%, and 6) have limited fees or points. If a mortgage is not a qualified mortgage, the lender must conduct the ability to repay analysis. If the mortgage meets these qualifications, the lender does not have to conduct the analysis. Mandatory arbitration clauses and single premium (lump sum) credit insurance are also prohibited for residential mortgages. Lenders’ violations of these provisions can be used as a defense to full repayment.

In addition to promulgating the ability to repay requirements in the mortgage-lending context, the CFPB is also seeking to require payday lenders to examine borrowers’ ability to repay before extending credit. Still, many other types of consumer lenders,


92 15 U.S.C. § 1639(c) (Dodd-Frank Act §§ 1411, 1412).


94 Id. High cost qualified mortgages (150 bps over prime for senior mortgages, 350 bps over prime for junior mortgages) are allowed a rebuttable presumption of ability to repay. Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), supra note 92. In addition, prepayment penalties are now prohibited for non-qualified mortgages, and for any residential mortgage the loan cannot include prepayment penalties unless the borrower has also been offered a loan without the penalties, and negatively amortizing mortgages can only be issued if accompanied by specific disclosures. Dodd-Frank Act § 1414. Balloon payments are prohibited on high cost mortgages if they ultimately will double payments. See 15 U.S.C. § 1639 (Dodd-Frank Act § 1432). Enhanced disclosures are also required, both at the time of the mortgage and with each monthly statement. 15 U.S.C. § 1638(a) (Dodd-Frank Act § 1419–20).

95 Dodd-Frank Act § 1414.


including auto lenders and lenders financing the purchase of household goods, are not required to consider debtors’ ability to repay. Credit card lenders are subject to a very limited ability to repay analysis: In 2009, the Card Act required lenders to scrutinize borrowers’ ability to repay—but the Act only requires that lenders ensure borrowers are able to pay the minimum balance, which is typically 2% of the outstanding balance. This can leave debtors trapped in repayment for years.\(^98\)

In addition to federal consumer protection efforts, states also employ a variety of consumer protection strategies, such as state attorney generals.\(^99\) Some states have also taken local action to curtail predatory lending. For example, eighteen states and the District of Columbia now ban payday loans.\(^100\)

As John Pottow has noted, other countries have robust, substantive restrictions on issuance of consumer loans, many involving consideration of debtors’ ability to repay and prohibition of issuance or enforcement absent certain conditions.\(^101\) Australia’s National Consumer Protection Act of 2009 imposes an affirmative duty of “responsible lending,” which includes the obligation to evaluate “whether the credit contract will be unsuitable for the consumer if the contract is entered or the credit limit increased.”\(^102\) The lender is required to consider whether the contract will pose a “substantial hardship” on the borrower.\(^103\) Austria, Hungary, Belgium, Ireland, Malta, and the Netherlands require mortgage lenders to evaluate whether the loan is suitable for the borrower based on his or


\(^{101}\) Pottow, supra note 76, at n.2.


\(^{103}\) Id. at Chapter 3, Part 3-1, Division 4, section 118(2)(a), Chapter 3, part 3-2, Division 3, section 131(2)(a).
her personal circumstances. Germany prohibits the “immoral overburdening with debts.” Sweden prohibits loans to borrowers who cannot repay, allowing private debt readjustment as a remedy for violations. At the EU level, the Consumer Credit Directive, designed to impose standardized lending obligations, is not as robust, although the directive emphasizes that creditors “should not engage in irresponsible lending or give out credit without prior assessment of creditworthiness . . .” The Consumer Credit Directive does not cover mortgages, although a 2010 Working Paper proposes an ability to repay directive, stating that the creditor should “thoroughly assess the suitability of credit contracts for the consumer’s personal and financial circumstances on the basis of sufficient information, where appropriate obtained from the consumer.”

C. Persistence of Market Concerns

Although there are now some substantive regulations for some types of loans in some jurisdictions, the majority of consumer credit

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106 Id. at 100.


regulation continues to be focused on “leveling the playing field” between lenders and borrowers. That is, the focus is on procedural fairness—ensuring that debtor consumers understand the contract terms and are able to make informed decisions, and ensuring that lenders do not conceal or obscure the actual terms of the credit contract. Proponents of more substantive consumer credit regulation are expected to (and typically do) defend their proposals on economic efficiency grounds. Despite evidence that the focus on “leveling the playing field” is not sufficient to prevent serious harms to consumers, the belief that the only legitimate purpose of regulation is to achieve optimal market functioning persists.

Recently, there has been important movement toward more substantive regulation that is concerned with consumer ability to repay, but despite these steps, consumer advocates are consistently required to provide reassurance that such regulation will not decrease market efficiency or increase the cost of credit. Consumer advocates often feel compelled to accept that a cost benefit analysis must be undertaken before the regulation can be proposed, and indeed, opponents of regulation often dispute protective regulation on the basis that it will increase costs or reduce access to credit. Even staunch defenders of consumer protection in the consumer credit context concede that proposed regulation should be evaluated under a “cost-benefit” analysis to determine whether the rules unduly increase credit costs or restrict access to credit.\textsuperscript{109} Indeed, some elements of the

\textsuperscript{109} See, e.g., William H. Meckling, Financial Markets, Default, and Bankruptcy: The Role of the State, Law & Contemp. Probs., Autumn 1977, at 23 (arguing that bankruptcy relief causes lenders to restrict supply and thus increases the cost of credit); Todd J. Zywicki & Joseph D. Adamson, The Law & Economics of Subprime Lending, 80 Univ. Colo. L. Rev. 3–4 (2008) (arguing that increase protection for debtors will increase the cost of credit and restrict access to credit). Also cite to Posner saying how some say regs do not give enough attention to market efficiency concerns.

\textsuperscript{110} See, e.g., \textit{A Tale of Three Markets}, supra note 34, at 1360 (“…the operative question is not whether narrowly targeted regulations would have some constraint on credit. Instead, the question is whether the potential harm from carefully crafted, targeted regulations outweighs the harm of maintaining the status quo. Thus, what is called for is a cost-benefit analysis to determine what suitability rules would best address the harm that occurs from predatory lending without inordinately limiting the availability of credit.”); \textit{Toward a Universal Ability to Repay Requirement}, supra note 101 (proposing that all consumer loans be subject to an ability to repay analysis, but also conceding misgivings about potential increases in the cost of credit: “I've got some misgivings about ability-to-repay requirements. They are paternalistic, and
CFPB regulation clearly accept problematic credit terms if such terms are economically efficient in that “countervailing benefits” offset the harm.111

Consumer credit regulation in Europe has also stemmed from a consumer protection approach. EU consumer credit regulation has focused on disclosure and consumer education.112 One scholar remarked that European consumer law “seems trapped in a market oriented perspective.”113 In the EU, consumer protection initially “was mainly used as an instrument to drive market integration.”114 Scholars advocated for greater focus on improving consumer rights and

they add costs that are hard to amortize for small-dollar-short-term loans. Nonetheless, it is time for consumer finance regulation to internalize the changes in the way the consumer finance market works.”).  

Markets in Financial Instruments Directive (MiFID) examines the services investment firms provide to the "average consumer." While the firm must account for the client's "knowledge and experience" with the requested financial service, the firm must at most provide a standardized warning in instances of doubt.  

Consumer Credit Directive aims to provide information to assist consumers understand important product characteristics through a standardized form. Additionally, the Directive provides a creditworthiness assessment, but "does not specify which consequences should be attached to a 'failed' creditworthiness test."

The Distance Marketing of Financial Services Directive also provides informational duties, similar to the Consumer Credit Directive.  

The Prospective Directive provides information to assist investors with making 'informed assessment[s]' of the issuer's "financial position and prospects."

The Directive on Mortgage Credit provides information in mortgage characteristics, similar to the Consumer Credit Directive, as well as an "extensive creditworthiness assessment." The creditor is required to examine the "consumer's ability to repay the credit" while accounting for personal circumstances and sufficient information.  

The Unfair Commercial Practices Directive "covers a wide range of B2C transactions before, during and after the transaction." It is especially related to advertisements and "precontractual information."

113 BENÖHR, supra note 30, at 77.  
114 Id. at 9.
consumer protection laws were enacted, but market goals were always in view.\textsuperscript{115} The Treaty of Maastricht of 1992 incorporated protection of consumer into objectives in Articles 3(s) and 129 (a).\textsuperscript{116} However, the treaty specified that consumer protection measures to be adopted should be “within the framework of the international market.”\textsuperscript{117} EU consumer efforts have focused on a “full-harmonization approach to consumer law” and preclude “more stringent national consumer protection.”\textsuperscript{118} These measures have also “mostly been adopted as a tool of market integration, and seldom for consumer protection per se.”\textsuperscript{119} The focus is on ensuring market efficiency rather than ensuring consumer safety.\textsuperscript{120}

The concerns highlighted in the UN Consumer Guidelines include the consumer’s right to dignity, distributive justice, participatory decision-making, and communal values. But even the UN Consumer Guidelines include “economic efficiency” among their list of concerns.\textsuperscript{121} These Guidelines focus on transparency, consumer literacy, and opportunities for redress.\textsuperscript{122}


\textsuperscript{116} \textsc{Bonöhr, supra} note 30 at 3 (describing 129(a)).

\textsuperscript{117} \textit{Id.} at 3, (describing 129(a)).

\textsuperscript{118} \textit{Id.} at 9. Too much focus on harmonization means it’s harder for member states to adopt stricter, more protective regulations. \textit{Id.} at 5; see \textit{e.g.}, S. Weatherill, European Consumer Law and Policy, (Cheltenham: Edward Elgar Publishing, 2005); H-W Micklitz, “European Consumer Law,” in E. Jones, A. Menon & S. Weatherill (eds.), \textit{The Oxford Handbook of the European Union} (Oxford: OUP, 2012), pg. 15-18: variety of national consumer protection approaches, then 1957 Treaty of Rome aimed at economic integration, focus on improving market. Drafters “assumed that consumer protection would automatically result” and didn’t consider consumer policy necessary. S. Weatherill, EU Consumer Law and Policy (Cheltenham: Edward Elgar Publishing, 2005), p. 4. Under Article 100 EEC (later 94 and 95 EC) the European Council of Ministers could harmonize legislation when “in conflict with the development of the internal market,” \textsc{Bonöhr} at 19. Any difference in national law that was barrier to trade can only be permitted if satisfying “mandatory requirements” relating to e.g. public health or defence of the consumer. Cassis de Dijon case of 1979, Case C-120/78 [1979] ECR 649. Concerns about “regulatory race to the bottom.” \textsc{Bonöhr} at 21. For more on EU developments and full harmonization trends see \textit{id.} at 21-35.

\textsuperscript{119} \textsc{Bonöhr, supra} note 30, at 9.

\textsuperscript{120} \textit{Id.} at 83 (describing how the full harmonization approach has been based on market efficiency rationales).

\textsuperscript{121} \textit{Id.} at 84.

\textsuperscript{122} \textit{See, e.g.}, \textit{Microfinance Consumer Protection Guidebook} (Oct. 2007), \textit{available at} http://www.bu.edu/bucflp/files/2012/01/Microfinance-Consumer-Protection-
European Union regulations have also focused predominately on market efficiency. The primary goal of the European Union is “competitive social market economic.” However, the list of EU objectives does include combating “social exclusion and discrimination” as well as the promotion of “social justice and protection.” The Treaty names three consumer rights: 1) the right to information, 2) the right to participate in policy debates, and 3) the right to access justice. Consumer protection is also mentioned in Article 36 of the EU Charter, but the Charter says only that “policies shall ensure a high level of consumer protection.” The International Consumer Protection Enforcement Network is an international agency comprised of consumer protection authorities from fifty countries.
The agency focuses primarily on fraud prevention, offering information on current scams, and organizing a “fraud prevention month.”

There are numerous EU regulations addressing consumer credit and over-indebtedness. The European Banking Authority is charged with addressing concerns related to consumer credit and over-indebtedness. Each member state also has its own consumer protection standards, most of which were initially more rigorous than the EU minimum. However, the EU emphasis has increasingly been on “maximum harmonization,” which has the effective of precluding individual member states from enacting regulations that are more protective than the harmonized principles provide. Nonetheless, there has been some pushback from consumer protection advocates to permit more robust consumer protection laws. The European Commission’s 2008 Credit Agreement Directive represents one effort to achieve harmonization in the consumer financial protection arena. The express goal of the CAD was harmonization, and the focus was on the “pre-contractual disclosure of information.” The CAD sought to increase consumer information, and also permitted repayment or withdrawal from a contract within 14 days. More radically, the CAD also included an “obligation to assess creditworthiness.” However, there are no sanctions for non-compliance with this provision. Thus, the focus

128 Id.
129 BENÖHR, supra note 30, at 111.
132 Id. at 116 (“EU approach may be evolving from the narrow market-building approach of its language.”).
133 Id. at 116.
134 Id. (citing COM(2004) 747 final, 2002/0222 (COD), Brussels, 28.10.2004); Id. at 119 (citing Amended proposal for a Directive on the harmonization of the laws, regulations and administrative provisions of the Member States concerning credit for consumers).
135 Id. at 117.
136 Id. at 118.
137 Id. at 120 (citing Art. 8 of Consumer Agreements Directive).
138 Id. at 120-22.
continues to be—in the U.S. as well as abroad—on “leveling the playing field” by combating procedural defects such as fraud and non-disclosure.

D. Weaknesses in Current Approach

There are two significant gaps in the current approach to consumer credit regulation. First, the persistent primacy of the “leveling the playing field” approach to consumer credit means that much regulation does not address some of the key problems with consumer debt—specifically, it does not address either consumer confusion or consumer desperation. Second, partly because consumer protection has been amenable to economic efficiency concerns, there has not been insistence on a basic level of protection for consumer debtors in all loans and all jurisdictions. Thus, while substantive regulation has emerged in some places, there are many jurisdictions and types of loans that are not covered. This creates a risk that problematic consumer loans will simply migrate to less protective products and jurisdictions.

1. Problems With “Leveling the Playing Field”

It has begun to become clear that preventing fraud and information asymmetry is insufficient to prevent onerous loans and situations of severe over-indebtedness. There are two reasons that increased disclosure, transparency, and fraud prevention are insufficient to address the harms associated with over-indebtedness. First, even when the lender includes complete, clear, and accurate disclosures, consumers may nevertheless be confused about the cost of the credit product or about other salient terms. Note that this concern is relevant even under a pure economic efficiency analysis, because this confusion is a market inefficiency. Second, even when the consumer is not confused, he or she may accept onerous terms out of desperation. This problem is not serviced by a market-based argument, since this problem can occur in a perfectly functioning market.

i. Consumer Confusion Even If Disclosures are Adequate
Sometimes lenders purposefully generate consumer confusion, but it may also be the case that consumers are confused even in cases with clear and complete disclosures. Studies indicate that even with excellent disclosures, consumers are still highly prone to confusion and manipulation.\(^{139}\) First, the consumer may not understand financial terms. Numerous studies have shown that most consumers have difficulty answering even basic financial questions.\(^{140}\) Second, consumers may be pressured into accepting an unfavorable loan even when they understand the terms—even with effective disclosures consumers are “still prone to succumb to the aggressive marketing and advertising of lending organizations.”\(^{141}\) Consumers also suffer from cognitive biases. They underestimate the risk of default and overestimate the chance of positive financial changes.\(^{142}\) If they do not perceive a risk of default, they may ignore all terms related to default.

Consumer confusion could possibly be adequately accounted for under a modified market-based analysis that does not assume a rational actor model, but the historical focus on “leveling the playing field” between lender and borrower by increasing disclosures and preventing fraud does not adequately account for this concern.


ii. Consumer Desperation

Even when consumers do understand the terms of the contract and are not being manipulated by clever marketing or sales tactics, they may accept onerous terms out of desperation. For debtors who are desperate for cash to acquire food, make rent or car payments, avoid water shutoff, or pay for a medical service, going into debt may be necessary—and they may accept the loan on whatever terms it is offered, even if they understand that they are getting a bad deal. The Pew Trust payday lending study demonstrates this: over a third of borrowers would have accepted the loan on any terms offered.143 That is, the borrowers’ sense of desperation for cash today was enough that they would have chosen to take out the loan even on egregiously harsh and unfair terms. In some instances, debtors’ income may at one point have been sufficient to meet basic needs, but the cost of servicing debt needed to cover a temporary income shortfall has rendered the individual chronically unable to meet basic needs. Again, this situation can arise absent fraud and abuse, and with full disclosure and full understanding of the debtor.

Sometimes the harm to debtors is caused by an unavoidable income shortfall, but the credit terms offered substantially exacerbate the economic harm. This can happen with or without fraud, and with or without information asymmetry. Unfortunately, for some households, incurring debt is the only way to meet basic needs. For other households, income is sufficient to meet basic needs, but a sudden emergency, such as a medical issue, family break-up, or job loss requires the family to incur debt. In either case, the cost of servicing the debt can contribute to decreased ability to meet basic needs. Some families cannot meet their basic needs due to income shortfall regardless of whether they incur debt. However, in many cases, the inability to meet basic needs is a combination of income shortfall and heavy debt servicing costs. In many cases income may be sufficient to meet basic needs if debt were discharged or deemed uncollectible.

The root problem, in many instances, is that basic needs are unaffordable, particularly when individuals face unexpected expenses.

If the government is both able and willing to subsidize the cost of basic needs, consumer debt need not be incurred to satisfy these requirements. In many cases, however, government aid is insufficient. Creditors are often there to fill in the gap between income and expenses. However, the cost of this credit is often too high to be sustainable. There are thus two problems: the initial cost of the basic need is too high, and the cost of servicing the debt that accumulated from failing to pay the initial cost is too high, increasing the gap between income and basic expenses.

Unfortunately, the norm of efficiency does not require alleviation of situations of acute suffering. In other words, if ten percent of affected consumers experience severe hardship but the remaining 90% are able to accumulate more wealth than they would absent the infliction of hardship, such hardship is acceptable as long as the total wealth generated is greater under that scenario.

2. Gaps in Protection

Not only does the current approach continue to be susceptible to economic efficiency concerns, that do not accurately account for the problems facing debtors, but the current approach has also not sought to provide a floor of protection for debtors that prioritizes debtors’ ability to meet their basic needs. As a result, the current approach poses a serious risk that 1) jurisdictions and regulators will compete to offer the most lenient regulations to lure lenders (the proverbial “race to the bottom”), and 2) lenders will flock to the loan products and jurisdictions with the most lenient regulations. The level of protection from onerous credit terms varies substantially depending on the jurisdiction and on the type of loan. As a result, creditors can move their activities to the most lenient jurisdiction, or can focus their activities on products that are not as heavily regulated. Indeed, jurisdictions may compete to offer lenient terms, as was the case with North Dakota’s lack of usury cap of which any lender operating at nationally can take advantage.144

Consumer protection regimes vary substantially from state to state and country to country—some jurisdictions want extremely robust consumer protection regimes. Other jurisdictions are more

144 Marquette Int’l Bank v. First of Omaha Corp. 439 U.S. 299 (1978) (banks can charge the interest rate of the state in which they are chartered regardless of where they conduct business).
interested in providing incentives for lending businesses to come, which can mean creating a landscape that is the most profitable for lenders rather than protective of consumer interests. Jurisdictions may be tempted to ease standards to lure lenders, and lenders are extremely adept at migrating to the most permissive avenue for lending. This phenomenon was evident in the run up to the crisis, with financial institutions shopping for the most permissive regulator, and regulators easing restrictions so as to maintain the membership of their financial institutions. Several U.S. states have struggled to aggressively target predatory lending practices for fear of losing business and harming consumers, as lobbyists threaten will occur. Between 2002 and 2006, the subprime lender Ameriquest gave $20.5 million to various state and federal political groups. Similarly, Countrywide donated $2 million in campaign gifts and spent $6.7 million lobbying in Washington.

Sometimes, protective legislation in one jurisdiction will encourage flight to a more lenient jurisdiction. Although the Consumer Financial Protection Bureau can address predatory practices in the United States, and the Federal Reserve Board can address matters that implicate safety and soundness, neither the Fed, nor the CFPB address behavior of U.S. based financial institutions that operate abroad.

Just as regulation varies from jurisdiction to jurisdiction, it also varies from credit product to credit product leading to gaps in protection. Current regulations that have bite, such as the “ability to repay” requirement for high-cost mortgages in the U.S., are not applicable to all kinds of consumer loans, and are not applicable across all jurisdictions. Although the CFPB is able to issue rules related to consumer financial laws, the agency does not have unfettered

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145 BENÖHR, supra note 30, at 21 (mentioning concerns about “regulatory race to the bottom”).
146 Kathleen Engel & Patricia McCoy, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS (2011) (describing the competition between the OCC and OTS to offer the most permissive mortgage lending rules that occurred in the run-up to the subprime mortgage meltdown.
149 Id.
discretion to ensure consumer protection. The CFPB is required to consult with federal banking regulators in proposing rules, and if the regulator objects in writing the CFPB must address the objection. Further, the FSOC may decline to accept a rule if it determines, by a two-thirds vote, that the regulation would “put the safety and soundness of the . . . financial system [of the United States] at risk.” The CFPB also does not have jurisdiction over most auto loans. Finally, although certain high-cost mortgages now include an “ability to repay” requirement, that requirement does not cover most mortgages and does not cover any other types of loans. The Card Act Ability to Repay requirement covers credit cards, but only ensures that the debtor can afford to repay the minimum balance, which can leave the debtor trapped in repayment and unable to close the gap in income for years.

Predatory lending is not limited to the United States. Banks have been particularly eager to export profitable subprime lending models to reach the many millions of consumers worldwide with untapped credit-based spending capacity. While there have been efforts to crackdown on predatory and near-predatory lending at the national level, lenders have taken nefarious lending models to countries with even less robust regulatory regimes. Citigroup, via CitiFinancial, and HSBC, via Household Financial, were the first to bring their subprime lending global. JP Morgan Chase also participated in the subprime market abroad by purchasing a subprime credit card portfolio from Providian Financial.

CitiFinancial operates in 140 countries. Travelers Group merged with Citicorp in 1998, and Citigroup acquired Associates,
another entity accused of predatory practices, in 2000. Citigroup’s subprime lending subsidiaries including Associates and Commercial Credit were ultimately collectively rechristened CitiFinancial. CitiFinancial is actively expanding in Brazil, where it charges interest rates up to 40 percent, and South Korea, where it charges 30 percent. Citi and HSBC are competing for lower income consumers globally, particularly in Brazil, where HSBC and Citi markets its services to low income customers. To access credit, such low income consumers pay “up to six times higher than the central bank’s current reference lending rate of 26.5%.” GE Capital also offers subprime lending in a number of countries, including Australia, Japan, the Czech Republic, and South Korea. AIG has also joined the overseas subprime business. Although the subprime loans offered by lenders such as Citi-Financial have been justified as a more favorable option than loan sharks, Citi has, at least in India, used debt collectors which allegedly use aggressive tactics, including at least one case of a threat at knife point.

Predatory lending is also prevalent in the microfinance context. While initially viewed as a solution to poverty, microfinance loans can

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156 Matthew Lee, Consumer Protection in a Deregulation Network Economy 187 (2004). Citi-Financial was then brought to India, Brazil, and other emerging markets.
157 Id.
158 Michelle Guevara, Branching Out, 11 Latin Trade 20 (July 2003).
159 Domestic Banks Forced to Sit by as CitiFinancial Streaks Past, Korea Herald, July 30, 2002.
160 Anthony Dovkants, Brazil to Become Battleground for Giants Citigroup, HSBC, Dow Jones Newswires, April 20, 2003.
163 Domestic Banks Forced to Sit by as CitiFinancial Streaks Past, Korea Herald, July 30, 2002.
end up entrenching poverty if the repayment amounts are too high to be sustainable. Sometimes microfinance loan terms are such that it makes impossible for micro-enterprise to be profitable—in many cases, studies found, all of the income of the micro-enterprise was directed to servicing debt. Some microfinance loans were shockingly high. For example, Compartamos, one micro-finance company, revealed at its 2007 IPO that it was charging 195% interest. Its clients consisted primarily of poor women. Some communities experienced collective crisis. For example, a microfinance company in the Indian state of Andhra Pradesh collapsed in late 2010 “thanks to a deluge of personal over-indebtedness, defaults, and MFI losses.” In Bosnia, debtors who struggled to repay microloans ended up selling off family assets (land, housing, vehicles, machinery) and/or had to “divert other important family income flows into microloan repayment, such as remittance income and pensions.” Many debtors were trapped into taking out multiple microloans to repay previous loans, “building up a mountain of personal debt that at some point needed to be repaid.”

There is no global regulator tasked with monitoring the lending practices of financial institutions. The only regulator with global scope is the Bank for International Settlement’s Basel Committee for Banking Supervision (BCBS), which orchestrates the Basel Capital Accords. However, the Bank does not address allegations of predatory

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166 Id. at 19.
167 Id.
168 Id. at 20-21.
170 *Microfinance and the Illusion of Development, supra* note 168, at 20-21. Neoliberal position “that the ‘opportunity’ and ‘freedom’ to establish a new enterprise is all that really counts, and not other conditions, such as the capabilities of the entrepreneurs involved or if there is a real demand for their simple outputs . . . ,” *Microfinance and the Illusion of Development, supra* note 168, at 21. Senior managers of microfinance companies like Compartamos in Mexico and SKS in India made tens of millions; gains were not to clients but enriched those at the top of the organizations. *Microfinance and the Illusion of Development, supra* note 168, at 26.
practices. In addition, even if predatory practices were targeted, activity that occurs outside depository institutions—in the shadow banking sector—would not be under the jurisdiction of the BCBS.

IV. A HUMAN RIGHTS APPROACH TO CONSUMER CREDIT

Part II demonstrated that there are serious problems associated with consumer credit, and that these problems can arise due to onerous debt terms, income shortfalls, or both—and can arise even absent predatory lending behavior. Part III demonstrated that the current approach to consumer credit regulation continues to be driven primarily by economic efficiency concerns, does not adequately respond to problems stemming from consumer confusion or consumer desperation, and leaves substantial gaps in protection because not cover all products and jurisdictions are covered. The remainder of this paper argues that a human rights approach to consumer credit can mend some of the weaknesses and gaps in protection I have identified. I begin by explaining what a human rights framework offers as a tool for filling some of the gaps in the current approach. I then discuss more specifically precisely how human rights are implicated in consumer credit problems. Finally, I address the existing mechanisms for ensuring that human rights concerns are considered in the consumer credit context.

A. Defining a Human Rights Approach to Consumer Credit

To persuade you to consider the human rights implications of consumer credit issues, I must demonstrate what a human rights approach to consumer credit would entail. First I must explain precisely what I mean by human rights, and offer a theory of human rights. As Amartya Sen articulated in Elements of a Theory of Human Rights, human rights are ethical demands whose importance relates to the “significance of the freedoms that form the subject matter” of

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171 CONSUMER PROTECTION IN A DEREGULATION NETWORK ECONOMY, supra note 159, at 197.
172 Amartya Sen, Elements of a Theory of Human Rights, 32 PHILOSOPHY & PUBLIC AFFAIRS 315 (Fall 2004). Sen contrasts the ethical demands of human rights with legal demands, although explains that these ethical demands can give rise to legislation.
these demands. To qualify as a freedom that generates ethical demands in the form of a human right, the freedom to be protected (e.g. the freedom from discrimination, slavery, hunger, etc.) must carry “special importance” and must also be socially influenceable—that is, actions of individuals and groups must be capable of helping to secure that right. What then, is the consequence of identifying a human right? Sen goes on to explain that human rights “generate reasons for action for agents who are in a position to help in the promoting or safeguarding of the underlying freedoms.” This action includes not only legislation, but also “public recognition and agitation;” that is, naming the right and pressuring governments or businesses to respect the right. Sen also holds that difficulty in realizing a right, particularly social and economic rights such as the right to be free from hunger, does not mean that there is no such right. The right may not correspond to a “perfect obligation” (i.e. a clear mandate to refrain from conduct, such as enslaving another person) but may include imperfect obligations, that is, the obligation to “consider what [one] can reasonably do” to secure or advance that particular freedom.

This approach to human rights includes more than the official international human rights organizations and instruments (such as the United Nations and regional human rights bodies); it is a recognition that human rights are obligations that precede and inform the formal international human rights structure. Of course, the formal human rights system and its enforcement mechanisms are extremely relevant in terms of determining the nature of implementing the human rights approach that I propose, and I discuss this in detail in Part V.

The purpose of identifying consumer credit as an area in which human rights are at stake is to make clear that we have obligations, even if these obligations are not legal obligations. What each person’s obligation is with respect to a given right varies considerably depending on that person’s position. As Sen explains,

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173 Sen, supra note 173, at 319.
174 Id.
175 Id.
176 Id.
177 Id. at 320.
178 Id. at 321. Finally, what gives human rights their universal nature is their survival under the scrutiny of unobstructed discussion, internationally. Id.
“[T]he recognition of human rights is not an insistence that everyone everywhere rise to help prevent every violation of every human right no matter where it occurs. It is, rather an acknowledgement that if one is in a plausible position to do something effective in preventing the violation of such a right, then one does have an obligation to consider doing just that.”

In the consumer credit context, legislatures then have an obligation to consider consumer credit legislation that protects and promotes human rights. Examples include regulation preventing discriminatory credit terms (including the credit adjustment terms reached in insolvency systems), regulation protecting debtors’ privacy rights, and regulation that seeks to protect debtors’ right to meet their basic needs with dignity. Academics like myself have an obligation to consider policy or regulatory proposals that work to protect and promote human rights; that is what I endeavor to do in section C below, and will continue to pursue in subsequent articles. Human rights organizations and consumer advocacy groups will use different tools; they can also make policy proposals, monitor countries, states, and companies, and engage in “active agitation.” This shaming mechanism can be an incredibly powerful tool, and can hasten both regulatory response and business compliance.

B. Benefits of a Human Rights Approach to Consumer Credit

I have identified at least two major weaknesses with the current approach: First, under the current approach, regulations are subject to scrutiny based on economic efficiency concerns, and the “leveling the playing field” focus does not adequately address many of the problems associated with consumer credit, particularly those stemming from consumer confusion or consumer desperation. Second, consumer protection has not insisted on at least a minimum level of protection for debtors, and the goal of protecting debtors’ basic needs has been less important than wealth maximization. Human rights principles are the most apt tool currently at our disposal to address these gaps. I identify four benefits here: first, human rights offers a universally

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179 Id. at 341. “It is still possible that other obligations or non-obligational concerns may overwhelm the reason for the particular action in question, but that reason cannot be simply brushed away as being “one of one’s business.”

180 Id. at 343.
comprehensible rhetorical framework that is applicable to consumer credit problems; second, human rights is capable of establishing a fundamental floor of protection that should be honored in every jurisdiction and cannot be removed or withheld on economic grounds; third, human rights prevents a race to the bottom because it has universal applicability, and fourth, human rights claims are powerful arguments that can alter business behavior to better protect consumers. After discussing these benefits, I will provide an illustration of a proposal to show how a human rights framework can be used to address consumer credit problems: specifically, I suggest that contracts that are substantially likely to cause debtors to be unable to meet their basic needs should be unenforceable.

1. Human rights offers a universally comprehensible rhetorical framework

The first benefit of a human rights approach to consumer credit is that human rights language offers a rhetorical framework for approaching these issues. The language of human rights is the framework applicable to consumer credit issues that is the most widely accepted; that is, it constitutes a universal language applicable to consumer credit matters. Human rights principles, while not uniformly and perfectly accepted, are the most universally accepted principles that can aid in responses to consumer credit. As it stands, the singular universal language with applicability to consumer credit matters is the language of economics, which has not proved up to the task either of adequately protecting debtor or creditor interests or of preventing broader economic distress. While consumer protection principles are gaining traction, they vary widely from jurisdiction to jurisdiction and do not yet constitute a commonly understood or accepted language. Human rights offers an established framework that is accepted by many countries, policymakers, and even businesses, and is the best available tool for working with and bolstering the consumer protection approach to consumer credit regulations.

General contract law principles also vary from jurisdiction to jurisdiction and, therefore, cannot constitute a universal rhetorical framework. For example, unconscionability is another tool that has been used to challenge problematic consumer credit contracts. However, there is substantial variation from jurisdiction to jurisdiction in what
constitutes unconscionability. Further, this remedy would not reach many instances of hardship caused by consumer credit contracts, as unconscionability only serves as a defense to contract enforcement if some procedural unfairness in bargaining occurred—substantive unfairness is insufficient. In addition, if a contract is sold to a third party the holder in due course doctrine may prevent the defense from being used. Human rights offer a powerful existing rhetorical framework that has universal applicability. Although there is not perfect agreement about the identification of these rights and the content of these rights, the human rights framework itself offers a platform on which to work toward convergence regarding which rights have “special importance” and can be influenced—and how they can and should be influenced. Consumer protection organizations, academics, judges, legislatures, and policymakers around the world all have access to this framework: human rights is the only applicable framework outside of economics that approaches universal relevance.

2. Human rights provides a fundamental floor of protection that cannot be subordinated to economic efficiency concerns

The second benefit of a human rights approach is that economic efficiency arguments cannot be used to justify circumvention of substantive protections against consumer credit contracts that violate human rights. As we have discussed, consumer protection principles, but consumer protection itself has historically cast itself primarily in economic terms, and consumer protection advocates historically defended reform efforts on the basis that the efforts did not interfere with the market and instead only “ leveled the playing field.” Substantive reforms or proposed reforms that require more than procedural fairness are often dismissed as overly paternalistic and exceeding the “proper” function of regulation.

I am not suggesting that market efficiency goals are inappropriate. I am instead emphasizing that human rights should be honored even if there is an efficiency cost. A number of limitations to

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181 Mel Kenny, James Devenney & Lorna Fox O'Mahony, Conceptualizing Unconscionability in Europe: In the Kaleidoscope of Private and Public Law, in UNCONSCIONABILITY IN EUROPEAN PRIVATE TRANSACTIONS: PROTECTING THE VULNERABLE 377-99 (Mel Kenny et al. eds., 2010).
fully free markets have long been accepted—restrictions on the sale of organs, for example. Above the fundamental floor of protection, economic efficiency concerns are perfectly appropriate. Indeed, economic efficiency concerns may in some cases support more robust regulation than human rights principles require.

I am also not suggesting supplanting consumer protection work with human rights work. Consumer protection advocates have made crucial gains for debtors. Far from supplanting the work of consumer protection advocates, a human rights framework would bolster and enable existing consumer protection work. Indeed, existing consumer protection agencies are one method of satisfying many of the human rights concerns raised in the consumer credit context.

However, if consumer protection organizations can borrow from human rights language, and if human rights organizations can consider what kind of consumer credit regulation human rights principles might require, debtors’ basic rights will be better protected. Human rights cannot and should not be expected to be the sole tool for consumer credit regulation. Rather, human rights principles provide a minimum level of protection for debtors. Beyond this minimal level of protection, consumer protection advocates may wish to push for greater protection, and concerns about access to credit and the cost of credit will appropriately be taken into account. The function of human rights should be to provide a basic floor of protection, but few consumer protection advocates would accept these protections as sufficient. Nations should be free to provide more robust consumer protection. Human rights and consumer protection can work hand in hand—human rights provides a minimum level of protection, while nations remain free to experiment with varying degrees of consumer protection beyond this floor.

Precisely because human rights provides a non-negotiable floor of protection it can prevent the “race to the bottom” that can occur when only certain jurisdictions or products are subject to meaningful regulation. As discussed above, without universally applicable restrictions, jurisdictions or regulators may compete to offer the most lenient terms in order to draw lender business, as lenders may flock to the jurisdictions with the most lenient terms. Because human rights principles are universal, a human rights approach can prevent lenders from fleeing a jurisdiction with robust consumer credit regulation in order to enter a jurisdiction without consumer protection. International human rights obligations are crucial to establishing “core
minimum requirements” and clarifying the bounds of permissible conduct.\textsuperscript{183} Constitutions and statutory regimes vary wildly across nations, and international human rights law provides a universal standard and establishes a floor of minimal protections.\textsuperscript{184} The labor movement, anti-sweatshop movement, and environmental justice advocates have each effectively used a human rights framework to address abuses.\textsuperscript{185} These advocates have effectively argued that national regulation is insufficient to address abuses because of the global “race to the bottom” that ensues when one nation cracks down on a problematic practice.\textsuperscript{186}

This is particularly critical as multi-national financial institutions continue to exercise their wealth and influence to fight national regulations that may be necessary to comply with human rights obligations.\textsuperscript{187} Individual nation states may not be able to enact regulations capturing the lending activity of such entities operating abroad, particularly those operating through subsidiaries purporting to be independent.\textsuperscript{188} As Dinah Shelton has argued in the environmental context, given the lobbying power of large businesses and organizations, it is crucial that we have an “absolute limitation on domestic political decisions.”\textsuperscript{189} This is particularly true in nations like the United States where large banks are outsize contributors to politicians on both sides of the aisle. Even though substantial improvement was made in the regulatory landscape subsequent to the financial crisis, a number of loopholes and carve-outs remain. For example, the auto-lending lobby successfully extricated itself from the regulatory scope of the CFPB. And new proposed legislation seeks to chip away at the CFPB’s new mortgage regulations.\textsuperscript{190}

\begin{thebibliography}{190}
\bibitem{184} See \textit{Beyond Voluntarism}, supra note 184, at 11.
\bibitem{185} \textit{CONSUMER PROTECTION IN A DEREGULATION NETWORK ECONOMY, supra note 159}, at 191; specific cites to ILO, environmental justice articles.
\bibitem{186} \textit{CONSUMER PROTECTION IN A DEREGULATION NETWORK ECONOMY, supra note 159}.
\bibitem{187} \textit{Beyond Voluntarism, supra} note 188, at 11.
\bibitem{188} \textit{Id.} at 12.
\bibitem{190} “H.R. 5461 would also allow banks to charge more in upfront fees when they issue a mortgage while still qualifying for special treatment under the government’s "qualified mortgage" rules. A bank that abides by QM rules receives the benefit of
credit regulations are viewed not only in terms of consumer protection but also in terms of satisfying human rights principles, it is more difficult to justify exceptions to coverage.

Human rights principles also prevent constituencies from being excluded from protection—domestic law may provide that only citizens or legal residents may avail themselves of remedies designed to alleviate debt burdens. Under a human rights analysis, it would be inappropriate to exclude individuals from protection on the basis of citizenship or residency, because the right inures by virtue of membership in the human race rather than membership in a particular state.

4. A human rights approach provides substantial pressure on lenders to avoid hardship inducing consumer credit contracts.

Corporations and policymakers do not want to be accused of violating human rights. As a result, a human rights approach is beneficial for an instrumental reason: it offers a powerful incentive for legislatures and businesses to avoid consumer credit terms that cause debtors substantial hardship. Over 8,000 businesses in 145 countries have signed on to the UN Global Compact, which accepts that businesses should “support and respect the protection of internationally proclaimed human rights” and “make sure that they are not complicit in human rights abuses.” Businesses do not want to be perceived as human rights violators. It may be more effective, from a practical standpoint, to publicize a problematic lending practice as a human rights problem rather than merely in terms of generalized unfairness. Businesses may feel more urgency to respond to and remedy practices that may violate human rights.

C. Human Rights and Consumer Credit Problems

the doubt in court if a consumer challenges the loan as predatory. To qualify for QM treatment, banks must limit upfront fees to a certain percentage of the loan balance. The new bill would exempt some title insurance fees from that total, effectively freeing banks to charge customers more.” Zach Carter, House Votes to Audit The Fed... And Deregulate Wall Street, HUFFINGTON POST POLITICS (Sept. 17, 2014), http://www.huffingtonpost.com/2014/09/17/wall-street-deregulation_n_5838718.html?ir=Politics.
In the U.S., a handful of organizations and agencies charged with addressing human rights concerns have tackled consumer credit issues. For example, the Leadership Conference on Civil and Human Rights wrote a letter defending the creation of a robust Consumer Financial Protection Bureau. The Minnesota Department of Human Rights produced a documentary, “On the Margins: People and Communities Locked Out of the American Dream,” that addressed predatory loans, redlining, and other discriminatory consumer credit practices. The Michigan Welfare Rights Organization submitted a report to the Special Rapporteur addressing Detroit’s violation of the human right to safe drinking water and sanitation. In addition, ESCR-Net (an international network of human right organizations that focuses on economic and social rights) filed an amicus brief in the bankruptcy case arguing that Detroit will violate human rights obligations if it fails to ensure access to water. International human rights organizations have also taken on consumer credit concerns. The Human Rights Watch has issued reports on predatory lending on Indian reservations and Spain’s harsh foreclosure laws. Despite this emerging recognition of the bridge between consumer credit and human rights, there has been little analysis of how

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197 “Civil society in Spain has led the struggle on these issues. In particular, the Platform of Mortgage Victims (Plataforma de Afectados por la Hipoteca, PAH), a unique, nation-wide grassroots movement that frames its activism in human rights terms, has mobilized thousands of people and fundamentally shifted the public debate about mortgage debt.” Human Rights Watch Report, Shattered Dreams 8 (May 27, 2014), available at http://www.hrw.org/node/125667.
human rights inform consumer credit regulation and why a human rights framework is necessary.\textsuperscript{198} Aside from my previous paper, there has been no exploration of how human rights might inform consumer credit issues in the United States.\textsuperscript{199} In this section I will briefly review the human rights that are implicated in consumer credit issues, and then propose an example of consumer credit legislation that promotes human rights.

1. Human Rights Implicated in Consumer Credit Problems

The human rights I include as universally accepted human rights are those found in the Universal Declaration of Human Rights, the International Covenant on Civil and Political Rights, and the International Covenant on Economic, Social, and Cultural Rights.\textsuperscript{200} I identified ten human rights that are implicated in situations of overindebtedness: the right to an adequate standard of living, the right to healthcare, the right to work, the right to be free from incarceration for inability to pay debt, the right to be free from debt peonage, the right to be free from discrimination, the right to human dignity, the right to due process, and the right to property.\textsuperscript{201}

While my previous paper focused primarily on what nations can do to address human rights concerns at the post-default stage of consumer credit relationships, human rights principles are relevant to

\textsuperscript{198} Benöhr argues for a human rights framework to consumer protection in the E.U. She focuses briefly on consumer protection in the credit context in Europe. \textit{Benöhr, supra} note 30.

\textsuperscript{199} See discussion \textit{supra} note 59; \textit{Benöhr, supra} note 30, at 3 (citing A. Fagan, “Buying Rights: Consuming Ethically and Human Rights,” in J. Dine & A. Fagan (eds), \textit{Human Rights and Capitalism, A Multidisciplinary Perspective on Globalisation} 115 (Cheltenham: Edward Elgar Publishing, 2006)). Benöhr identifies a number of human rights as having implications for consumers, including the right to an adequate standard of living, the right to physical and mental health, the right to a fair trial, the right to freedom of expression, and the right to freedom of assembly. \textit{Benöhr} at 49-50. She discusses the right to an adequate standard of living in Art. 11(1) of the ICESCR, and the right to physical and mental health in Article 12 of the ICESCR, the right to fair trial in Article 6 of the ECHR, the right to freedom of expression in Article 10 of ECHR, and the right to freedom of assembly in Article 11 of the ECHR. As Benöhr argues, human rights can serve as a “counterweight” to the “predominantly economic- and market-based concept of integration of the EU.” \textit{Benöhr} at 53.

\textsuperscript{200} See Ondersma, \textit{supra} note 11.

\textsuperscript{201} \textit{Id.}
all stages of the consumer credit relationship. Nations’ regulation of consumer credit contracts implicates human rights issues whether at the contract stage, the collection stage, or the post-default stage. At the enforcement stage, each nation must determine the circumstances under which credit contracts will be enforceable. It is possible for a nation (or state) to conclude that it will not enforce a credit contract that interferes with human rights. If so, this has implications at the contracting stage; if lenders are on notice that certain types of loans will interfere with human rights and thus not be enforceable, this will limit the permissible contract terms. It is also possible for businesses to decline to enforce contracts in situations where human rights are imperiled. In addition, as discussed in more depth in my previous paper, there may be situations in which human rights principles call for debt to be discharged, perhaps through a formal insolvency process.

Many of the human rights are implicated not only in the context of responding to over-indebtedness, but at the contract formation stage as well. After all, the risk of a situation of over-indebtedness is created when the credit agreement is initiated. In addition to the human rights risks stemming from an overall situation of over-indebtedness, there are human rights concerns specific to individual contracts. First, a consumer credit contract may deprive a debtor of an adequate standard of living. Second, credit terms or practices may be discriminatory. Third, credit terms or collection practices may interfere with a debtor’s right to privacy. Fourth, contract terms or collection practices may violate debtors due process rights; for example, when mandatory arbitration clauses effectively preclude debtors from bringing claims against creditors.\(^2\) If a consumer credit contract imperils individuals’ human rights, human rights principles should come to bear not only on nations’ responses to over-indebtedness in general, but also on the entirety of the consumer credit regulatory landscape. Human rights principles can inform not only the type of debt relief that should be available, but also the types of contracts that the state should be willing to enforce, and the collection activities that the state should permit. In addition, states

\(^2\) See, e.g., Consumer Financial Protection Bureau; Arbitration Study Preliminary Results, available at http://files.consumerfinance.gov/f/201312_cfpb_arbitration-study-preliminary-results.pdf. The CFPB has already prohibited mandatory arbitration in residential mortgages, and may propose additional limits for other products, such as credit cards, checking accounts, and payday loans.
must provide an “effective remedy” for securing these rights, and absence of counsel in certain proceedings (such as eviction or bankruptcy) may violate this requirement.

Each of these potential human rights issues merits separate analysis. In subsequent papers, I will pursue specific problems and propose human-rights-influenced solutions to these problems. Presently I would like to propose a regulation that would explicitly incorporate human rights—the prohibition enforcement of contracts substantially likely to interfere with debtors’ ability to meet their basic needs. It is important to keep two considerations in mind: first, this is just one of many possible proposals that would incorporate human rights concerns; second, there are other proposals that, while not explicitly incorporating human rights rhetoric, in fact further human rights by protecting debtors’ due process and property rights.

2. Consumer Credit Regulation Designed to Promote Human Rights: An Example

Here I offer a proposal for consumer credit regulation that is designed to support debtors’ rights to an adequate standard of living. My proposal is this: contracts that are substantially likely to interfere with the debtor’s ability to meet his or her basic needs should be unenforceable. This proposal addresses one problem I have identified in this paper: situations in which individuals end up contracting to devote so much of their disposable income to servicing debt that they are unable to meet their basic needs. Under human rights principles, it is unacceptable for individuals to be able to contract to devote so much of their disposable income to servicing debt that they are unable to meet their basic needs as a result of the cost of credit. Human rights principles can thus be used to help prevent situations in which a credit relationship causes an individual to be unable to meet his or her basic needs. Under this proposal, lenders could be required to conduct the following query: Is this transaction substantially likely to interfere with the debtor’s ability to meet his or her basic needs? If the answer is yes, human rights principles would suggest that the debt should not be enforceable. This inquiry is consistent with consumer protection work currently proposed, but the human rights language offers an additional impetus and supporting framework. It should not be insurmountable for lenders to accomplish this, at least in the United States, where lenders already use underwriting software capable of
discerning factors relevant to debtors’ ability to repay the loan and still meet their basic needs. For example, to conduct the ability to repay analysis now required for residential mortgages, lenders are required to look at pay stubs, tax returns, credit history, and must determine the debtors current monthly debt obligations as well as their debt-to-income ratio. In the end, the underwriting standard may not be different from the one already required for residential mortgages; this proposal requires two additional things, however. First, the permissible debt-to-income ratio calculation must be such that the debtor’s disposable income is sufficient to meet his or her basic needs; if careful analysis shows that the underwriting standard meets this requirements, it would be sufficient to apply that formula. Second, the analysis must be done for all loans—under a human rights approach, there is no justification for excluding certain products or individuals from this protection.

The benefits of framing this proposal in human rights terms are 1) its universal application—arguments that not all individuals, products, or jurisdictions should be covered would fail because the purpose of the proposal is to promote human rights, and 2) its rhetoric: if it can be persuasively shown that human rights requires such a regulation, it would be bad policy, from a public relations standpoint, for businesses to oppose the regulation.

Again, just to be clear, this proposal is by no means sufficient to satisfy human rights obligations in the consumer credit context, and alone it is not even sufficient to ensure that debtors will be able to meet their basic needs; however, it is one example among many of legislation that would bring us closer toward a consumer credit regime that takes human rights seriously. While my proposal explicitly incorporates human rights—the right to an adequate standard of living or basic needs—proposed regulations need not explicitly incorporate human rights rhetoric in order to do work that in fact protects and supports human rights. Many other proposals could also bring us closer, without explicitly mentioning human rights. For example, the ability to pay proposals may also succeed in protecting debtors’ ability to meet their basic needs. Unconscionability doctrine is another tool; although it has weaknesses, these weaknesses should not prevent it from being deployed in cases in which it can be effective.

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203 A Tale of Three Markets, supra note 34, at 1299-1301.
Other regulations would be needed to ensure the protection of
due process rights, privacy rights, anti-discrimination rights, and other
human rights. There are a number of consumer credit related
proposals that in fact further debtors’ rights to process, property, and
other rights: efforts to prevent lenders from discriminating based on
race,\textsuperscript{204} efforts to ensure that debt relief is available to all regardless of
race (specifically, that African American debtors are not
disproportionately steered into chapter 13 bankruptcy filings, which
seldom offer debt relief),\textsuperscript{205} efforts to ensure access to counsel in the
defense of home or other property, efforts to better protect debtors’
privacy in debt collection and debt relief proceedings,\textsuperscript{206} and efforts to
limit the enforcement of mandatory arbitration clauses that would
interfere with debtors’ due process rights.\textsuperscript{207}

Finally, as discussed in my previous paper, nations’ obligations
related to consumer credit often turn in large part on the available
social safety net: that is, if nations’ are careful to ensure affordable
access to adequate food, housing, and water, debt relief may not be
necessary to satisfy these human rights. On the other hand, if nations
do ensure that basic needs are affordable and accessible, consumer
debt regulation may be required. Because I am a commercial law
scholar, my focus is on situations in which consumer credit situations
imperil human rights; of course; however, debtors may be dealing with
human rights concerns unrelated to consumer credit. Poverty creates
situations where individuals are without access to basic needs
including housing, healthcare, and water. Other scholars have spoken
specifically about the human rights obligations pertaining to situations

\textsuperscript{204} See, e.g., \textit{Credit Discrimination}, \textsc{Natl Consumer Law Ctr.},
\textsuperscript{205} See, e.g., Tara Siegel Bernard, \textit{Blacks Face Bias in Bankruptcy, Study Suggests},
differences in bankruptcy filings).
\textsuperscript{206} See, e.g., \textit{Consumer Privacy}, \textsc{Natl Consumer Law Ctr.},
of poverty. Even though poverty itself imperils human rights, it is important to ensure that consumer credit regulation (or lack thereof) does not exacerbate these problems or trigger other human rights concerns. In addition, consumer credit solutions may be a tool that at least partially remedies some of these concerns, particularly where debt is responsible for an individual’s inability to make ends meet. In the Detroit case, the state failed to provide affordable access to water in the first instance. The state could subsidize the provision of water, or could force utilities to bear the cost by limiting collection of unpaid debt and limiting water shut off as a remedy.

V. IMPLEMENTING A HUMAN RIGHTS FRAMEWORK

If we accept that human rights principles can inform the regulation of consumer credit, how specifically can this be implemented? This Part reviews some of the ways human rights obligations can be triggered in the consumer credit context. As Sen explains, legal action is not the exclusive or even necessarily the most important way of implementing a human rights framework in the consumer credit context. Of course, legal academics like myself will focus on legal proposals because that is the area of influence available to us. I will discuss other implications for consumer credit to show that a human rights approach is more expansive and includes a role for non-profit organizations, government agencies, and of course regulators and lawmakers themselves.

There are a number of ways in which human rights principles and obligations can play a role in consumer credit regulations. First, to the extent that the remedies upon default are legal remedies, the state is involved at the enforcement level. Although the consumer credit contracts do not involve “state action,” legal enforcement of debts is state action. Second, if credit practices that violate human rights are widespread, the government may have an obligation to pass or better enforce legislation prohibiting the conduct. Even absent an obligation for government to act, citizens can apply pressure to their representatives to take legislative action. Third, there is increasing

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209 Sen, supra note 173 at 319.
pressure on businesses to increase and recognize human rights. Even if businesses cannot be held accountable for human rights violations in a human rights court, consumers may nevertheless demand compliance with human rights principles.

A. Nation State Obligations

Article 2 Section 2 of the International Covenant on Civil and Political Rights states, “Where not already provided for by existing legislative or other measures, each State Party to the present Covenant undertakes to take the necessary steps, in accordance with its constitutional processes and with the provisions of the present Covenant, to adopt such laws or other measures as may be necessary to give effect to the rights recognized in the present Covenant.” Thus, some states may be under obligations to make sure that their laws pertaining to consumer credit respect human rights obligations. The International Covenant on Economic, Social, and Cultural Rights does not require the immediate passage of laws to give effect to its rights, but instead requires nations to endeavor to “progressively realize” these rights. Even if there is no binding obligation, however, states may wish to comply with human rights principles, particularly if they face pressure from constituents.

Because human rights principles already exist and in many cases nations have already indicated a willingness to comply with these principles, all that is needed is an articulation of the ways in which permitting or enforcing certain contracts may violate such principles.

Most human rights obligations will be implemented via regulations promulgated by nation states. In most cases, specific human rights legislation will not be required for states to carry out their obligations to ensure compliance. Indeed, although existing regulation falls short of satisfying human rights concerns, there are legislative measures that address human rights matters, even if they are not labeled that way. For example, contract and commercial law principles often address unconscionable conduct.

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211 Beyond Voluntarism, supra note 188, at 11.
212 Id. at 15.
prohibit discrimination, and consumer laws (including the new consumer financial protection bureau) also address predatory lending problems. Some states have passed domestic human rights legislation—for example, the U.K. passed the Human Rights Act, which adopts as domestic legislation and provides an enforcement mechanism for the European Convention on Human Rights. However, legislation does not have to be labeled under the human rights category to serve the function of satisfying human rights concerns.

Because the remedies upon default are determined at the time of contract, states may have an obligation (or can be pressured) to curtail the available contract terms on human rights grounds. Because enforcement of a debt involves state action, enforcement of certain debts would involve state interference with human rights. For example, I have suggested that the state should not permit enforcement of consumer credit contracts that are substantially likely to interfere with a debtor’s ability to meet his or her basic needs. I am not claiming that, at this juncture, a successful legal action could be brought against states that enforce such debts; I am, however, arguing that such enforcement does interfere with human rights principles, and that, if states wish to honor human rights principles, they should pass legislation prohibiting enforcement of such debts.

Human rights advocates and organizations have pressured states to comply with human rights principles, even when there may be no enforcement mechanism. For example, the Michigan Welfare Rights Organization submitted a report to the Special Rapporteur addressing Detroit’s violation of the human right to safe drinking water and sanitation. United Nations experts agreed that the Detroit water shut off violated human rights. In a UN Press release, Catarina de Albuquerque, an expert on the human right to water and sanitation at the UN, explained, “Disconnections due to non-payment are only permissible if it can be shown that the resident is able to pay

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214 Beyond Voluntarism, supra note 188, at 17.
216 Detroit: Disconnecting water from people who cannot pay – an affront to human rights, say UN experts, UNITED NATIONS HUMAN RIGHTS (25 June 2014), Catarina de Albuquerque, expert on human right to water and sanitation at UN.
but is not paying. In other words, when there is genuine inability to pay, human rights simply forbids disconnections. In the same press release, Leilani Farha, a UN expert on right to adequate housing, explained that in some cases human rights were threatened because children were removed by social services due to inadequate housing as a result of water shut off.

Farha also explained that the water shut off may also be discriminatory because African American families are disproportionately affected. These experts agreed that, according to international human rights law, states are required “to provide urgent measures, including financial assistance, to ensure access to essential water and sanitation.” The Detroit example suggests that a human rights framework can indeed be used to apply pressure to state entities in the United States to protect individuals in the consumer credit context. In that case, the human rights framework provides a more powerful justification for restricting that particular collection action of withholding water access. Advocates were able to argue not that individuals’ and families’ economic interests were being harmed but that their basic human rights were harmed.

B. Human Rights Responsibilities for Businesses

A discussion about the extent to which human rights consumer credit lenders have human rights responsibilities must be situated in the larger debate regarding the human rights responsibilities of businesses. John Ruggie, a UN Special Representative, proposed a framework addressing the human rights obligations of businesses that focuses on three goals: 1) the state’s obligation to “protect against human rights abuses by third parties, including business;” 2) business entities’ obligations to “respect human rights;” and 3) increased victim access to effective remedies. The Human Rights Council approved

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217 Id.
218 Id.
219 Id.
220 Id.
this “protect, respect, and remedy” framework in 2008. Ruggie was then tasked with “operationalizing” and “promoting” the framework, which ultimately resulted in the “Guiding Principles on Business and Human Rights,” endorsed by the UN Human Rights Council in 2011. The Human Rights Council then established a Working Group on the issue of human rights and transnational business enterprises which was charged with “disseminating and implementing” the Guiding Principles on Business and Human Rights.

The Guiding Principles provides some suggestions regarding how states should view their human rights obligations with respect to corporate conduct. The first principle emphasizes that it is the obligation of states to “protect against human rights abuse within their territory” including abuses perpetrated by business enterprises. The commentary clarifies that states are to “prevent, investigate, punish, and redress” such abuse. To carry out the mandate, the second principles states that states should “set out clearly the expectation that all business enterprises” in their jurisdiction are required to “respect human rights through their operations.” States are also expected to enforce laws that “have the effect of requiring business enterprises to respect human rights.” States must also ensure that other areas of law “such as corporate law, do not constrain but enable business respect for human rights.” In addition, states should provide guidance to business entities so that they understand exactly what their

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222 Id. The Guiding Principles specifies that the human rights obligations that business entities must respect includes, at a minimum, the International Bill of Rights (which includes the Universal Declaration of Human Rights, the International Covenant on Civil and Political Rights, and the International Covenant on Economic, Social, and Cultural Rights) as well as the fundamental rights set forth in the eight ILO core conventions. Guiding Principles at 14.
223 Id.
225 Guiding Principles, supra note 216, at 3.
226 Id.
227 Id.
228 Id. at 4 (3(a)).
229 Id. at 4 (3(b)).
human rights obligations are. Governments can turn to human rights institutions to ascertain whether their national laws “are aligned with their human rights obligations.”

In some states, human rights organizations or departments accept complaints for violations of domestic law that infringe on human rights principles. For example, Maine’s human rights commission accepts reports of violations of 5 M.R.S. § 4595, which provides for a right to freedom from discrimination based on age, race, color, sex, sexual orientation, marital status, ancestry, religion or national origin in any credit transaction” as well as for the “opportunity for every individual to be extended credit without discrimination” based on those factors.

The Guiding Principles on Business and Human Rights specify how business entities can be expected to comply with their human rights obligations. Human rights instruments may also oblige business entities both directly and indirectly. Indirect obligations arise because states are required to ensure that business entities respect human rights and are required to provide enforcement mechanisms for violations of human rights. Business entities fulfill indirect obligations by complying with the national laws that honor such obligations.

According to the Guiding Principles, business entities may also have direct obligations arising from human rights standards. Although controversial, imposing international human rights obligations on business entities is consistent with business entities’ ability to invoke international law, including treaties created through the United Nations. Businesses are expected to “avoid causing or contributing to adverse human rights impacts through their own

230 Id. at 4 (3(c)), 5 (commentary).
231 Id. at 6 (commentary).
233 Id. at § 4595 (2011).
234 Beyond Voluntarism, supra note 188, at 3.
235 Beyond Voluntarism, supra note 188, at 3.
236 Id. at 3.
237 Id. at 12.
activities” and to “address such impacts when they occur.” They are also to prevent human rights harms “directly linked” to their operations, even if they do not cause them. Human rights obligations of businesses are expected to be proportional to their “size and circumstances,” meaning that large entities will have greater obligation consistent with their greater capacity to address adverse human rights consequences. To meet their obligations, business entities must have “policies and processes” in place, including a policy commitment, due diligence, and a process for remediation of harms. Business entities should exercise due diligence on an ongoing basis, and should exercise due diligence as soon as possible upon the initiation of a “new activity or relationship,” including new products. This past summer the United Nations Human Rights Council narrowly voted to establish a working group to prepare a treaty that would impose human rights obligations directly on businesses.

In addition to formal actions, it is not unprecedented for international entities charged with protecting human rights to identify a practice as implicating human rights and then employ a variety of international and domestic mechanisms to combat the practice. For example, International treaties adopted by the Organization of American States, the OECD, and the Council of Europe require states to prohibit and punish bribes by individuals and businesses under its jurisdiction.

239 Id.
240 Id.
241 Id.
242 Id.
International bodies have limited authority over inappropriate business practices. National Contact Points—usually government offices in OECD member states—can receive complaints that the Guidelines have been violated. The Contact Point will then act as a mediator between the company and complaining party, seeking consultation from NGOs, other “relevant experts,” and Contact Points in other countries. If the Contact Point cannot resolve the dispute, they can refer the matter to the Committee on International Investment and Multinational Enterprises (CIME), which will then interpret the Guidelines. However, the decision does not judge the behavior of any corporation or even reveal its name; it merely provides guidance for future disputes.

Even in the absence of official obligations to comply with human rights principles, consumers can pressure businesses to comply. The impact of guidelines, monitoring, and reporting should not be understated, particularly in an age of social media where it is possible to rapidly spread awareness of human rights and violations and trigger boycotts of offending corporations. For example, a resolution successfully triggered consumer action on baby formula in the 1970s. Several NGOs, with support from UNICEF and the World Health

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245 The OECD Guidelines for Multinational Enterprises: Decision of the Council, OECD (June 2000), http://www.oecd.org/investment/mne/theoecdguidelinesformultinationalenterprisesdecisionofthecouncil.htm; “If issues arise in non-adhering countries, [the National Contact Point] will take steps to develop an understanding of the issues involved…”).

246 Id.


Organization, prompted the World Health Assembly to adopt the International Code of Marketing of Breast-milk Substitutes.\textsuperscript{249} The Code imposed direct requirements on manufacturers and distributors, including the obligation not to distribute gifts or articles that promote the use of breast-milk substitutes.

Often consumer public demands are more powerful than government or international action. For example, the UN Security Council’s prohibition on trade of diamonds supplied by certain rebel groups was insufficient to affect the trade; however, public reaction was integral.\textsuperscript{250} NGO campaigning on human rights abuses connected with the illicit trade in small arms has also resulted in actions designed to reduce such trade.\textsuperscript{251} Some international action has targeted the tobacco industry’s practices as a threat to the right to health. The WHO has issued a number of non-binding resolutions on tobacco use, and an international treaty on tobacco control is currently being negotiated by WHO members.\textsuperscript{252} The OECD (Organization for Economic Cooperation and Development) has revised its \textit{Guidelines for Multinational Enterprises} to state that businesses should “respect the human rights of those affected by their activities consistent with the host government’s international obligations and commitments.”\textsuperscript{253}

\begin{footnotesize}
\footnotesize Para. II.2 (members include Australia, Austria, Belgium, Canada


\footnotesize\textsuperscript{250} ICHR\, Report, \textit{supra} note 251, at 146; other cite. “NGOs and the media succeeded in drawing public attention to the connection between diamonds and the financing of conflict in Africa. The threat of boycotts led the industry to create the World Diamond Council, an entity charged with eradicating the trade of conflict diamonds.”


\footnotesize\textsuperscript{253} OECD Guidelines for Multi-national enterprises, available at http://mneguidelines.oecd.org/text/
\end{footnotesize}
Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxemborg, Mexico, The Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, UK, U.S.)

The potential for organizations or committees (such as U.N committees, human rights organizations, or consumer protection organizations) to capture the attention of and harness the power of consumers may be one of the most effective ways to stop human rights abuses, including economically devastating lending practices. For example, after ICP Fair Finance Watch opposed AIG’s acquisition of American General on the basis of its sale of credit insurance connected to subprime loans, AIG agreed to discontinue the practice. However, this assurance did not apply to its consumer finance offices outside the U.S. If organizations everywhere were on the lookout for human rights violations in the consumer credit context, this could facilitate well-coordinated opposition to problematic practices.

Financial institutions themselves have increasingly agreed to accept adherence of human rights principles. Barclay’s website proclaims: “We operate in accordance with the Universal Declaration of Human Rights and take account of other internationally accepted human rights standards. We also promote human rights through our employment policies and practices, through our supply chain and through the responsible use of our products and services.” Citi also promised to engage with human rights stakeholders to understand how banks can “operationalize” the “Protect, Respect and Remedy” framework and Guiding Principles. A total of eighty financial institutions have agreed to accept responsibility for the human rights implications of the projects that they finance.

255 CONSUMER PROTECTION IN A Deregulation NETWORK ECONOMY, supra note 159, at 191.
rights principles can deter corporations from engaging in behavior or selling products that conflict with these principles—this helps a “culture of compliance” to emerge. Media pressure can also be extremely effective to push corporations to change practices that conflict with human rights.

C. Human Rights Compliant Loans

With respect to state action, state regulation of business action, and business obligations, human rights can play a role whether or not there is an immediate remedy available. If nations (and states, in the U.S.) are focused on human rights principles in crafting consumer credit regulations, and if businesses are conscientious of human rights issues in crafting their contract terms, the remaining gaps in protection for consumer debtors can be filled.

Scholars can and should analyze whether the regulations they are proposing are consistent with human rights principles, whether or not they make the human rights discussion explicit. I have argued here that consumer loans not be enforced if, at the time of contract, it was substantially likely that the contract would render the debtor unable to meet his or her basic needs. Regulations consistent with this principle need not explicitly incorporate human rights language; however, if they fail to satisfy this condition they will run afoul of

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259 ICHRP Report, supra note 251, at 10.
260 Id.
human rights principles. Note that this does not mean that if this condition is satisfied human rights principles are satisfied—there are a number of other human rights principles implicated in the consumer credit context, and future work—both my own and, I hope, that of others—will suggest other ways in which consumer credit regulation can become more consistent with human rights principles. This includes, among many other human rights concerns, measures necessary to protect debtor privacy, measures necessary to prevent discrimination, and measures necessary to prevent due process violations.

Crafting regulations consistent with human rights principles is important even absent a cause of action for debtors victimized by regulation that runs afoul of human rights principles. For example, the United States’ failure to prevent consumer credit contracts that render debtors unable to meet their basic needs will not give rise to a cause of action because the U.S. has not ratified the International Covenant on Economic, Social, and Cultural Rights, and remedies are limited even in countries that have adopted the ICESCR. However, this does not mean that the human rights protected by the ICESCR are irrelevant to regulation. The U.S. did sign the treaty, which was adopted by the UN General Assembly. 261 Human rights language and principles can be used to push for reform consistent with these rights even absent penalties for failure to pass reform. For example, the right to water that advocates in Detroit cited is also a right contained in the ICESCR. 262 For countries that are signatories to the ICESCR, even more pressure can be applied, as governments are required to “progressively realize” the rights contained in the ICESCR. 263

262 The right to an adequate standard of living includes a right to water. UN Committee on Economic, Social, and Cultural Rights (CESCR), General Comment No. 15: The Right to Water (Arts. 11 and 12 of the Covenant) 3 (Jan. 20, 2003), available at http://www.refworld.org/docid/4538838d11.html.
Organizations working on consumer protection policy changes or organizations working on human rights issues could publicize the need for changes in contract terms. I have proposed a change in legislation, but pressure can also be applied on companies directly. Companies can be encouraged not to enforce contracts that have caused individuals to be unable to meet their basic needs. Indeed, this is a market opportunity for a forward-thinking financial institution to capture market share of socially conscious bankers who would prefer an institution that accepts human rights obligations—not just pays lip service, but actually implements policy changes.

VI. POTENTIAL OBJECTIONS TO A HUMAN RIGHTS FRAMEWORK

This Part addresses several of the potential objections to following a human rights approach to regulating consumer credit: A) A human rights approach will unduly increase the cost of credit or reduce access to credit, B) the risk that a guaranteed floor of protection will generate macro-economic or “systemic risk” problems, C) the risk that business interests will be either inadequately or excessively protected, and D) the risk that applying human rights to consumer credit concerns will “water down” human rights.

A. A Human Rights Framework Will Not Unduly Increase the Cost of Credit or Reduce Access to Credit

I have spent some time defending a human rights approach precisely because human rights principles are not subject to economic efficiency arguments; that is, protections are inviolable even if they have a cost. For some, this will be reason not to adopt a human rights approach—maintaining access to credit and the current cost of credit is considered critical. Economic efficiency purists would not accept my approach without proof that this approach would not raise the overall economic cost. Others may be more willing to increase the overall cost somewhat, but would not adopt the approach if it meant a drastic reduction in access to credit or drastic increase in the cost of credit. From a human rights standpoint, these concerns are still relevant, albeit not in a pure economic efficiency sense. Rather, the appropriate inquiry would be whether the approach would cause more individuals to be unable to meet their basic needs. That is, if refusing to enforce
contracts that were, at the time of contract, substantially likely to render the individual unable to meet her basic needs ends up causing another individual to be unable to meet her basic needs, this approach would be unacceptable. For example, if the regulation caused lenders not to lend in situations in which the extension of credit would in fact enable an individual to meet her basic needs, this would be a problem. However, the substantive regulation that currently exists around the globe has not had the effect of drastically cutting off access to credit or drastically increasing the cost of credit.

The controversial universal ability to repay approach—whereby all lenders of consumer credit must ensure debtors’ income and debt loads are such that repayment is possible—is not dissimilar from the analysis I suggest here. As discussed, other countries have successfully implemented universal underwriting standards in the consumer credit context that prevent loans that would cause debtors’ substantial hardship. In addition, studies indicate that if high cost loans were banned, individuals would pursue safer methods of closing income gaps. For example, a Pew study of borrowers in states where payday lending was formerly legal and now is impermissible found that “former borrowers are relieved that payday loans are gone and have not sought them elsewhere.” In states where payday loans are legal, payday loan borrowers indicated that if they did not have the option of payday loans, they would have cut back on expenses, borrowed from family or friends, delayed paying bills, or pawned or sold items.

Finally, in the long term, a human rights approach to consumer credit will include applying pressure on states to ensure that individuals are able to meet their basic needs. Whether this entails states devoting more resources to ensuring affordable food, health care, and housing, and/or whether this entails subsidizing credit so that it is not so expensive as to interfere with individuals’ basic needs, a human rights approach would not accept unaffordable credit in a

264 How Borrowers Choose and Repay Payday Loans, supra note 147; see also Nathalie Martin, Giving Credit Where Credit is Due: What We Can Learn From the Banking and Credit Habits of Undocumented Immigrants, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2587436, at 21.
society in which credit is at least sometimes necessary to ensure an adequate standard of living.

**B. A Human Rights Framework Will Not Generate Systemic Risk**

This concern is closely related to the preceding concern. Some may worry that a floor of fundamental protection for consumer debtors may pose macroeconomic risks; that is, access to credit will shrink, and the economy will be endangered as a result. However, there is reason to think that rather than increase systemic risk, providing a floor of protection for consumer debtors would decrease macroeconomic risk. An international human rights approach to financial regulation can reduce abusive and dangerous lending practices that generate and exacerbate global systemic risk. The global race to the bottom in lending standards generates systemic risk and one way to mitigate that risk is to police relationships between lenders and borrowers.

If lenders are giving loans that borrowers cannot repay and also meet their basic needs, these are loans that are likely to have high default rates, and they likely would not be issued unless the risk can be transferred. But if the risk is transferred it is not eliminated, it is just being moved to another area of the financial system, whether it ultimately falls on a different financial institution, investors, or some combination.

Human rights principles provide a commonly accepted (or at least the most commonly accepted) method of addressing microeconomic concerns internationally. Thus far, international regulation of consumer credit matters has been limited to macroeconomic concerns; specifically the three Basel Accords which address only the regulation of commercial banks. Thus, not only is the regulation exclusively macro but the international regulation is also focused only on banking activities and not on bank-like activities that may occur outside entities labeled as banks. The only way to ensure the safety of credit products is to regulate such products at a micro level, and human rights provides a basis for international coordination resulting in a floor of protection in the area of consumer credit products.

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Economists have not been able to devise macroeconomic solutions that eliminate risk. Regulations addressed at the macroeconomic level—quantitative easing, Basel III banking regulations, safe harbor proposals, most of the Dodd Frank provisions—suffer from a number of shortcomings. First, economists and scholars disagree about whether proposed regulations exacerbate or mitigate risk to the financial system. For example, some argue that the Basel III regulations are necessary for the safety of the financial system, while others argue that such regulations simply push risky activity into unregulated or under-regulated shadow banking entities. Similarly, with respect to protections for financial institutions (such as the bankruptcy safe harbors), some argue that protections are necessary to prevent systemic risk, whereas others argue that the protections exacerbate systemic risk. Second, it is impossible to know with precision the effect macroeconomic regulations will have, just as it is impossible to know the precise degree to which any given macroeconomic regulation is responsible for a particular economic outcome. This is to some extent true for any regulation, macroeconomic or not, but is exacerbated in the case of macroeconomic regulations because of the interconnectedness and complexity of the global financial system and real economies. Macroeconomic regulations cannot eliminate economic risk—they are more likely to purport to cabin but in fact shift risk—unless they are coupled with micro-economic regulations that thwart the creation or expansion of harmful economic products. As discussed, financial institutions are at risk of engaging in a global race to the bottom with respect to consumer lending and securitization practices. As regulation addresses one area of abuse or systemic risk, lenders move activities outside regulated entities or outside regulated countries.

There may be a real or perceived conflict between human rights and the macro-economic protection and individual human rights. The argument may be: the individual consumer is not protected unless the broader economy is protected. And indeed, it is perfectly appropriate, for that reason, for macroeconomic concerns to be taken into consideration, just as environmental concerns should be taken into consideration when considering cultural and social rights, for example. To combat the view that individual economic concerns were jeopardized by environmental protection, one advocate responded: “The view that mankind is part of a global system may reconcile the aims of human rights and environmental protection, since both
ultimately seek to achieve the highest quality of sustainable life for humanity within the existing global ecosystem.” Similarly, the appropriate goal of economic regulation is to achieve a sustainable global economy. While there may be narrow economic goals that would maximize short term gains only, or would maximize gains for only certain favored groups, a sustainable global economy is served, not harmed by ensuring that debtors fundamental human rights are respected. The economy is made up of human participants and is affected by the economic failure of these participants. Further, as discussed, risk is much more likely to be reduced if risky credit agreements are limited at the micro level. Macroeconomic policy cannot succeed in eliminating risk, only in displacing it. If, on the other hand, individual contracts are secure and sustainable, the economy will be more protected rather than endangered.

C. A Human Rights Framework Adequately Protects Business Interests

Some may be concerned that a human rights framework is too debtor friendly and does not account for legitimate business interests and concerns. However, far from opposing a human rights approach, business interests should readily embrace a human rights framework because creditors have human rights as well. A human rights framework can work to protect the interests of both debtors and creditors. Indeed, as discussed in my previous paper, creditors have thus far been more apt to take action to enforce their human rights than have debtors. For example, creditors’ property rights are protected by human rights principles. In fact, some may have precisely the opposite concern—that a human rights framework is overly protective of creditor rights. However, as discussed in my previous paper, the human rights principle of the right to property is limited in two ways: first, the state determines the scope of creditors’ property interests, and second, infringements on creditors’ property rights are acceptable if they further the public interest.

Not only does a human rights framework provide support for creditors in addition to debtors, but applying universal human rights principles to credit products will also benefit those companies who are currently pursuing fair and transparent lending practice. Absent

267 Human Rights Environmental Rights, and the Right to Environment, supra note 194, at 111.
universal standards, such companies can lose out to competitors and indeed may violate obligations to shareholders in some countries.\footnote{ICHRP Report, supra note 251, at 18; U.S. Corporate Law.}

D. A Human Rights Approach to Consumer Credit Does Not Dilute Human Rights

Approaching consumer credit concerns from a human rights standpoint will not result in a dilution or over-expansion of human rights. Although some have argued that consumer rights and consumer protection perhaps should be a \textit{new} right, or a new generation of rights,\footnote{See BENÖHR, supra note 30, at 48.} that is not what I propose. Instead, I am proposing that we consider existing human rights principles in the context of consumer credit. No new human rights body would be required to address these concerns. As is the case with most human rights protections, most of the work would be done by existing national organizations, resulting in human-rights compliant legislation.

Consumer protection currently has the status of a fundamental “principle” under the EU Charter.\footnote{Id. at 64.} Some have suggested that perhaps consumer protection could evolve into a right.\footnote{Id.} I am not suggesting that consumer financial protection be considered a human right—or even a human rights principle. However, as I discuss here and in my previous paper, there are \textit{existing} human rights principles that are closely related to consumer financial protection. The rights to human dignity, housing, water, health, education; the rights to be free from discrimination; the right to be free from indentured servitude and not to be imprisoned for inability to pay a debt; the right to due process; the right to privacy—all of these are existing human rights that are currently at times infringed upon in the consumer credit context. Indeed, applying human rights in this context should be even less controversial than doing so in other contexts in which it has already been accepted, for example, labor protections, protection against corruption, and in the foreign debt context.

VIII. CONCLUSION

\footnote{268 ICHRP Report, supra note 251, at 18; U.S. Corporate Law.}
\footnote{269 See BENÖHR, supra note 30, at 48.}
\footnote{270 Id. at 64.}
\footnote{271 Id.}
Although there have been substantial strides made recently that advance the protection for consumer debtors, some critical gaps in protection remain. Many debtors are at risk of becoming trapped in onerous debt obligations and unable to meet their basic needs. Often these situations of over-indebtedness are not a result of predatory lending, but rather of consumer confusion or consumer desperation. The consumer protection approach, with its focus on “leveling the playing field” and susceptibility to economic efficiency concerns, has so far been inadequate to alleviate the problems stemming from consumer confusion or consumer desperation. Consumer protection advocates have succeeded in achieving meaningful protection in some contexts, such the “ability to repay” requirement for high cost mortgages in the U.S. However, this protection is not present for all types of loans and across all jurisdictions, and there is constant political pressure to let lenders do as they please in the consumer credit context. Something more is needed to ensure that consumer credit does not inhibit debtors’ abilities to meet their basic needs, and that “something more” is human rights. A human rights framework can work hand-in-hand with a consumer protection approach to ensure a basic floor of protection for all consumer creditors, in all consumer credit contracts. This protection will stand up in the face of economic efficiency arguments, because it will be guaranteed even if there are necessary economic costs for some. In addition, human rights is our best shot at achieving a universal floor of protection—in the U.S. and abroad—which combats the “race to the bottom problem” in which lenders pursue ever more lenient jurisdictions. A human rights approach, without the existing consumer protection infrastructure, would not be sufficient to protect debtors from harm stemming from onerous credit contracts. But the existing consumer credit infrastructure can benefit from incorporating human rights principles and working with existing human rights organizations. There is much to gain and little to lose by pursuing this collaboration.
Insolvency of financial institutions

The role of the UK deposit guarantee scheme following the EU bank resolution and recovery directive
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The Role of the UK Deposit Guarantee Scheme following the EU Bank Resolution and Recovery Directive

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Abstract

Deposit Guarantee Schemes (“DGSs”) exist in order to protect some or all of those who place funds at credit institutions against the consequences of the insolvency of that credit institution, and may also compensate investors for losses suffered on the insolvency of credit or other types of financial institution in relation to certain types of investment product. The UK DGS is known as the FSCS.

DGSs are expected to cover depositor losses and contribute to the financing of the resolution of credit institutions in accordance with the requirements of the EU Bank Resolution and Recovery Directive. (“BRRD”) Amounts due in respect of eligible deposits and in respect of contributions to the costs of resolution are required to be given preferential status. Compensation for other losses does not attract preferential status and therefore both the FSCS and/or uncompensated non-depositor customers remain ordinary unsecured creditors for these amounts.

The calculation of the FSCS claim relating to compensation and its interrelationship with the original customer gives rise to issues relating to coverage, timing of compensation, valuation and subrogation. In addition, there is a possibility of moral hazard. Where, instead of compensation, the FSCS might be required to contribute to costs of resolution, the calculation of its contribution also gives rise to major practical considerations.

1. Background

Deposit Guarantee Schemes (“DGSs”) exist in order to protect some or all of those who place funds at credit institutions against the consequences of the insolvency of that credit institution¹, and may also compensate investors for losses suffered on the insolvency of credit or other types of financial institution in relation to certain types of investment product.

DGSs exist in many countries across the world and are required to exist in EU countries. In the UK, the relevant DGS is known as the Financial Services Compensation Scheme (“FSCS”), upon which this paper will focus.

2. Depositor protection

Depositor protection falls into two broad categories:

- Continuity of access; and
- Compensation.
Within the EU, it has been considered necessary that DGSs should be subject to harmonisation in order to achieve parity of treatment of depositors no matter where they deposit their capital. This reduces any incentive to deposit funds in institutions with higher protection, which would introduce distortions between Member States. The intention is that depositors will have clarity as to coverage, faster repayment, better information and robust funding for DGSs².

All credit institutions incorporated in the EU are required to be members of the relevant State’s DGS. States are also required to decide how to deal with branches of institutions headquartered elsewhere. The FSCS covers banks incorporated in the UK, including their branches in EEA countries. Branches located in the UK of banks incorporated in the EEA are covered by the relevant home DGS, although the FSCS would effect payment as agent of the home DGS (and would be funded by the home DGS).³

2.1 Continuity of access

A key social policy objective should a retail deposit-taker default is to ensure that consumers (and others) maintain continuity of access to their funds – in short, that people can access their money. Continuity of access is only practicable where the deposit book is transferred, but even then it is unlikely that there will not be a short period when the account is frozen. A key objective of a DGS must be to minimise this period.

If the deposit book cannot be transferred to a new provider, then depositors must be paid out as swiftly as possible. At present the FSCS works to pay out the vast majority of depositors within 7 days, although the Directive allows for longer than this for a transitional period until 31 December 2023⁴. The FSCS targets paying out as quickly as possible and in any event within 7 days in order to improve continuity of access and reduce the likelihood of hardship.

2.2 Compensation

Within the EU the level of deposit coverage has been harmonised at €100,000 (or local currency equivalent for non-Euro countries)⁵. In the UK this was previously £85,000 for existing depositors until 1 January 2016, when it reduced to £75,000⁶. Newly covered deposits from 3 July 2015 were subject to the £75,000 limit from inception. This protection applies to eligible depositors, which is the vast majority of all depositors with, broadly, the exception of authorised firms and deposits arising from money laundering. Larger corporates became covered from 3 July 2015.

In order for the FSCS to be able to pay out compensation, it needs the institution to provide it with certain data on depositors. To try to standardise this process, thereby reducing the time it takes to pay out, from 1 December 2016 the Prudential Regulation Authority (“PRA”) and the FSCS expect all deposit takers to be able to provide an electronic Single Customer View (“SCV”) file within 24 hours of a default which will contain all those depositors who are eligible for compensation, together with a so-called “exclusions” file in a standard format⁷. In broad terms, the SCV file covers:

1) Depositor details (identification of compensation recipient);
2) Address details (where the compensation will be sent);
3) Account details (all account details for a depositor, including separate details for each of multiple accounts); and  
4) Aggregate balance details (the total compensation amount to be paid).

The file formats may be four separate files for each of the four categories above; two files:  
one containing items 1, 2 and 4, and a separate file containing item 3 above; or a single file containing all four categories. If any format other than a single file containing all information is used then depositors must be linked using a single unique identifier.

The SCV file covers deposits which are eligible and the account holder entitled absolutely to the deposit: i.e. the account is neither excluded (e.g. where the deposit relates to a trust or is a client account) nor ineligible; whether an individual account is marked for “fit for straight through payout” or not. “Fit for straight through payout” essentially means that there are no queries or issues with the data and therefore that compensation can be paid within the 7 day time limit. “Not fit for straight through payout” might include records where the account holder details are incomplete, or if a depositor has special needs (e.g. correspondence in Braille). The FSCS has three months to investigate the deposits in the exclusions file for eligibility and payout.

The file name and file contents must be in standardised formats.

Data on ineligible accounts must be available to the FSCS, but must not be included in either the SCV or the exclusions file.

3. Practical issues – deposits

3.1 Coverage

As of July 2015, almost all deposits are covered up to the statutory limits (see above). The exceptions are:

- credit institutions’ own deposits (on their own behalf and for their own account) including credit unions (though the deposits of the members of the credit union will be covered);
- credit institutions’ own funds;
- deposits arising from criminal convictions for money laundering;
- deposits by financial institutions;
- deposits by investment firms;
- deposits where the holders have not had their identity verified as required by KYC rules;
- deposits by insurance and reinsurance firms;
- deposits by collective investment schemes;
- deposits by pension or retirement funds (with some exceptions);
- debt securities, own acceptances and promissory notes issued by the DGS member; and
- deposits by local authorities with budgets of over €500,000.
All corporates, of any size, are included for the first time, although it is difficult to see how a £75,000 payment relating to the compensation limit will make a material difference to a major global company.

3.2 In-flight transactions

The basic principle governing in-flight transactions is that where a payment or receipt has been reflected on the depositor’s account, such that the depositor would have seen a balance which has taken account of that transaction, then that transaction should be included in the balance in the SCV file. All other in-flight transactions should be subject to a process of reconciliation between the insolvency practitioner for the failed institution, the FSCS, and (if relevant) any acquiring firm.

In-flight transactions may settle almost immediately (e.g. the UK Faster Payment system); or over a number of days (BACS: the UK Bank Automated Clearing System); or be subject to manual intervention, for example cheques, which the recipient must take to the bank to be paid in (which may not be immediate) and which then take some days to clear. Clearly, to wait for all of these possibilities to be completed would be likely to ensure that the 7 day payout target would never be met.

3.3 Temporary high balances

Temporary high balances (being those deposits held by an individual depositor above the compensation limit) arising from specified life events may be compensated up to an amount of £1 million, with one uncapped exception. Temporary is defined as six months from the later of the date the balance is credited to the depositor’s account, or the date the balance becomes legally transferable to the depositor. These balances are included in the balance in the SCV file but are not identifiable (as the FSCS is not aware of the life events) and so will not be paid out within the 7 day period, as the FSCS will require depositors to make a manual application for these amounts.

The life events that may be covered as a temporary high balance are:

- Deposits for, or proceeds of, the purchase of or equity release from private residential property (as an aside, this may be unlikely to compensate the depositor fully where such transactions relate to London property);
- Insurance benefits
- Compensation or State benefits for personal injury or incapacity (note that this is not limited in amount);
- Compensation for wrongful conviction;
- Compensation for unfair dismissal or redundancy payments;
- Sums relating to marriage, divorce, civil partnerships or their dissolution;
- Retirement benefits;
- Death benefits, compensation for death, or legacies from wills;
- Executor’s accounts for administering the deceased’s estate; and/or
- It is otherwise linked to marriage or divorce, civil partnership or its dissolution; retirement; incapacity (physical or mental); death; or buying or selling a main residential property.
The key connecting factor of these items is that these are expected to be one-off events which are largely not within the control of the depositor either as to timing or amount, for which it is expected that the balance would be either disbursed (a new house, for example) or withdrawn and invested against a broad range of entities such that the risk of having a balance above the compensation limits would be minimised. Socially, the events from which these balances arise are such that a loss of the funds would be catastrophic to the depositor’s life, which is likely to be the reasoning behind the absence of any cap on amounts arising from compensation for personal injury or incapacity, where the funds may well be intended to provide care and income for the rest of the subject's life.

In each case, it appears that if these temporary high balances were not treated as exceptions, then there would be a risk that the depositor would fall back on some form of State support to deal with the loss. In common with the underlying principles of the BRRD, which are intended to minimise the risk that the failure of a financial institution imposes costs on the taxpayer, the eventual bill for compensation falls on the industry (see 7: Funding, below), and so the cost of meeting these exceptions will not fall on the State.

3.4 Set off

Negative balances are not to be set off against the balance to be compensated. In practice, set off in insolvency is a very complex area, and if set off were to be applied it would be almost impossible to provide compensation within the required period. A sample of the issues which might arise would be between an in-credit current account and, for example, overdrafts, credit card balances or mortgages. Set off in such a situation, especially where repayment were not yet due, would damage continuity of access for consumers and might easily leave them without funds for basic necessities. Such a lack would be undesirable from a humanitarian perspective and could potentially lead to adverse social consequences as consumers were deprived of their funds.

3.5 Currency

All balances are required to be converted to sterling to calculate compensation. This corresponds to the procedure for proving a debt in insolvency, where a debt payable in a currency other than sterling (GBP) must be converted to sterling on the relevant date using the Official Exchange Rate\textsuperscript{10}. However, the FSCS does not require a particular exchange rate (although it recommends use of the Bank of England spot rate) which runs the risk that eligible and ineligible deposits will be translated at different rates.

3.6 Hardship

The Directive\textsuperscript{11} recognises that some small businesses and natural persons may suffer considerable hardship if they do not have access to their funds for a period. Therefore, if the FSCS cannot pay compensation within 7 business days, provision is made to allow cost of living or necessary business expenditure (one might speculate that salaries fall within this area) to be paid out within 5 business days of a request.
3.7 International issues

Within the EEA, depositors holding funds with UK branches of institutions who are members of a DGS within another EEA state are to be repaid by the FSCS on behalf of the other EEA State’s DGS, but the home DGS must provide the FSCS with funds to cover the payment12.

4. Practical issues – other compensation

The FSCS may also be responsible for compensating investors for other losses incurred on the insolvency of an authorised financial institution. (This paper does not seek to deal with insurance institutions.) Here, however, the first complication is whether or not the institution is in default. Where an insolvency process has begun, default occurs on the date of the insolvency. Where a resolution has taken place without an insolvency, whether there is a default at all is not nearly as clear.

After establishing that a default exists, the FSCS must decide whether each investment product is eligible for compensation. Given the growth in complex products being offered to retail customers, this is not as simple as it might first appear, and a careful analysis is needed before the FSCS can confirm whether – or which – products13 are covered. Compensation for such products differs from the £75,000 deposit compensation, and for investment products is capped at £50,000.

Finally, it is necessary to establish the eligibility of each customer seeking compensation in respect of an eligible product. There are two limbs to this:

- the customer falls into an eligible category;
- the claim itself is valid and agreed.

Whether a customer is eligible is a matter for the FSCS alone. However, the agreement of a client’s or creditor’s claim against the insolvent firm will normally be a matter for the failed institution or its appointed insolvency practitioners.

On the insolvency of a financial institution having a large number of customers eligible for compensation, liaison with the FSCS must be among the earliest and most important actions. The sooner that the FSCS can become involved, the more likely it is that a default can be declared and the process begun. It follows that customers will be repaid more quickly.

The most efficient way of working with the FSCS will depend on the facts of the case. For deposits, a clear process is set down (see above). In large, complex cases where other losses are eligible for compensation, it may be most convenient to adapt the company’s existing systems to allow claim agreement and assignment (see below). On smaller cases this may not be cost-effective and ordinary methods of claim agreement may suffice.

In any case, the insolvency practitioner must agree claims in accordance with both best professional practice and CASS14 rules. Only once a customer’s claim has been agreed with the insolvency practitioner can the details be passed to the FSCS for it to pay compensation. It will normally be in the interests of all parties for as many customers as possible to take up their rights to compensation:
• the FSCS acts as a single creditor in place of many individual creditors, which reduces costs and increases efficiency (for example, only one dividend need be paid to the FSCS covering many claims, as opposed to the insolvency practitioner paying many claims);
• customers are likely to be paid a larger percentage, or all, of their claim than they might receive from the insolvency. This is most helpful to eligible customers with claims of less than the compensation amount, who will be paid in full by the FSCS but would be unlikely to be paid in full from the insolvency. For customers owed more than the maximum compensation level, they will receive the compensation payment and then dividends will be paid on to them via the FSCS until they are either paid in full or all funds have been distributed from the insolvency. (see box)
• The FSCS can pay sooner, as it does not have to make the same provisions for unpaid amounts and/or costs, and does not have to wait for realisations to be made, as an insolvency practitioner must do. It simply has to pay the compensation amount, without deduction.

4.1 FSCS payment examples

The FSCS has to ensure that a customer is not disadvantaged, whether it claims compensation at the beginning of a case or at the end. Clearly, this risk only exists for eligible customers who are owed more than the compensation limit, as all other eligible customers will be compensated in full in the first place. In order to do this, it pays out both the maximum compensation and then further amounts received in dividends. It does not retain any dividend payment relating to a particular customer until that customer has been paid in full. The £50,000 limit mentioned above is used for these examples.

Example 1:

■ Client account balance = £80,000
■ the FSCS initial compensation = £50,000
■ Initial dividend announcement of 50p/£ results in a payment from the Joint Special Administrators to the FSCS of £40,000
■ the FSCS pays further compensation of £30,000 to claimant so he is fully compensated (total £80,000), and retains £10,000 recovery for itself

■ TOTAL RETURN TO CLIENT = £80,000
■ Total paid by the FSCS (net) = £50,000+£30,000 less £40,000 = £40,000
This procedure ensures that “gaming the system” for high value customers, by waiting until all distributions from the insolvency have been made and then claiming, produces no better or worse result than claiming immediately. It is, however, somewhat counter-intuitive, as in certain other cases where quasi-Government compensation is paid (e.g. the UK’s Redundancy Payments Office, who make payments to employees) the relevant fund is repaid first, and only then do the creditors receive further amounts.

Although in general it will be in a customer’s financial interest to take FSCS compensation, the assignment of the claim (see below) to the FSCS means that the customer will no longer be a creditor in the insolvency and therefore has given up all creditor rights. In particular, the customer is not eligible to be a member of the creditors’ committee. Some customers may therefore prefer to join the creditors’ committee and defer claiming compensation. The FSCS will normally be expected to want to join, and does join, the committee in order to represent client/customer interests, but for a non-deposit taker it is not compulsory for the FSCS to be included.

Once a customer’s claim is agreed by the insolvency practitioner and the details passed to the FSCS, the customer must agree to assign the whole value of his claim in return for the compensation payment (and further dividends as described above). The total claim is assessed on an entity/individual basis, not by account, so that a single entity/person having multiple accounts will have the claim aggregated and the total balance assigned. In contrast to the position relating to deposits, for non-deposit-related balances eligible for compensation, where the multiple accounts comprise both debtor and creditor balances these will be netted off to arrive at a single figure.

Example 2:

- Client account balance = £150,000
- the FSCS initial compensation = £50,000
- Initial dividend announcement of 50p/£ results in a payment from the Joint Special Administrators to the FSCS of £75,000
- the FSCS pays further compensation of £75,000 to claimant (total £125,000), and retains nothing for itself
- Second dividend announcement of 10p/£ results in a payment from the Joint Special Administrators to the FSCS of £15,000 to claimant (total £140,000), and retains nothing for itself
- **TOTAL RETURN TO CLIENT = £140,000**
- Total paid by the FSCS (net) = £50,000+£75,000+£15,000 less £75,000 less £15,000 = net £50,000
- If no further dividends are paid, the client/claimant will suffer a loss of £10,000.
In general, the customer fills in a paper form, but the assignment is not formally perfected until the compensation cheque is cashed\(^\text{15}\). This leads to practical problems where customers do not cash (usually) small value cheques and therefore, at the end of the case, a major reconciliation exercise is required in order to understand which customers have formally assigned their claims to the FSCS and which have not. Advances in technology and changes to the FSCS’s rules have allowed the FSCS to agree a form of assignment which can be completed on-line and is valid once electronically signed, with no need to wait for the cheque to be cashed. In addition, the FSCS can now make payments to customers electronically, which also removes the need for the customer to cash a cheque. This has significantly improved the efficiency and certainty of the process.

The final issue which must be discussed between the FSCS and the insolvency practitioner is the timing of payments, to ensure that there are no “cut-off” issues. It would obviously be undesirable for a customer to be paid twice, or not paid at all; and therefore it is important that the FSCS do not make compensation payments very shortly before the insolvency practitioner declares and pays a dividend. This is easily addressed simply by keeping communications open.

As discussed above, the process for deposit compensation is likely to be far simpler as the majority of the payouts arise from the SCV file, without the need for claim agreement by the depositor.

5. Contribution to the costs of resolution

5.1 Funding the resolution

DGSs are now expected to contribute to the financing of the resolution of credit institutions\(^\text{16}\) in accordance with the requirements of the Bank Resolution and Recovery Directive\(^\text{17}\). (“BRRD”) The BRRD requires that DGSs are to contribute to the costs of a stabilisation power, which has been incorporated into UK law (FSMA) by the Deposit Guarantee Scheme Regulations (Statutory Instrument 2015/486). If a stabilisation power (e.g. bail-in) is exercised such that eligible deposits are not affected in any way, then if this provision did not exist the FSCS would not have to make any payment, as there would be no loss to eligible depositors requiring compensation. Instead, it is expected to contribute to the costs of the resolution up to the extent to which it would have to have paid compensation in an insolvency.

There are four options for stabilisation\(^\text{18}\), which may also be used in any combination:

- Bail in (essentially the conversion of debt to equity)
- Private sector purchaser (sale to a private institution)
- Bridge bank (sale to an institution owned by the central bank)
- Temporary public ownership (equivalent to nationalisation)

In each case, the DGS may have to contribute to the cost by paying towards the costs of the stabilisation option or by paying compensation to eligible depositors, or a combination of these elements.
5.2 Status of DGS on resolution or insolvency

The BRRD, which was largely incorporated into UK legislation with effect from 1 January 2015\textsuperscript{19}, requires that the claims of DGSs are given preferred status in the event that a deposit-taking institution is placed into a stabilisation option (including the use of formal insolvency processes to achieve the chosen stabilisation route). In the UK, implementing that requirement resulted in an alteration in the statutory scheme of creditor priority contained in insolvency law.

Prior to the implementation of the BRRD, amounts due in respect of eligible deposits were not given preferential status under English insolvency law. This was the case regardless of whether they were in respect of subrogated payments to the FSCS (following payment of compensation by the FSCS) or in respect of a direct payment to depositors.

Following the BRRD’s implementation, amounts due in respect of eligible deposits were required to be given preferential status. Amounts in respect of contributions to the costs of resolution (see below) were also given preferential status\textsuperscript{20}.

<table>
<thead>
<tr>
<th>Creditor priorities</th>
</tr>
</thead>
<tbody>
<tr>
<td>The ranking of claims in UK insolvency procedures is currently as follows:</td>
</tr>
<tr>
<td>Fixed charge assets are used to satisfy costs and expenses of their realisation and distribution, and then to pay fixed charge claims, with any surplus or deficit respectively falling for the benefit of, or claimed as, unsecured liabilities.</td>
</tr>
<tr>
<td>Floating charge assets are utilised as follows:</td>
</tr>
<tr>
<td>• costs and expenses of the process;</td>
</tr>
<tr>
<td>• ordinary preferential creditors;</td>
</tr>
<tr>
<td>• secondary preferential creditors;</td>
</tr>
<tr>
<td>• prescribed part (an amount set aside for the claims of unsecured creditors from amounts which would otherwise be due to floating charge creditors);</td>
</tr>
<tr>
<td>• floating charge creditors;</td>
</tr>
<tr>
<td>• unsecured creditors.</td>
</tr>
</tbody>
</table>

5.3 Preferential creditors

Until the Financial Services (Banking Reform) Act 2013 (“BRA”), preferential creditors were largely confined to employee claims, e.g. for wages or salary, holiday pay, and certain other entitlements. Preferential status had been removed from claims made by the tax authorities for payroll taxes and value added taxes following the Enterprise Act 2002. All preferential claims ranked equally, and if funds were insufficient they abated equally.

The changes to the categories of preferential creditors discussed in the section immediately below have altered the principle that all preferential creditors should rank
equally. Now, all pre-existing categories of preferential creditor rank equally with “ordinary” preferential creditors, but “secondary” preferential creditors rank behind all of the ordinary preferential creditors.

There are, therefore, now two classes of preferential creditor.

5.4 How it works: amounts due to the FSCS

Any debt due to the FSCS under s215 (2A) of the Financial Services and Markets Act 2000 (“FSMA”) will be preferential. S215 (2A) refers to “Any payment made… in connection with the exercise of a stabilisation power… is to be treated as a debt due….”

The amount of such a payment is defined in s214C FSMA as being the difference between:

- the amount that the FSCS would have paid out (net of recoveries) had the institution become insolvent; and
- the amount it has actually paid out (net of recoveries).

An eligible deposit is preferential up to the limit in respect of which compensation would be payable. When the FSCS pays compensation to a depositor, it takes an assignment of all of the depositor’s rights and therefore steps into the shoes of the creditor in respect of all its claims. Therefore, the FSCS can recover the compensation paid out as an “ordinary” preferential creditor.

5.5 How it works: amounts due other than to the FSCS

If a depositor does not accept FSCS compensation for the amount which would otherwise be compensated, then that depositor will be an “ordinary” preferential creditor. Where an eligible deposit exceeds the compensation limit, then that excess will rank as a “secondary” preferential creditor in relation to individuals and SMEs.

Where a deposit has been made through a non-EEA branch of an institution which is authorised by the regulator of an EEA state, and such a deposit would have been eligible had it been made through an EEA branch of the institution, then that deposit will also have preferential status.

Deposits which are not eligible for compensation do not appear to have preferential status and therefore continue to rank as unsecured.

The main effect is that the costs of the resolution will fall upon unsecured creditors as a result of the transfer of value from unsecured creditors to eligible depositors and the FSCS, as shown in the example below, where for simplicity there is no floating charge holder:
Note that only deposits qualify for preferential status. Compensation for other losses does not attract preferential status and therefore both the FSCS and others remain ordinary unsecured creditors for these amounts. This could give rise to a number of issues where the customer is involved with the insolvent institution in different capacities having different rights and rankings: in particular that compensation for deposits will be paid over without set off and in a very much shorter time than for other losses.

5.6 Payments in respect of the exercise of a stabilisation power

The BRRD requires that DGSs are to contribute to the costs of a stabilisation power, which has been incorporated into UK law28. If a stabilisation power (e.g. bail-in) is exercised such that eligible deposits are not affected in any way, then if this provision did not exist the FSCS would not have to make any payment, as there would be no loss to eligible depositors requiring compensation. Instead, it is expected to contribute to the costs, as discussed above.

Practically, the amount to be contributed is assessed net of assumed recoveries. As the contribution to costs ranks as an ordinary preferential debt, the level of recovery is likely to be high, and indeed may be a full recovery. It is therefore possible that the FSCS would not be required to contribute as a result of its preferential status (whereas if it had remained an unsecured creditor a contribution would be required). In any event, the amount of the contribution will have to be established by conducting an insolvency counterfactual of the institution, which will require making wide ranging assumptions about the possible levels of recovery from the insolvency in a situation where there have been very few bank insolvencies and therefore the available empirical evidence which might support any assumptions is limited.

In addition, the amount that the FSCS has actually paid out may take time to establish. Although the FSCS has a target of 7 days to pay out the majority of depositors, that still leaves the question of temporary high balance holders and deposits in the Exclusions file,
and there will always be depositors where specific issues may delay payment. Even where the amount paid out is certain, the actual level of recoveries will not be established in the short term, as this will depend on the speed of the process. Generally, financial institution insolvency is complex, difficult and takes time to resolve. The choice will be – as with many aspects of financial institution insolvency – between speed and accuracy. It may be that the most reasonable solution is to make a best estimate early in the resolution, when the funds will be required for practical purposes such as meeting running expenses while the resolution plan is put in place, and then to allow for a true-up mechanism when exact figures are known.

Where compensation is being paid in relation to claims which do not arise from deposits, but from investments where customers were entitled to segregation of their funds, even where all funds have been properly segregated, there is likely still to be a shortfall, as the costs of dealing with the client estate must, under the Special Administration Regime, fall on the client estate. Practically, this means that where most customers take compensation from the FSCS, the bulk of the cost of the insolvency (to clients) falls on the FSCS: not dissimilar from the principles laid down that the FSCS should contribute to the costs of resolution. However, here the FSCS is an unsecured creditor, and will therefore be unlikely to recover in full. (unlike the depositor situation, discussed above, where the FSCS is preferential)

6. Moral hazard

It has been argued that the existence of compensation schemes encourages “moral hazard” in that consumers are protected from the consequences of their own choices and therefore can opt for high-risk, high-return entities without actually suffering the real level of risk to which they should be exposed. The current level of deposit protection (£75,000/€100,000) materially exceeds the levels of savings of the vast majority of retail customers, and therefore appears to remove any risk from them. This means that customers have no incentive to assess the stability of a financial institution and a clear incentive to place their money in high return, higher risk institutions, knowing that if the institution becomes insolvent they will be unlikely to suffer significant loss.

Against that, there is a public interest in ensuring that ordinary consumers should not be disadvantaged due to an inequality of knowledge. It is not reasonable to expect an ordinary person on the street to be able to assess the creditworthiness of a complex regulated deposit taking financial institution, although it may be reasonable to expect them to understand whether they are protected by the FSCS or not, given that this must now be shown on bank statements and on online banking pages. In practice, anecdotally, most consumers seem to regard the basic fact of a financial institution being regulated as a “guarantee” of stability and creditworthiness.

Socially, the impact of a large number of retail customers losing their savings and thereby suffering substantial hardship is difficult to manage other than with some form of compensation fund. There are few alternatives to having a bank account in order to deal with modern life, and indeed certain anti money laundering regulations actively discourage the use of large amounts of cash.
The question of compensation for loss arising from insolvency relating to other areas of financial product is more straightforward. FSCS compensation is paid in respect of the amount of loss where the funds lost should have been segregated: that is, held separately from the company’s own money. It is reasonable that a consumer entitled to segregation should expect their funds to be segregated. However, the availability of compensation at a level which is expected to compensate the majority of customers for the whole of their loss relating to such defaults still removes some of the responsibility from the consumer to pay attention to the behaviour, trustworthiness and creditworthiness of the institution. As with deposit takers, anecdotal comments from the victims of insolvency suggest that regulated status “guarantees” that the institution will not become insolvent and/or consumers will not lose any money.

7. Funding the FSCS

Different models of funding DGSs exist within the EU: in some countries they are pre-funded, i.e. contributions to fund the scheme are sought and obtained regardless of whether an event requiring compensation has occurred; and in some levies are only requested when compensation is required. There may also be a “mixed model” where levies are set for the year ahead but may be supplemented by an emergency levy if a large, unexpected event requiring compensation occurs. The FSCS falls into the “mixed model” category.

The FSCS is funded by levy from financial institutions. Therefore the cost of a covered insolvency will fall on the financial services sector as a whole, instead of falling on taxpayers directly. Some of this cost will, of course, be met from distributions from the insolvency, as recoveries received by the FSCS from the insolvency of the defaulted firm are credited back to the relevant levy class (reducing future levies). The change to provide certain elements of compensation/cost with preferential status is likely to mean that those amounts are, eventually, largely or fully recovered, with no net cost to the sector. However, there is a timing issue and may be a funding issue which leads to a cash need: covered deposits must be paid out within a very short time, whereas distributions from insolvency may take much longer (and may not cover the full amount). Therefore, there needs to be a mechanism which provides funding to cover the period. In extremis, this could be a loan from Government funding, (i.e. taxpayers) whilst a levy demand is made against the sector and the funds collected within a “reasonable time”.

The FSCS will levy wherever possible, up to the annual limit, but it also has the option of accessing a fund held by Government raised under the bank levy, in addition to its own levy, which would later be repaid by the FSCS’s own levy. The FSCS estimates its likely liabilities and then makes an annual levy request to the financial services sector of sufficient size to cover those liabilities: both compensation and running expenses. However, should an insolvency occur, and the existing funds be insufficient to cover the compensation, then the FSCS may at any time make a further levy to cover compensation, though such a levy is capped without the consent of the Prudential Regulation Authority.
8. Conclusions

Depositor protection requires a political balance to be struck between the need for consumers to be protected and to have continuity of access to funds, and the risk of moral hazard. In the UK and indeed the whole of the EU, that balance is presently tipped very much towards consumer protection. Compensation levels for depositors have been set at a level for which the majority of ordinary persons are very unlikely to suffer loss. Exceptions have been made in order to allow for significant life events.

Compensation is treated differently in terms of priority and amount depending on whether it is for deposits or for investment losses. This may give rise to significant complexities where customers have different types of account. Early liaison between the insolvency practitioner and the FSCS is critical.

The BRRD has significantly altered the priority of compensation for deposits or resolution costs incurred by a DGS in dealing with an insolvent institution or one undergoing resolution. The elevation of such costs to preferential status significantly increases the likelihood that they will be repaid, and the result will be that the cost falls upon unsecured creditors.

Funding models are intended to ensure that the cost of compensation falls upon the financial sector. As noted above, this is not entirely achieved. However, the funding model does ensure that the cost does not, ultimately, fall upon taxpayers to any greater extent than absolutely necessary.

3 FSCS also covers eligible deposits of UK branches of non-EEA banks – see http://www.bankofengland.co.uk/prn/Documents/publications/ss/2014/ss1014.pdf e.g. Box 1, footnote 3.
4 Directive 2014/49/EU of 16 April 2014 on Deposit Guarantee Schemes, Article 8(2)
5 Directive 2014/49/EU of 16 April 2014 on Deposit Guarantee Schemes, Article 6
6 Directive 2014/49/EU of 16 April 2014 on Deposit Guarantee Schemes, Article 6, Subsection 5
7 Prudential Regulation Authority Rulebook (20/01/16) Depositor Protection 12.9
8 Prudential Regulation Authority Rulebook, Depositor Protection 2.2(4)
9 Prudential Regulation Authority Rulebook (20/01/16) Depositor Protection 10.7
10 Rule 2.86 (administrations) and Rule 4.91 (liquidations), Insolvency Rules 1986; Rule 166 Investment Bank Special Administration Rules 2011.
11 Directive 2014/49/EU of 16 April 2014 on Deposit Guarantee Schemes, Article 8(4)
12 The Deposit Guarantee Scheme Regulations 2015, S.I. 2015/486, regulation 10
13 This may include client money amounts held by a firm; losses caused by the firm’s negligence or misconduct; or shortfalls in client money or assets arising from the costs of the insolvency.
14 The Financial Conduct Authority’s Client Asset Sourcebook
17 Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, Article 109
18 Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, Article 37(3)
19 Initially by way of the Financial Services (Banking Reform) Act 2013 (“BRA”) and then by subsequent amendments to secondary legislation
20 Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, Article 109
21 Sub-sections 1A and 1B, section 386 Insolvency Act 1986 (as amended)
22 Paragraph 15AA, Sch6 Insolvency Act 1986 (as amended)
23 Paragraph 15B, Sch6 Insolvency Act 1986 (as amended)
24 Paragraph 15B, Sch6 Insolvency Act 1986 (as amended)
25 Paragraph 15BA, Sch6 Insolvency Act 1986 (as amended)
26 Paragraph 15C, Sch6 Insolvency Act 1986 (as amended)
27 Paragraph 15BB, Sch6 Insolvency Act 1986 (as amended)
28 The Deposit Guarantee Scheme Regulations 2015, Statutory Instrument 2015/486
29 The Investment Bank Special Administration (England and Wales) Rules 2011, Part 4 (Rules 133-137)
30 For example, see the report from the Centre for Policy Studies published on 15 January 2016 http://www.cps.org.uk/publications/reports/the-abolition-of-deposit-insurance/
31 Prudential Regulation Authority Rulebook (20/01/16) Depositor Protection 32.3
32 Prudential Regulation Authority Rulebook (20/01/16) Depositor Protection 33.2
After 12 years working in finance trading interest rate derivatives Simon decided to train as a lawyer. He graduated in law from City University, London with First Class Honours in 2005. He was awarded the prize for Best Exam Results in 2004, a scholarship in 2005 and after completing his final examinations he was awarded the Recorder of London Prize for Best Law Student. Simon went up to Brasenose College, Oxford University and completed the Bachelor of Civil Law Degree (the “BCL”) in 2006.

Simon completed the Post Graduate Diploma in Legal Practice at the Inns of Court School of Law in 2007 with Distinction, before completing his two year Training Contract with Davies Arnold Cooper in 2009. He was admitted to the Roll of Solicitors of England & Wales at that time. He joined Moon Beever in 2011. He is particularly interested in financial law and insolvency law, and writes the banking litigation series for the New Law Journal. He is a Guest Lecturer in Corporate Insolvency at Queen Mary University of London.
Insolvency set-off in the aftermath of the banking crisis

Simon Duncan

Introduction

The banking crisis in 2008 has led to a large number of small businesses entering into insolvency as a consequence of having been sold interest rate hedging products by their banks. Typically the businesses swapped a high fixed rate of interest for a floating rate and could not afford to maintain the payments as interest rates fell dramatically in 2009.

A redress scheme was introduced under the auspices of the Financial Conduct Authority in 2013 to compensate those found to have been ‘mis-sold’ an interest rate hedging product. The FCA estimates that there are 18,000 potential claimants and of these 2000 are insolvent estates with potential claims.

Insolvency set-off

Set off is the right of a debtor, himself owed money by his creditor, to effectively secure payment of the debt due to him by setting it off in reduction of his own liability.1

Insolvency Rule 4.90 applies in company liquidations.

IR 4.90 Mutual credits and set-off

(1) This Rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.

(2) The reference in paragraph (1) to mutual credits, mutual debts or other mutual dealings does not include—

(a) any debt arising out of an obligation incurred at a time when the creditor had notice that—

(i) a meeting of creditors had been summoned under section 98; or

(ii) a petition for the winding up of the company was pending;

(b) any debt arising out of an obligation where—

(i) the liquidation was immediately preceded by an administration; and
(ii) at the time the obligation was incurred the creditor had notice that an application for an administration order was pending or a person had given notice of intention to appoint an administrator;

(c) any debt arising out of an obligation incurred during an administration which immediately preceded the liquidation; or

(d) any debt which has been acquired by a creditor by assignment or otherwise, pursuant to an agreement between the creditor and any other party where that agreement was entered into—

(i) after the company went into liquidation;

(ii) at a time when the creditor had notice that a meeting of creditors had been summoned under section 98;

(iii) at a time when the creditor had notice that a winding up petition was pending;

(iv) where the liquidation was immediately preceded by an administration, at a time when the creditor had notice that an application for an administration order was pending or a person had given notice of intention to appoint an administrator; or

(v) during an administration which immediately preceded the liquidation.

(3) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other.

(4) A sum shall be regarded as being due to or from the company for the purposes of paragraph (3) whether—

(a) it is payable at present or in the future;

(b) the obligation by virtue of which it is payable is certain or contingent; or

(c) its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion.

(5) Rule 4.86 shall also apply for the purposes of this Rule to any obligation to or from the company which, by reason of its being subject to any contingency or for any other reason, does not bear a certain value.

(6) Rules 4.91 to 4.93 shall apply for the purposes of this Rule in relation to any sums due to the company which—

(a) are payable in a currency other than sterling;

(b) are of a periodical nature; or

(c) bear interest.
Rule 11.13 shall apply for the purposes of this Rule to any sum due to or from the company which is payable in the future.

Only the balance (if any) of the account owed to the creditor is provable in the liquidation. Alternatively the balance (if any) owed to the company shall be paid to the liquidator as part of the assets except where all or part of the balance results from a contingent or prospective debt owed by the creditor and in such a case the balance (or that part of it which results from the contingent or prospective debt) shall be paid if and when that debt becomes due and payable.

In this Rule “obligation” means an obligation however arising, whether by virtue of an agreement, rule of law or otherwise.

A bank (“B”) is owed £500,000 on an overdraft advanced to a company (“A”). A has since entered insolvent liquidation. I will refer to this claim as the ‘Debtor’s Cross Claim.’ Typically, the Debtor’s Cross Claim will be secured.

A (acting by its liquidator) sues B for the mis-selling of an interest rate swap. A is awarded £500,000 in damages or offered the same sum as redress out of court. I will refer to this claim as the ‘Creditor’s Primary Claim.’ B then applies insolvency set-off pursuant to IR 4.90. The effect is to extinguish the payment that would otherwise flow to A. In other words, B has set off his asset, the Debtor’s Cross Claim, in reduction of the Creditor’s Primary Claim, extinguishing the payment due to A. This result is detrimental to A’s creditors but advantageous to B because B would otherwise have to pay the Creditor’s Primary Claim and then prove its claim in A’s insolvency or rely on its security. If A has no other assets then B will suffer a shortfall.

This presents a real difficulty for Liquidators trying to realise redress payments into the estates of insolvent companies because no funds flow. There is no redress. Does it make a difference if the Debtor’s Cross Claim is secured? To consider this further it is necessary to think about how insolvency set-off works.

The nature of insolvency set-off

Insolvency set-off is both ‘automatic’ and ‘self-executing’ rather than procedural in nature. The set-off account is taken when the ‘company goes into liquidation.’ That date is the relevant date. It is not possible to contract out or waive the operation of insolvency set-off.

The automatic nature of insolvency set-off suggests that the claim of the secured (solvent) party (the bank, B, above) who enforces its security between the relevant date and the date the account is taken, is subject to insolvency set-off. This in turn suggests that there would be no debt due at the time the security is enforced. In other words, insolvency set-off applies first. The enforcement of the security would therefore be wrongful, there being no debt.
This interpretation however, runs counter to the decision in *Re Norman Holding Co Ltd.* In that case, Mervyn Davies J held that there is no set-off unless the creditor proves (or claims to prove) for his debt in the liquidation. Where the secured creditor intends to rely on his security, he is not proving in the liquidation and as such falls outside of the scope of Rule 4.90 (1).

Whilst *Re Norman* remains good law, its narrow interpretation of Rule 4.90 has been doubted by some.

In *MS Fashions Ltd v Bank of Credit & Commerce International SA (No. 2)* Dillon LJ held that if there have been mutual credits or mutual debts or mutual dealings between a company and a creditor then set-off applies notwithstanding that one or other of the debts or credits may be secured. He cited the judgment of Lord Selbourne L.C. in *Ex Parte Barnett; In Re Deveze* and the judgment of Dixon J in *Hiley v Peoples Prudential Assurance Co. Ltd* with approval. He added (again citing Dixon J) that:

“To the extent that the secured debt is answered by set-off the security is freed.”

Relying on this decision, Roy Goode concludes that:

“The effect of the automatic nature of insolvency set-off is that the debt due to the secured creditor is *pro tanto* reduced by the company’s cross claim, leaving secured only the balance, if any... Accordingly, the decision to the contrary in *Re Norman Holding Co Ltd* ... must be taken to be overruled.”

Again, the application of set-off is first in time.

In practical terms this causes some difficulty. If insolvency set-off operates automatically as regards secured cross claims then the election to enforce that security is denied to the holder of the security. Furthermore, enforcement by the secured creditor prior to the account being taken would be unlawful as he is enforcing his security that must already be subject to set-off. That set-off may have extinguished his claim.

Where a creditor agrees not to prove for its debt (by electing to rely on its security) then the debt is not a provable debt and cannot be subject to insolvency set-off as this situation falls outside of Rule 4.90 (1). This has been described as the ‘default position’ such that secured creditors rely on their security outside of the insolvency process, only proving for any shortfall, unless they elect to surrender their security and prove for their entire debt. The shortfall or the entire debt on surrender being subject to insolvency set-off. This addresses the practical difficulties described above though it does not deal with the conceptual difficulty that arises before any election is made, if insolvency set-off is automatic in nature.

Always automatic?

*Swissport (UK) Limited (in liquidation) v Aer Lingus Ltd* is a decision of Mr Peter Prescott QC, sitting as a Deputy Judge of the High Court.
The Claimant had secured summary judgment in its favour in the sum of £998,849.32 in respect of charges for ground handling services performed for the Defendant at Heathrow Airport.

The Defendant brought an appeal contending that summary judgment was not appropriate because of the existence of a counter claim whose value exceeded the ground handling charges, alternatively that set-off applied.

The Judge summarised the Appellant’s position in these terms:

“The argument for Aer Lingus, as I understand it, is that if their cross-claim... has any real prospect of succeeding, the court has no option but to refuse summary judgment. It is not a matter of discretion but of legal entitlement because, to the extent that Aer Lingus may be able to set-off pound for pound, Swissport is not owed the money at all.”

This suggests that Aer Lingus was not only trying to rely on the automatic nature of insolvency set-off to defeat summary judgment. Aer Lingus asserted that after set-off as of right, there was no debt owed to Swissport.

The Judge did not accept the Appellant’s position. He considered that it skipped over an essential step of the reasoning.

“The Rule says that ‘an account shall be taken of what is due from each party to the other,’ with a set-off. But who is to take the “account,” and what does it mean?”

Citing Lord Hoffmann in Stein v Blake:

“But the winding up of the estate of a bankrupt or an insolvent company cannot always wait until all possible contingencies have happened and all the actual or potential liabilities which existed at the bankruptcy date have been quantified. Therefore the law adopts a second technique, which is to make an estimation of the value of the claim. Section 322(3) Insolvency Act 1986 says:

‘The trustee shall estimate the value of any bankruptcy debt which, by reason of it being subject to any contingency or contingencies or for any other reason, does not bear a certain value.’

This enables the trustee to quantify a creditor’s contingent or unascertained claim, for the purposes of set-off or proof, in a way that will enable the trustee safely to distribute the estate, even if subsequent events show that the claim was worth more...

In reliance of this authority, the Judge concluded that if the cross claim was ‘shadowy’ (as here) then nobody is forced to proceed on the basis of a fiction.

Whilst Stein v Blake concerned a bankruptcy, there was no suggestion that the position would be different as regards insolvent companies. Referring to Rule 4.90 the Judge concluded that the account to be taken must properly involve a valuation of the cross claim. That such a claim was ‘barely arguable’ was not enough. The appeal failed. Aer Lingus was obliged to pay the full amount of Swissport’s claim.
This conclusion supports the view that the claim and the cross claim continue to coexist after the relevant date.

A similar issue arose in *Re Kingstons Investments Ltd*.xxii

Adlon Ltd contended that the Chairman of a Section 98 meeting of creditors cannot reject or reduce a liquidated claim for voting purposes on the basis that it may be reduced or extinguished by a cross claim. Registrar Barber agreed. Citing Lord Hoffmann’s speech in *Stein v Blake*, where he accepted that for certain purposes claim and cross claim must continue to be considered separately.xxiii

In *Stein v Blake*, the first issue in the appeal was whether where A, against whom B had a cross claim, becomes bankrupt, A’s claim continued to exist as a chose in action so that A’s trustee could assign it to a third party. Lord Hoffmann held that the original chose in action ceased to exist and was replaced by a claim to the net balance (at the bankruptcy date.) The cross-claims as choses in action could not therefore continue to exist.

However, and evidently, the cross claims can coexist for some albeit limited purposes as described above. What does this say about the automatic and self-executing nature of insolvency set-off? Lord Hoffmann addressed this apparent anomaly in *Stein v Blake*.

“"The claims and the cross claims must be considered separately for the purpose of ascertaining the balance... This may suggest that the respective claims actually do continue to exist until the court has decided the amounts to which each party is entitled and ascertained the balance due one way or the other... But the litigation is merely part of the retrospective calculation, from which it will appear that from the date of bankruptcy, the only chose in action which continued to exist as an assignable item of property was the claim to a net balance."xxiv (Emphasis added.)

Discussion

It would seem that the inevitable delay between the relevant date and the date of account does not inform the nature of insolvency set-off. The decision in *Swissport* is confined to the application of CPR 24.2.6. The decision in *Re Kingston* relies on the application of IR 4.70(3). In *Stein*, Lord Hoffmann considered the delay to be part of the retrospective calculation. That being so then I return to my example where B is asserting his cross claim against A, and A is asserting his primary claim against B. Whilst the amount of each claim will be articulated as such, possibly many months after the relevant date, that is simply to establish the value of the net balance due to either party. Where that calculation shows the net balance to be nil then the respective claims have been extinguished as of the relevant date. This means that there is no debt due to B that he can properly collect by enforcing his security.

However, in practical terms, it is unlikely that both claim and cross claim exactly match each other. That being so B is most unlikely to wait for an account to be taken at which point the liquidator of A will determine whether both claims have been set-off and B has secured payment. I suggest that it would be more likely that B would make an election to rely on his security. It is open to B to do so in reliance on
the decision in *Re Norman*. If B does that then the Liquidator of A will, in practice, consider B to have taken himself out of the insolvency process. The ‘default’ position described above pertains. (Note, B elects to rely upon his security, he does not enforce it.)

Equally, B could simply allow an account to be taken and rely on insolvency set-off. If the amount owed to B on the cross claim exceeds the amount B owes to A (which is the usual position in the writer’s experience) then B will obtain full value for it.

**Conclusion**

It is submitted that these conclusions would explain the differing position of some of the banks in swaps mis-selling claims. For example, Royal Bank of Scotland (“RBS”) relies upon insolvency set-off. Barclays, relies upon its security.

What can be said of the cross claims before the account is taken? They are subject to set-off unless an election is made by the secured party to rely upon its security. So insolvency set-off is automatic where it applies.

**Why does this matter?**

**Public policy**

The FCA wrote to the participating banks on 29 January 2013.xxv The FCA stated that:

“We are confident that our position will provide fair outcomes for consumers sold IRHPs, and, where appropriate, fair and reasonable redress.”

Where insolvency set-off applies, there is no redress to the insolvent company. This does not appear to me to be evidence of fair and reasonable redress. It appears that insolvency set-off allows the bank to secure payment of the debt due to it by setting it off in reduction of its liability to the company as a result of the bank’s own wrongdoing (mis-selling the swap). Is this right?

As a matter of public policy, one would expect to see wrongdoing being remedied as far as possible. Equally, it is arguably a matter of public policy that debts should be paid.

**Is the court likely to be persuaded to dis-apply insolvency set-off?**

Insolvency set-off has been part of English law since 1705xxvi (at the latest.)xxvii That being so any challenge would have to be thoroughly grounded.

Clearly, this in turn would depend upon the bank not having made an election to rely upon its security in any particular case.

I will share my latest thoughts on this at the Colloquium.
In doing so I am adopting the terminology developed by Philip Wood in English and International Set-off London: Sweet & Maxwell, 1989 paragraphs [TBC]  
ii Stein v Blake [1996] AC 243  
n IR 4.90 (1)  
y Insolvency Act 1986 S247 (2)  
vii The view of Pascal Pichonnaz and Louise Gullifer in Set-off in Arbitration and Commercial Transactions 1st edn OUP 2014 paragraph 12.45.  
ix [1993] Ch. 425  
(1874) L.R. 9 Ch. App. 293  
(1938) 60 C.L.R. 468  
[1993] Ch. 425 at Page 426  
Loc. Cit  
iv Ante, note i, at Paragraph 9-23  
v Ante, note vii, at Paragraph 12.86  
vii [2007] EWHC 1089 (Ch)  
vii At Paragraph 47  
viii At Paragraph 48  
ix Stein v Blake [1996] AC 243 at Paragraph 252H  
xx Ante, note xvi, at paragraph 48  
xxi Ante, note xvi, at paragraph 50  
xxii Re Kingstons Investments Ltd (in Creditors’ Voluntary Liquidation); subnom Adlon Ltd v Sale (as Liquidator of Kingstons Investments Ltd) and another [2015] EWHC 1619 (Ch)  
xxii Ibid at Paragraph 127 (Referring to Stein v Blake at Paragraph 255E)  
xxv A copy of their letter is available on the their website at http://www.fca.org.uk/your-fca/documents/irhp-letter-january-2013#  
xxvi The Bankruptcy Act (1705) 4&5 Anne c. 17 s11  
xxvii Derham suggesting that insolvency set-off operated as early as 1612, see Rory Derham The Law of Set-Off edn London: OUP, 2010 paragraph 6.33
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Georg E. Kodek studied law at the University of Vienna where he graduated ("doctor juris") with honors in 1987 after writing a thesis on “Rechtswidrig Erlangte Beweismittel im Zivilprozeß” (Unlawfully Obtained Evidence in Civil Cases), a revised version of which was published. Furthermore, he holds a LL.M. from the Northwestern University School of Law and interned at the King’s County District Attorney’s Office, Brooklyn, N.Y.

In 1991, he was appointed a district court judge in Vienna. After serving at the superior court of Eisenstadt and the Vienna Court of Appeals, he was appointed to the Austrian Supreme Court, in 2006.

In addition, he is professor of civil and commercial law at the Vienna University of Economics and Business. He has published extensively in the fields of civil and commercial law, insolvency law and civil procedure law.
This paper deals with the first ever case in which creditors of the public sector may actually lose money in German-speaking countries. Hypo Alpe Adria Bank, a bank in Carinthia, Austria’s southernmost province, was founded in 1896 as a state mortgage bank (“Landeshypothekenanstalt”). The Province of Carinthia acted as guarantor for the bank’s debts. From the mid to late 1990s, the bank underwent a process of rapid expansion and was highly active in southeastern Europe. As a result, the Province of Carinthia incurred potential liabilities of some 25 billion Euros, almost eight to ten times its annual budget. The rapid expansion process, together with poor management, brought the bank into serious financial difficulty. These difficulties led to the Hypo being nationalised in December 2009 in order to avert a collapse of the bank. The outstanding debts (for which the Province of Carinthia is liable) are estimated to be around 19 billion Euros, most of which were bond obligations. There are allegations of criminal misconduct involving the management of the bank and several former Carinthian politicians. The events are subject of some 73 criminal proceedings, an investigation by a committee headed by a former chief judge of the Austrian Supreme Court and two investigatory panels of the Austrian parliament. Several managers of the bank have already been convicted for abuse of their authority.

In 2014, the Austrian government decided to split Hypo into an operational Austrian unit, a Balkans banking unit, an Italian business and a bad bank, Heta Asset Resolution. While the operational units were to be sold, the bad bank, Heta Asset Resolution, was to be wound-up over a period of several years. In 2015, a new statute on the winding-up of banks entered into force. In March 2015, the Austrian Banking Supervision Authority imposed a one-year moratorium and took over the resolution of Heta. Already before this, in 2014, a special statute was enacted imposing a haircut on certain creditors whose claims became due before 30 June 2019 which purportedly was based on EC Directive 2001/24/EC on the reorganisation and winding up of credit institutions. This statute was promptly overturned by the Austrian Constitutional Court on the ground that it violated property rights of and unfairly discriminated against certain creditors. While in principle a “haircut” for creditors was not objectionable, the Court held that it was unconstitutional to place this burden only on a certain category of creditors. Subsequently, the Austrian parliament inserted a provision into the Financial Market Stability Act according to which it was possible to impose a collective-action regime on certain bonds if this was required for the stability of the Austrian financial market. Based on this provision, in January 2016 the state of Carinthia offered to pay 75 percent (to be financed, in large measure, by a loan from the Austrian federal government), which was slightly higher than the price of the bonds at that time. At present, it is unclear whether the required majority of 75 percent of the creditors will accept this offer.

This paper will describe some of the legal issues arising in this case. Special focus will be given to the statutory measures enacted in light of applicable EU law. Aspects to be addressed include restrictions resulting from the prohibition against state-aid in EU law, equitable subordination of certain claims and the compatibility with a “haircut” for creditors with the guarantees under the Austrian constitution and
the EU Charter of Fundamental Rights. Finally, since clearly the Province of Carinthia is unable to pay Heta’s outstanding debts and would become bankrupt if it actually had to pay these debts, the paper will examine what a bankruptcy proceeding against a province would like under Austrian law. While in Austria, unlike some other countries, subdivisions of the State can become bankrupt, there are almost no special statutory provisions for this scenario. As a result, many questions have to be solved by resorting to very general constitutional concepts of the organization and functioning of the State.
Law reform developments

Insolvency law reform in India: potential risks and rewards
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Associate Professor Anil Hargovan (BA; LLB; LLM) teaches corporate law in the School of Taxation and Business Law at the University of New South Wales, Sydney, Australia.

His research interests are in the area of corporate and insolvency law, a discipline in which he has presented many conference papers and published widely in Australian and international law journals, with over 90 publications. His research has been cited by law reform committees and the judiciary. Anil has authored and co-authored several books, including Australian Corporate Law (2013, 4th ed, LexisNexis Butterworths) and Principles of Contemporary Corporate Governance (2015, 3rd ed, Cambridge University Press).

Anil is the immediate past President of the Corporate Law Teachers Association (founded 1991), the peak body representing over 100 academics in the Australasian region. He is a member of the Corporate Governance Subject Advisory Committee for the Governance Institute of Australia (formerly Chartered Secretaries, Australia).
Insolvency hot topics

Taking control: who should control the insolvency process?
Dr Colin Anderson, Queensland University of Technology

An evaluation of the role of creditors in insolvency proceedings
Donna McKenzie-Skene, University of Aberdeen and Professor David Burdette, Nottingham Trent University

Retail, franchising and collective redundancies: an American, European and Australian study of social costs in insolvency
Associate Professor Jenny Buchan, University of New South Wales and Jenny Gant, Nottingham Trent University

Assignments of book debts – outright transfers of rights or unregistered securities?
Professor Peter Walton, University of Wolverhampton

The powers and role of the Australian Commissioner of taxation in face of corporate distress
Associate Professor David Brown, University of Adelaide
Colin Anderson
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Colin is an academic member of the Australian Restructuring Insolvency and Turnaround Association, a member of the Institute of Chartered Accountants in Australia and a Chartered Tax Advisor in the Taxation Institute of Australia. He is also on the executive of the Corporate Law Teachers Association and a member of INSOL International.
Taking Control: Who Should Control the Insolvency Process?

Insolvency procedures are recognised as being critical elements in our laws that facilitate commerce both at national and even an international level. There are a number of fundamental elements that are always present in insolvency procedures though how these elements are dealt with varies across jurisdictions for many historical, cultural, social, and economic reasons. In broad terms, one of these fundamental elements of any insolvency system is how the insolvency process itself is controlled and supervised. One of the key aspects of the control of the insolvency process is who (beyond the stakeholders) may play the role of controlling the process. In the Anglo-Australian model the key role in the control process is the insolvency practitioner. This paper will provide a preliminary study of the basis for the reliance on the insolvency practitioner in the Australian system of insolvency and make comparisons with other models of control – particularly the system in the United States. It will consider whether there is any scope for a movement away from the model used in Australia and will consider if recent suggestions in the US of the appointment of an “estate neutral” party in Chapter 11 suggests some movement towards the Anglo-Australian model in that jurisdiction. This paper will also provide a review of some of the issues that arise with our system within Australia regarding the control of the insolvency process and how a reconsideration of the parties who might undertake that control might assist in resolving those issues.

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David Burdette is a graduate of the University of South Africa (Bluris, LLB) and the University of Pretoria (LLD), South Africa. He joined Nottingham Trent University in Nottingham, England, in September 2007 as a Professor of Insolvency Law from the Faculty of Law at the University of Pretoria, and is currently the Director of the Centre for Business and Insolvency Law at Nottingham Law School.

He is co-author of the leading insolvency text book in South Africa, Meskin, Insolvency Law and its operation in winding-up (LexisNexisButterworths, loose-leaf edition) and contributor to the first service issue of Henochsberg on the Companies Act 71 of 2008 in South Africa (LexisNexisButterworths, loose-leaf edition). In 2007-2008 he was appointed to the King III Committee on Corporate Governance (South Africa) as convener of the subcommittee on corporate rescue. David is a Senior Consultant for the World Bank (Debt Resolution and Business Exit), and was the INSOL Scholar for the Europe, Middle East and Africa region for the 2006-2007 academic year.

David also holds appointments as Extraordinary Professor in the Department of Mercantile Law, Faculty of Law at the University of Pretoria and in the Department of Mercantile Law, Faculty of Law at the University of the Free State, South Africa, and as Visiting Professor at the Faculty of Law, Radboud University, Nijmegen, Netherlands. David has been an honorary member of the South African Restructuring and Insolvency Practitioner Association (SARIPA) since 2004, and is also an academic member of the ILA (UK) and INSOL International.

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Donna is a senior lecturer in law at the University of Aberdeen and teaches and researches in domestic and international insolvency law and related fields. She is a qualified solicitor although no longer practising and is a former member of the Law Society of Scotland Insolvency Solicitors' Committee.

She is currently a member of R3’s Scottish Technical Committee and external examiner for the postgraduate diploma in international insolvency at Nottingham Law School. She has just retired as a non-executive board member of the Accountant in Bankruptcy and was a member of the Expert Group advising the European Commission on the revision of the EU insolvency regulation in 2012.

AN EVALUATION OF THE ROLE OF CREDITORS IN INSOLVENCY PROCEEDINGS

ABSTRACT FOR INSOL LONDON ACADEMICS’ COLLOQUIUM

Given the changing role of insolvency processes over time, particularly personal insolvency processes, and the drive for further development of the rescue culture in the corporate context and for harmonisation, it seems to be an appropriate time to look at the role of creditors in insolvency proceedings generally.

The project will commence with a paper looking at current international best practice regarding the role of creditors in insolvency proceedings, and benchmarking the current position against the position in the UK. Tracing the historical development will entail examining how the law has developed from personal / non-corporate insolvency to corporate insolvency, and finally to corporate rescue.

From this first exploratory paper further themes will be identified and analysed that will be used to underpin a comparative study (including civil law, common law and mixed jurisdictions) and an analysis of any European or other developments in this regard. The project will particularly look at the extent to which the role of creditors has changed over time, and the main cause of that change. Aspects such as policy (including conflicting policy in insolvency and other areas of law), creditor apathy, and the substitution of public bodies for creditor oversight of insolvency proceedings will be examined in this regard.

The project will aim to help identify the appropriate role of creditors in different insolvency contexts in the modern era.
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Jenny worked for 19 years as a commercial lawyer before becoming an academic in 2002. Through representing shopping centre clients in negotiations with franchisors, and then a major petroleum franchisor she became fascinated by franchise relationships and franchise law.

Jenny is the author of the book Franchisees as Consumers: Benchmarks, Perspectives and Consequences (Springer, 2013) and of articles on franchise law.

Jenny is a member of the Australian Competition and Consumer Commission's Small Business and Franchising Consultative Committee, the Law Society of NSW, the International Society of Franchising and ARITA. She is on the Editorial Review Board of two journals and Deputy Chair of the UNSW Australia Human Research Ethics Committee.

Jenny teaches franchise law, international franchise law and contract law. Her research passions are franchise law and policy; in particular the intersection of franchising with consumer protection and insolvency law. She is currently hosting the world’s first MOOC on International Franchise Law.

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Jennifer is a non-practicing employment solicitor and holds an LLM in Insolvency and Employment Law. She is currently researching her PhD in insolvency, employment and comparative law under the supervision of Professors David Burdette and Paul Omar. Her project focus is on business transfers occurring out of corporate rescue procedures and the application of acquired rights in the UK and France. Her aim is to identify a means of improving the balance between employment protection and corporate rescue procedures, thereby improving the efficiency of cross-border insolvency with considerations of employment and social policy in mind.

Jennifer has presented at the INSOL International Academic’s Colloquium in The Hague in 2013 and Hong Kong in 2014. She has also presented at INSOL Europe in Paris and the Society of Legal Scholars annual conference in September 2014. Jennifer has published a number of papers and articles and looks forward to several more before completing her PhD.
Employees and franchisees often find themselves in a position of risk when insolvency comes to decentralised organisations such as retail companies. While in most jurisdictions, there is some form of protection in place for employees, franchisees do not benefit from similar protective provisions. When faced with insolvency, collective redundancy and lay-off processes are often engaged in order to reallocate resources and redistribute assets, as it is often the employees that are the most costly assets to maintain. Franchisees, on the other hand, are the least costly assets for an administrator to maintain. Their franchise agreements typically remain binding until disclaimed by a liquidator. Until that time franchisees and their employees provide what amounts to a free labour force for the duration of the franchisor’s administration.

While true that franchisees can generally be said to have more control over their position than employees, protective provisions are conspicuously absent. To that end, the purpose of this paper will be primarily to evaluate the risks associated with insolvency for both franchisees and employees associated with decentralised corporate organisations and the extant protections available to them in the United States, Great Britain by way of European Union social policy, and Australia, with a focus on aspects of participation, consultation, and/or the provision of information in relation to the risk that insolvency poses to their relative position. It is envisaged that franchisees could also benefit from some form of participative processes similar to what exists for employees in a number of jurisdictions, particularly within the EU but also under the Fair Work Act 2009 in Australia, without creating any undue complication to insolvency procedures occurring in decentralised corporate organisations.
Professor Walton has taught at the University of Wolverhampton for over twenty years. He is a Professor of Insolvency Law and for many years was the Course Director of the Legal Practice Course. He is currently the Director of the University's Law Research Centre.

Professor Walton has published widely on all aspects of insolvency law and his work has been quoted by the New Zealand Law Commission, cited by the New Zealand High Court, cited in argument in the Privy Council and been relied upon by the UK Supreme Court. He co-authors, with Professor Andrew Keay of Leeds University, a well-received textbook entitled Insolvency Law: Corporate and Personal published by Jordans, is case editor for Bankruptcy and Personal Insolvency Reports and is the General Editor of Totty, Moss and Segal on Insolvency published by Sweet & Maxwell.
Assignments of Book Debts – Outright transfers of rights or unregistered securities?

Professor Peter Walton University of Wolverhampton

Recent empirical projects carried out on behalf of, respectively, the Insolvency Service and the insolvency practitioner profession, have shown that SMEs are increasingly being financed by receivables financiers who take an absolute assignment of an SME’s book debts. The receivables finance industry in the UK is estimated to be worth over £250 billion per annum and across Europe £3 trillion. In the event that the SME goes bust, the assigned book debts are swept away by the financier, as legal owner.

The financier will either give notice to the debtor at the time of taking the assignment (a practice known as “debt factoring”) or delay such notice until sometime later, often post formal insolvency (a practice known as “invoice discounting”). This latter type of arrangement (invoice discounting) is far more common than debt factoring and is arguably particularly objectionable as the financier takes title to (usually) the whole debt ledger by way of a secret agreement which only comes to light on the company’s insolvency.

The accepted wisdom is that such agreements are absolute assignments and not security interests which would require registration under the Companies Act 2006.

The paper will consider the history of assignments of book debts and will suggest that an equitable assignment of a debt (that is, an assignment without notice to the debtor) is not an out-and-out transfer of the debt but operates by way of charge. Such agreements are therefore securities which are void against other creditors without registration. Due to the restrictions placed upon dealing with the book debts by the invoice discounter, such charges are likely to be fixed charges rather than floating charges, but will nevertheless require registration under the Companies Act 2006. Although the invoice discounter may make the equitable assignment into a legal assignment by giving notice to the debtor, if that notice is subsequent to the commencement of a compulsory winding up it will, prima facie, be void under s.127 Insolvency Act 1986. If the notice is given once a company enters administration the statutory moratorium will prevent the notice taking effect as the conversion into an absolute assignment would be an enforcement of a security interest akin to foreclosure of a mortgage.

The ostensibly unassailable position of the invoice discounter on the insolvency of its client may not therefore be as secure as is commonly believed.
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He Teaches and researches at all levels in insolvency and secured transactions and his latest co-authored publications include Australian Personal Property Securities Law (LexisNexis 2015), New Zealand Land Law (3rd edition due out later this year), and Australian Insolvency Law Cases and Materials (LexisNexis, 2015).
The Australian Commissioner of Taxation (ACT), as with global peers, has a mandate to collect as much tax as possible for the Government’s Treasury department, as its agent. The Treasury also oversees the administration of insolvency laws and initiates reform proposals, which in modern times facilitate and encourage a business rescue culture. The ACT has special powers of recovery and enforcement against companies, their directors, and, through garnishee notices, third parties; in addition it has the normal creditors’ remedies, such as statutory demands. But even here, not all creditors are created equal, as case law on statutory demands issued by the ACT shows.

Notwithstanding this array of statutory powers, the ACT has discretion as to how to achieve its statutory mandate. This paper sets out the context of the ACT’s position in Australia’s modern corporate insolvency framework, and then explores the scope for utilising its discretion more effectively than has been done to date, in order to re-align the methods of achieving what, at first sight, seem to be two irreconcilable policy objectives of government. In both cases it appears to be agreed that early intervention assists, so the paper suggests that developments in other jurisdictions such as use of predictive tools and client engagement mechanisms particularly with SMEs, and an emerging mutual interest in early assessment of ‘viability’ of businesses, should be further researched. In addition, the law on statutory demands and garnishee notices, and the ACT’s approach to them, should be reviewed.

Whilst the focus of this paper is on the Australian position, it is part of a wider comparative study into the approach to administration of revenue law and policy in the face of corporate distress.