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The European Restructuring Directive and stays on Creditor Enforcement Action

Abstract

The European Restructuring Directive can be spoken of as Europe's response to Chapter 11 of the US Bankruptcy Code.

Under the Directive, debtors will have access to early warning tools that enable them to detect a deteriorating business and this should lead to more restructurings at an early stage. The debtor will benefit from a time-limited 'breathing space' from enforcement action in order to facilitate negotiations on a restructuring plan.

This paper analyses in critical detail the stay or moratorium on actions against the debtor during the restructuring process. The stay is a fundamental part of the Directive. The paper highlights the importance of the stay and locates the stay in the context of the Directive and also in light of the international parallels.

The European Restructuring Directive can be spoken of as Europe's response to Chapter 11 of the US Bankruptcy Code.[1] Chapter 11 has been ascribed a prominent place in 'the pantheon of extraordinary laws that have shaped the American economy and society and then echoed throughout the world.'[2]On 26th June 2019[3] of the Restructuring Directive was officially published in the EU's Official Journal. EU Member States are required to implement it by 17th July 2021[4] though they may request a one year extension.[5] With 'Brexit', the UK is no longer an EU State and is not obliged to implement the Directive[6] but in fact many of the provisions in the UK's Corporate Insolvency and Governance Act 2020, introduced in response to the Covid-19 pandemic, are in conformity with the Directive.

Under the Directive, debtors will have access to early warning tools that enable them to detect a deteriorating business and this should lead to more restructurings at an early stage. The debtor will benefit from a time-limited 'breathing space' from enforcement action in order to facilitate negotiations on a restructuring plan. To enhance the possibility of a successful

[1]See http://www.euractiv.com/section/euro-finance/opinion/a-chapter-11-law-for-europes-entrepreneurs/

[2] See E Warren and JL Westbrook, 'The Success of Chapter 11: A Challenge to the Critics' (2009) 107 *Michigan Law Review* 603 at p 604.

[3] L 172/18.

[4] Article 34(1) of the Directive.

[5] Article 34(2).

[6] See the UK's European Union (Withdrawl)) Act 2018 and the European Union (Withdrawl Agreement) Act 2020.

restructuring, there is provision for dissenting minority creditors and shareholders to be 'crammed down' under strict conditions and with due safeguards for their legitimate interests.

The Directive builds on earlier European Commission initiatives in this area most notably the 2014 *Recommendation on a new approach to business failure and insolvency*.[7] According to the Commission, this Recommendation, lacking formal legal status, had been only partially implemented by Member States.[8]

This paper analyses in critical detail the stay or moratorium on actions against the debtor during the restructuring process. The stay is a fundamental part of the Directive as it was in the earlier recommendation on *A New approach to Business Failure and Insolvency*.[9] The paper highlights the importance of the stay and locates the stay in its appropriate context, both in the context of the Directive and also in light of the international parallels.

Apart from this introductory section, the paper consist of 4 other sections including a conclusion. Section 2 considers the reasons behind the stay and also the international comparisons; in particular the UNCITRAL Legislative Guide on Insolvency and Chapter 11 of the US Bankruptcy Guide. Section 3 pulls out some features of the stay for detailed scrutiny such as whether the stay should be automatic or discretionary; adequate protection for creditor interests; relief from the stay; and conditions for getting the stay lifted. Section 4 details the treatment of executory contracts. Finally, section 5 concludes. But first to sketch out the main features of the stay.

Article 6 refers to a stay of individual enforcement actions to the extent necessary to support negotiations on a restructuring plan and Member States are required to put in place measures to allow for such a stay. The stay is not automatic nor necessarily comprehensive however, though it may include secured and preferential creditors. The only exception is the outstanding claims of workers unless, and to the extent, Member States put in place alternative measure for the protection of such claims.[10] The initial maximum duration of the stay is 4 months[11]

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[7] C (2014) 1500 final and see also the Commission Communication A New European Approach to Business Failure and Insolvency COM (2012) 742. For discussion of the recommendation see, inter alia, G McCormack, 'Business restructuring law in Europe: making a fresh start' (2017) 17 *Journal of Corporate Law Studies* 1; S Madaus, 'The EU Recommendation on Business Rescue: Only Another Statement or a Cause for Legislative Action across Europe?' [2014] *Insolvency Intelligence* 81; H Eidenmuller and K van Zweiten, 'Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency' (2015) 16 *European Business Organization Law Review* 625.

[8] See the Commission evaluation published on 30th September 2015 – the same date as the Capital Markets Action Plan. http://ec.europa.eu/justice/civil/files/evaluation_recommendation_final.pdf at p 5. See also SWD (2016) 357 final.

[9] C (2014) 1500 final. Articles 10-14 of this Recommendation dealt with the stay.

[10] Article 6(3).

[11] Article 6(4).

though the stay may be extended for a period or periods reaching a maximum duration of 12 months.[12] In general the stay precludes the filing of insolvency proceedings for its duration[13] unless the debtor becomes illiquid, although such a state of affairs does not bring the stay automatically to an end.[14] There is also provision for relief from the stay if affected parties can establish unfair prejudice to their rights or interests.[15] Member States are also required to allow the lifting of the stay when it appears that negotiations on a restructuring are not likely to yield a plan that will gain approval – 'if it becomes apparent that a proportion of creditors who under national law could block the adoption of the restructuring plan does not support the continuation of the negotiations'.[16] Article 7 deals with some of the consequences of the stay and these include the treatment of 'executory contracts' i.e. contracts not yet performed by the debtor. It also enables Member States to exclude certain contractual arrangements such as close out netting agreements from the stay.

2. Why have the stay – the international consensus

a. Why have the stay?

In short, the stay is designed to provide the debtor with the necessary free space to negotiate a restructuring plan free from the threat of hostile creditor action.[17] If there is no stay, then creditors may seize or otherwise immobilise assets that are useful or indeed essential for the carrying on of the debtor's business and thereby jeopardise the prospects of a successful restructuring. The 'common pool' metaphor has been used in this connection. If creditors 'overfish' in the common pool then this harms the overall ecological structure and prevents the possibility of fish stocks being replenished.[18] A business essentially consists of a network of assets and relationships and these should be worth more collectively than if they are scattered in different directions. According to Professor Jackson:[19] 'To the extent that a non-piecemeal collective process (whether in the form of liquidation or reorganization) is likely to increase the aggregate value of the pool of assets, its substitution for individual remedies would be advantageous to the creditors as a group. This is derived from the commonplace notion: that

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[12] Article 6(7).
[13] Articles 7(1) and 7(2).
[14] Article 7(3).
[15] Article 6(5).
[16] Article 6(8).
[17] But see S Paterson, 'Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century', (2015) 35 *Oxford Journal of Legal Studies* 1. In her view, one should distinguish between liquidation law where creditors face a 'prisoners' dilemma' justifying a stay and restructuring law. The latter is concerned with providing a deadlock resolution procedure that can discipline hold-outs but does not necessarily need a stay.
[18] On the use of the 'overfishing' analogy in another context see J Diamond, *Collapse: How Societies Choose to Fail or Survive* (New York, Viking Penguin, 2005) at pp 427-428.
[19] See TH Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge MA: Harvard University Press, 1986) p 14. See also O Couwenberg and SJ Lubben, 'Essential Corporate Bankruptcy Law' (2015) 16 *EBOR* 49.

a collection of assets is sometimes more valuable than the same assets would be if spread to the winds. It is often referred to as the surplus of a going concern value over a liquidation value.'

The stay is intended to augment the common pool of assets and on the flip side of the coin, it addresses the 'anti-commons' problem of blocking actions by individual creditors who are seeking to frustrate the wishes of the majority.[20]In the US, the stay has been described as one of the fundamental debtor protections provided by the bankruptcy laws:[21] 'It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganisation plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.'

The stay contemplated by Article 6 of the Directive is intended to give the debtor a breathing space in order to negotiate a restructuring plan. Recital 32 refers to the 'aim of supporting the negotiations on a restructuring plan, in order to be able to continue operating or at least to preserve the value of its estate during the negotiations.'

b. International comparisons

The stay is a prominent features of international insolvency instruments such as the UNCITRAL Legislative Guide on Insolvency.[22] Under the Guide, a secured creditor is however, entitled to relief from the stay if the encumbered asset is not necessary to a prospective restructuring or sale of the debtor's business. Moreover, while the stay lasts, a secured creditor is entitled to protection of the value of the asset in which he or she has a security interest.[23] Appropriate measures of protection are stated to include cash payments by the debtor's estate, provision of additional security interests, or such other means as the court determines.

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[20] For a discussion of 'anti-commons' problems, see D Baird and R Rasmussen, 'Anti-bankruptcy' (2010) 119 *Yale L J* 648; R de Weijs, 'Harmonisation of European insolvency law and the need to tackle two common problems: common pool and anticommons' (2012) 21 *International Insolvency Review* 67; and, more generally, MA Heller, 'The tragedy of the anticommons: property in the transition from Marx to markets' (1998) 111 *Harvard Law Review* 622.

[21] HR Rep No 595, 95th Cong, 1st Session 340 (1977). The statement continued: 'The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that.'

[22] See Recommendations 39-51 of the UNCITRAL Guide.

[23] Recommendation 50 of the UNCITRAL Guide.

The stay is also an intrinsic feature of Chapter 11 of the US Bankruptcy Code. It is automatic and imposes a freeze on proceedings or executions against the debtor and its assets and has worldwide effect.[24] The US courts have inferred extraterritorial effect from the language of the Bankruptcy Code provisions[25] and they have also held that the bankruptcy estate comprises property of the debtor wherever situated throughout the world.[26] The long arm of the US automatic stay is illustrated by a series of Chapter 11 cases involving foreign shipping companies.[27] These debtors have recognized the benefits and advantages served by Chapter 11 proceedings including the debtor in possession norm and the reach of the automatic stay but, in some cases, the US connections of the debtors have been rather tenuous.[28] Due to the global economic reach and power of the US, this stay cannot be ignored unless an affected party has no US connections.[29]

In Chapter 11 however, a secured creditor can apply to have it lifted and there is a specific requirement of 'adequate protection' for the holders of property rights who are adversely affected by the stay.[30] Chapter 11 provides examples of 'adequate protection' although the concept itself is not defined.[31] It should however be noted that it is only the value of the collateral that is entitled to adequate protection. [32] An under-secured creditor may find itself footing the bill for an unsuccessful restructuring attempt. He or she is prevented from enforcing the collateral by the automatic stay yet it is not entitled to interest during what may be a long drawn out Chapter 11 process. However, an over-secured creditor is entitled to be paid interest out of the security 'cushion' at the plan confirmation stage as a condition of the court approving the plan.

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[24] See *In re Nortel Networks Inc* (2011) 669 F3d 128.

[25] See *Nakash v Zur (In re Nakash)* (1996) 190 BR 763 where the automatic stay was enforced against a foreign receiver in respect of the foreign assets of a foreign debtor.

[26] See *Hong Kong & Shanghai Banking Corp v Simon (In re Simon)* (1998) 153 F3d 991 at 996: 'Congress intended extraterritorial application of the Bankruptcy Code as it applies to property of the estate'.

[27] For an early example see *In re Global Ocean Carriers Ltd* (2000) 251 BR 31 which concerned a shipping company headquartered in Greece and where it was held that the unearned portions of retainers provided to US counsel constituted property that was sufficient to form the basis for a US bankruptcy filing.

28 See generally I Darke, 'Use of US Chapter 11 Filings by Non-US Corporations; Realistic Option or Non-Starter' [2011] *International Corporate Rescue* 206.

[29] On the worldwide effect of the US automatic stay see: *In re Nortel Networks Inc* (2011) 669 F 3d 128.

[30] Section 361 US Bankruptcy Code.

[31]The examples given are cash payments, additional or replacement security interests on other property and, unusually expressed, something that will give the creditor the 'indubitable equivalent' of its security interest.

[32] See *Re Alyucan* (1981) 12 BR 803 where the court rejected the view that the preservation of a certain collateral-to-debt ratio was part of the creditor's property interest that warranted protection. See also *United Savings Association of Texas v Timbers of Inwood Forest Associates Ltd* (1988) 484 US 365 where the Supreme Court held that the adequate protection provision did not entitle an under-secured creditor to compensation for the delay caused by the stay in enforcing the security.

However, it should be noted that while the US Bankruptcy Code stay applies to both liquidation proceedings under Chapter 7 and restructuring proceedings under Chapter 11, other countries may draw a distinction between liquidation and restructuring and apply a wider stay only to restructuring proceedings.[33]This is the case under the UK Insolvency Act 1986, where there is a clear distinction between a liquidation stay under s 130(2) and a broader restructuring or 'administration order' stay in Schedule B1 para 43. The liquidation stay is designed to avoid the unnecessary expenditure of assets that were otherwise available for distribution among creditors and to support the replacement of a creditor's right to establish a claim by judgment in an action with a right to lodge a proof of debt.[34] The liquidation stay does not affect however, certain rights such as rights to enforce security and rights to repossess goods under hire-purchase and retention of title agreements. The 'administration stay' in Schedule B1 para 43 if however, much broader and applies to the enforcement of these rights.

3. **Particular aspects of the stay**

The Restructuring Directive stresses the importance of safeguarding creditor rights during the period of any stay. Recital 35 refers to providing a fair balance between the rights of the debtor and those of creditors and therefore limiting the stay to a maximum initial period of up to 4 months.[35] In seeking this balance, the Directive is in keeping with international precedents. Long drawn out restructuring proceedings and in particular those involving restrictions or a stay on the enforcement of collateral have the effect of transferring wealth to managers and shareholders at the expense of creditors. Creditors are kept out of their money while managers may keep their jobs. Shareholders may also benefit from the restructuring efforts in that if the company is kept afloat, the value of their shareholdings can be preserved. However, these international precedents also illustrate how the precise manner of protection may vary across countries and legal regimes.

a. Automatic or discretionary stay?

The original European Commission Recommendation on a *New Approach to Business Failure and Insolvency* suggested that debtors should generally be granted a stay where '(a) creditors representing a significant amount of the claims likely to be affected by the restructuring plan support the negotiations on the adoption of a restructuring plan; and (b) a restructuring plan has a reasonable prospect of being implemented and preventing the insolvency of the debtor.'[36]The Recommendation also suggested that the stay, in terms of duration, should

[33] But see S Paterson, 'Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century', (2015) 35 *OJLS* 1.
[34] *Gardner v Lemma Europe Insurance Co Ltd [2016] EWCA Civ 484* at 2.
[35] See also Article 6(6) and Article 6(7) on extensions of the stay in 'well-defined circumstances'.
[36] Recommendation 11.

strike a fair balance between the interests of debtor and creditors, including in particular secured creditors. The stay should depend on the complexity of the case, and the anticipated restructuring. In the first instance, it should not exceed 4 months but, depending on progress in the negotiations, it might be extended – though the total duration should not exceed 12 months.[37] Linked with duration is the question of lifting the stay and the Recommendation provided that where the stay is no longer necessary for facilitating the adoption of a restructuring plan, it should be lifted.

In the Directive, the language on the stay has been strengthened somewhat from the earlier Recommendation and, in particular, Member States are free to provide for a stay by operation of law.[38] Nevertheless, the Directive does not mandate an automatic and worldwide automatic stay like the US Chapter 11.

The US automatic stay has directly influenced certain national laws. In the UK, the Corporate Insolvency and Governance Act 2020 Act introduces a new stay/moratorium procedure for a company in financial distress and is available on making certain e-filings with the court.[39]This is essentially a 'debtor-in-possession' process with the aim of facilitating the rescue of a company as a going concern. The moratorium protects the company's directors who remain in place and continue to run the business with the protection of the moratorium. It gives the company breathing space and, subject to some exceptions particularly for financial creditors, prevents creditors from pursuing payment or taking enforcement action while the company explores its rescue and restructuring options.

The moratorium is available for an initial 20 days which is extendable in the same manner for a further 20 days and can then be extended with the consent of pre-moratorium creditors for up to 12 months from the date of initial filing.[40] The court also has a discretion to extend the moratorium especially where particular restructuring options are being considered. A 'monitor' oversees the moratorium.[41] The assumption underlying the legislation is that the monitor will be a qualified and licensed insolvency practitioner[42], but there is the possibility that, in the

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[37] Recommendation 13.

[38] Recital 32. The detailed provisions on the stay are contained in Articles 6 and 7 along with recitals 32-41.

[39] See the new A3 and A6 in the Insolvency Act 1986 as introduced by the Corporate Insolvency and Governance Act 2020.

[40] The moratorium is also extendable on application to the court but here there is no time limit

[41] Application of the legislation in practice depends a lot on the attitude of the proposed monitor - see the new s A6 inserted into the Insolvency Act. What is required is (a) a statement from the company directors that, in their view, the company is, or is likely to become, unable to pay its debts, and (b) a statement from the proposed monitor that, in the proposed monitor's view, it is likely that a moratorium for the company would result in the rescue of the company as a going concern. These statements point in different directions and some insolvency practitioners may take the view that it is difficult, if not impossible, to satisfy the requirements involved in both.

[42] Section 388 of the Insolvency Act is modified by Schedule 3, para 21 CIGA.

future, a broader pool of suitably qualified professional such as accountants or turnaround 'experts' might become monitors.[43]

Singapore is also building itself up as a global restructuring hub and a new law in Singapore adopts some of the features from Chapter 11. There is now an automatic 30 day interim stay on the filing of a moratorium application and the stay may be extended on application to the court, but more stringent information requirements are likely to be required to be satisfied by the applicant for an extension.[44] The stay may also be given worldwide in personam effect provided that the Singapore court has jurisdiction over affected creditors or their assets.[45] Under case law developed in the English courts, creditors may be restrained by injunction from pursuing foreign proceedings where the conduct of such creditors is oppressive, vexatious or otherwise unfair or improper[46] and there are suggestions that the Singapore courts would adopt a similar approach in the absence of statutory guidance. A 2016 *Report on Singapore as an International Debt Restructuring Centre*[47] suggested however that an express statutory statement would have a greater visibility internationally. The Committee said at para 3.14:

'Express provisions for this injunctive relief should therefore allow the Singapore courts to make an order to stay creditors, who are based in Singapore or having sufficient nexus to Singapore such as to invoke the jurisdiction of the Singapore courts, from taking action globally (i.e. similar in nature to the in personam effect of an anti-suit injunction). This injunctive relief is useful as it leverages on Singapore's status as an international financial hub and can bind creditors registered in and/or operating from Singapore from taking actions that might frustrate a restructuring.'

The Singapore reforms also allow the stay to be extended to entities related to the debtor.[48] Various conditions have to be met to the satisfaction of the court, including the fact that that

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[43] See generally Glen Davis QC 'The Role of the Monitor in a Rescue Moratorium' South Square Digest special issue on Corporate Insolvency and Governance Act 2020 at p18 and available at https://southsquare.com/wp-content/uploads/2020/07/Digest_Magazine_Mini_Digital-CIGA.pdf

[44] Companies Act (Singapore), section 211B(8) read with s 211B(7). See also 2016 *Report on Singapore as an International Debt Restructuring Centre* available at https://app.mlaw.gov.sg/files/news/press-releases/2016/04/Final%20DR%20Report.pdf at para 3.10.

[45] Companies Act (Singapore), section 211B(5).

[46] The leading case is now the decision of the Privy Council in *Stichting Shell Pensioenfonds v Krys [2014] UKPC 41 and s*ee generally the case for a more extensive stay under UK law: H Anderson, 'The Extra-Territoriality of the Statutory Stay in an English Administration' (2004) 23 *International Insolvency Review* 40.

[47] Available at https://app.mlaw.gov.sg/files/news/press-releases/2016/04/Final%20DR%20Report.pdf

[48] Companies Act (Singapore), section 211C.

the related company plays a 'necessary and integral role' in the debtor's scheme and the creditors of the related company will not be unfairly prejudiced by an extension order.[49] In making the case for this legislative innovation, the *2016 Report* pointed to the fact that many businesses organise themselves across a corporate group structure and that 'a restructuring can potentially be frustrated if creditors are able to take action against related corporate entities that are a necessary and integral part of the restructuring plan.'[50]

However, it should be noted that that there is no express statutory authority for such an extension in the US Chapter 11 – though there is judicial authority. These decisions stem from s 105(a) Bankruptcy Code which allows US courts to 'issue any order, process, or judgment that is necessary or appropriate' to implement the provisions of the Code. The courts have used this provision as a sufficient base for extending the protections of the automatic stay to non-debtors and apply a fact-specific analysis to determine whether the stay applies to such entities as well as the debtor itself. Nevertheless, it is only in 'unusual circumstances' where the interests of a debtor and non-debtor are very closely related that the stay can reach the non-debtor party. It was held in the leading case of *AH Robins Co v Piccinin*[51] that 'unusual circumstances' exist where it is established that 'there is such identity between the debtor and the non-debtor that the debtor may be said to be the real party defendant and that a judgment against the non-debtor will in effect be a judgment or findings against the debtor.' In another leading case, *Queenie Ltd v Nygard International,*[52] it was held that the automatic stay can apply to non-debtors if a claim against the non-debtor will have 'an immediate adverse economic consequence for the debtor's estate'.

The substantive provisions of the Restructuring Directive are silent on the subject of extending the benefits of the stay to non-debtors, though Recital 32 of the preamble does not display a similar reticence. It states that it 'should also be possible for the stay to apply for the benefit of third-party security providers, including guarantors and collateral givers, but does enter the proviso that this course of action should be permitted by national law. This proviso does not really add very much because the sovereign authority of Member States remains intact except insofar as it is taken away by the EU treaties.[53]

b. Scope of the stay

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[49] Companies Act (Singapore), section 211C(2).
[50] *2016 Report* at para 3.15.
[51] (1986) 788 F 2d 994, 999.
[52](2003) 321 F 3d 282, 287.
[53] *Articles 4 and 5, Treaty on European Union.*

Article 6 of the Directive refers to a 'stay of individual enforcement actions to support the negotiations of a restructuring plan in a preventive restructuring framework'. The stay does not necessarily encompass a stay on all legal actions against the debtor, but there is nothing to prevent Member States from enacting such a wide ranging stay that would include a stay of individual enforcement actions.

The decision of the European Court in *LBI hf v Kepler Capital Markets SA*[54] recognises a distinction between individual enforcement actions and lawsuits more generally.[55] As examples of enforcement actions, one might highlight actions taken for the realisation of assets or the enforcement of collateral whereas a simple breach of contract action that determine the existence, validity, content or amount of a claim exemplifies a more general instance of a lawsuit. A collateral enforcement action that takes away assets from the debtor that are needed for the debtor's business clearly impairs, in a very direct fashion, the debtor's ability to carry on business. Nevertheless, having to defend a potentially complicated legal action such as a breach of contract claims also consumes the time of the debtor's employees and representatives that might more usefully be spent on preservation of the business and business recovery. It seems sensible for Member States to legislate for a stay that is much broader that that suggested by the relatively limited language of Article 6.

Section 362 US Bankruptcy Code sets out the effect of the Chapter 11 and is much wider than Article 6. Section 362(a) includes very broad language prohibiting the commencement or continuation of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the Chapter 11 proceedings or to recover a claim against the debtor that arose before the commencement of those proceedings. It also includes any act to obtain possession of property of the debtor's estate or of property from the estate or to exercise control over property of the estate.

The current version of Chapter 11 also shows the effect of lobbying by special interest groups, which have brought about exemptions from the stay that seem difficult to justify or rationalise in the abstract and seem more the product of political expediency. Moreover, it should be noted that s 362 merely establishes a set of presumptions. A party may apply to have the stay lifted and the court may stay an action under s 105 US Bankruptcy Code even if the action is not automatically stayed under s 362.

More generally, s 362(b)(4) exempts from the stay commencement or continuation of an action or proceeding by a governmental entity to enforce the regulatory or police power of the

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[54] *Case C-85/12* [2013] All ER (D) 301).
[55] M Virgós and F Garcimartín, *The European Insolvency Regulation: Law and Practice* (Kluwer, 2004) at p 76.

governmental entity. Essentially, this means that the process of business restructuring should not be permitted to interfere with the operation of essential governmental functions. The public interest in enhancing the common good presumptively outweighs the company's interest in being restored to profitable trading or the interests of creditors in enforcing their security promptly. The commencement of reorganisation proceedings should not displace the rights of a regulator to have a dispute arising out of the exercise of regulatory functions settled in a forum that is different from that of the reorganisation proceedings. The would apply where a public or regulatory body is suing a business entity to prevent or stop the violation of fraud, environmental protection, consumer protection, safety or similar regulatory laws or attempting to establish liability to pay damages for violation of such a law.

The goals of business restructuring, however laudable or praiseworthy, should not excuse compliance with other laws.[56] It has also been held in the US that public bodies should not be able to use their special s 362 position as a means of obtaining preferential treatment as a creditor.[57] The s 362 exception should be construed narrowly and thereby allowing public bodies to pursue actions to protect public health and safety, but not actions that were designed to safeguard a financial interest.

Because the European stay is intrinsically more limited, there is no need in a European context to set out such qualifications expressly. However,Member States may exempt certain claims or categories from the scope of the stay where appropriately justified and where enforcement is not likely to jeopardise the restructuring of the business.[58] Moreover, while as a general rule the stay covers creditor initiation of insolvency proceedings, it seems that 'insolvency proceedings can [still] be opened at the request of public authorities which are not acting in a creditor capacity, but in the general interest, such as a public prosecutor.'[59]

c. Effect on collateral - decrease in value

Secured creditors may be adversely affected; for instance, by seeing the value of their collateral decrease during the period of the stay, but with no viable business emerging from the restructuring process. Effectively, the debtor is gambling unsuccessfully on resurrection

[56] Section 959(b) US Bankruptcy Code reflects the same sentiment stating: '[A] trustee … appointed in any cause … including a debtor in possession, shall manage and operate the property in his possession … according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.'

[57] See the comment in the US Congress: 'Since the assets of the debtor are in the possession and control of the bankruptcy court, and since they constitute a fund out of which all creditors are entitled to share, enforcement by a governmental unit of a money judgment would give it preferential treatment to the detriment of all other creditors' – HR Rep No 595, 95th Congress, Ist Session 343 (1977).

[58] Article 6(4)(a).

[59] Recital 38.

and the debtor is footing the bill for the rescue/restructuring attempt. Recital 37 states bluntly that the directive 'does not cover provisions on compensation or guarantees for creditors of which the collateral is likely to decrease in value during the stay.' This statement is to be contrasted with a the UNCITRAL Guide on Insolvency which suggests that while the stay lasts, a secured creditor is entitled to protection of the value of the asset in which it has a security interest.[60]

In the US, the statutory safeguards are very similar to that in the UNCITRAL Guide. Section 362(d) US Bankruptcy Code provides that a 'party in interest' may apply to have the stay lifted for cause, including the lack of adequate protection of an 'interest in property'. There are many legislative and judicial statements to the effect that secured creditors should not be deprived of their bargain.[61] The property in question may be necessary for use by the company in the reorganisation process, but the interest of secured creditors and other property rights holders should be protected during this period. In particular, holders of proprietary rights should be protected against the risk that their property may depreciate in value. A secured creditor's property interest is not adequately protected if the security is depreciating during the term of the stay.

In *Re Bermec*[62] judicial notice was taken of the deep concern of secured creditors lest their security depreciate beyond adequate salvage. On the other hand, the court said that this had to be balanced with the legislative mandate to encourage attempts at corporate reorganisation where there is a reasonable possibility of success. The objective of the adequate protection requirement is to leave a secured creditor with essentially an alternative means in value to that bargained for. It appears that the US Congress left the concept deliberately vague so as to facilitate 'case-by-case interpretation and development. It is expected that the courts will apply the concept in light of [the] facts of each case and general equitable principles.'[63]

This analysis has been developed in subsequent judicial interpretations. A leading case is *In re Alyucan Interstate Corp*[64] where the court said:

'Congress was aware of the turbulent rivalry of interests in reorganisation. It needed a concept which would mediate polarities. But a carefully calibrated concept, subject to a brittle construction, could not accommodate the indefinite number of variations possible in dealings

[60] See Recommendation 50 of the UNCITRAL Legislative Guide on Insolvency.
[61] See HR Rep No 595, 95th Congress, Ist Session 339 (1977).
[62] (1971) 445 F2d 367
[63] See HR Rep No 595, 95th Congress, Ist Session 339 (1977).
[64] (1981) 12 BR 803 at 805.

between creditors and debtors. This problem required, not a formula, but a calculus, open-textured, pliant and versatile.'

Section 361 provides 3 examples of ways in which adequate protection may be given: (1) periodic cash payments; (2) additional or replacement security interests; (3) other relief amounting to the indubitable equivalent of the person's interest in the property.[65] The unusual terminology of 'indubitable equivalence' comes from *Re Muriel Holding Corp*[66] where the judge said with reference to a proposed restructuring plan:

'Interest is indeed the common measure of the difference [between payment now and payment 10 years hence], but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.'

It is also specifically stated that administrative expense priority is not an acceptable means of adequate protection.[67] Such a manner of protection was considered too uncertain to be meaningful.[68] Elevating a claim to administrative expense status means that it will rank before the unsecured creditors, but after secured creditors at the plan confirmation stage. Section 507(b) in fact confers super-priority administrative expense status as back up protection to a secured creditor who had been given an approved method of adequate protection that subsequently turned out not to be adequate in reality.[69]

It has been argued that as part of the 'adequate protection' criterion, a secured creditor is entitled to have an equity cushion remain in place.[70] For example, a secured creditor who insisted in the security agreement that the value of the collateral should be, for example, 120%

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[65] For discussion see generally American Bankruptcy Institute (ABI) *Commission to Study the Reform of Chapter Full Report* at pp 70-71 and available at www.commission.abi.org/full-report/. See in particular the statement at p 71 'the Commission agreed that, for purposes of determining adequate protection …, a secured creditor's interest in the debtor's property should be determined based on the "foreclosure value" of such interest, instead of more commonly used valuation standards such as liquidation value and going concern value. The foreclosure standard is meant to capture the value of the secured creditor's interest as of the petition date (i.e., the value that a secured creditor's state law foreclosure efforts would produce if the automatic stay were lifted or the bankruptcy case had not been filed)'.

[66] (1935) 75 F2d 941 at 942.
[67] Section 361(3).
[68] S Rep No 989, 95th Congress, 2d Session 54 (1978) and see generally the discussion in CJ Tabb *The Law of Bankruptcy* (New York, Foundation Press, 1997) at p 193. Another example of adequate protection would be where a financially very well endowed third party provides a guarantee.
[69] By this is meant, super-priority in relation to other administrative expense claims.
[70] See J White, 'Death and Resurrection of Secured Credit' (2004) 12 *American Bankruptcy Institute Law Review* 139 at 146.

of the value of the debt – might contend that the reference in s 361(3) to preserving the indubitable equivalent of its interest in such property, would mean that the same debt/collateral ratio would be maintained during Chapter 11. Ultimately however, this view was rejected in *Re Alyucan*[71], where the court held that the interest in property entitled to protection was not measured by the amount of the debt, but by the value of the secured property. If the value of the creditor's collateral position was not threatened, then adequate protection was not necessary. Moreover, the court also said that the equity cushion could itself be regarded as adequate protection for the secured property. As one commentator caustically observes, a vigilant creditor is forced to devour his own collateral, but a prodigal son who had allowed his collateral to shrink to the amount of the debt was entitled to new security as adequate protection.[72]

In the Directive, everything is subsumed within the concept of 'unfair prejudice'. Instead of seeking compensation for a decline in the value, a secured creditor could apply for the stay to be lifted.[73] In fact, Article 6 does not really distinguish between secured and unsecured creditors. The only claims that are specially singled out for distinctive treatment are claims from employees which are not subject to the stay as a general rule – though Member States may subject them to the stay if they are guaranteed a similar level of protection in a preventive restructuring framework that they have outside the framework.[74]Across the board, creditors, and not just secured creditors, may be excluded from the stay[75] or from a continuation of the stay[76] if this would cause them unfair prejudice. They can also apply to a judicial or administrative authority to have the stay lifted on grounds of 'unfair prejudice' though Member States may limit this facility to situations where the affected creditors did not have the opportunity to be heard before the stay came into force or was extended.[77] Member States may also limit the opportunity to apply for a lifting of the stay to situations where the initial 4 month maximum period has expired.[78]

It may be that the concept of 'unfair prejudice' is being asked to do too much and that some of its workload can reduced by more particularised guidance. A possible precedent in this regard comes from the stay associated with the administration procedure in the UK. This

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[71] (1981) 12 BR 803.
[72] See J White, 'Death and Resurrection of Secured Credit' (2004) 12 *American Bankruptcy Institute Law Review* 139 at 146. For a general discussion see also American Bankruptcy Institute (ABI) *Commission to Study the Reform of Chapter Full Report* at pp 72-73 and available at www.commission.abi.org/full-report/.
[73] See Article 6(9)(c).
[74] Article 6(5).
[75] Article 6(4)(b).
[76] Article 6(7)(b).
[77] Article 6(9) final paragraph.
[78] Article 6(9) and see also Article 6(8) limiting the total duration of the stay to 12 months.

procedure was purposely designed to promote the rescue of the business of a company as a going concern, though in practice it seems to be used to achieve a more advantageous realisation of company assets than could be accomplished in a liquidation.[79] The procedure comes with a stay on creditor enforcement actions. There is no such explicit requirement of adequate protection and it is inherent in the scheme of the legislation that the interests of secured creditors and other property interest holders should yield to the interests of creditors as a collective body.[80] As Nicholls LJ said *in Re Atlantic Computers plc*:[81]

'To the extent that the [statutory moratorium] precludes an owner of land or goods from exercising his proprietary rights, [it] does have an expropriatory effect. But that is provided for in unequivocal terms. The safety valve which Parliament has built into the system is the owner's ability to make an application to the court.'

The courts thereupon enunciated a comprehensive list of guidelines on when the stay should be lifted.[82]

d. Getting relief from the stay - assets not necessary for the restructuring

If assets are not needed for an effective restructuring, then it seems that a stay should not be granted or continued under the Directive. Article 6(1) refers to the refusal of a stay where such a stay is not necessary.[83] Article 6(9)(a) instances the lifting of the stay where it no longer fulfils the 'objective of supporting the negotiations on a restructuring plan', such as where it 'becomes apparent that a proportion of creditors which, under national law, could prevent the adoption of the restructuring plan do not support the continuation of the negotiations.'

The US Bankruptcy Code takes a somewhat different approach though the end results are likely to be largely the same. According to s 362 where the stay relates to acts against property, relief may be granted where (a) the debtor does not have any equity remaining in the property and (b) the property is not necessary for an effective reorganisation. In the *Inwoods* case[84], the US Supreme Court used this provision to speed up the restructuring process.[85] The

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[79] See schedule B1 Insolvency Act 1986 para 3 setting out the purposes of administration.
[80] See generally D Milman, 'Moratoria on Enforcement Rights: Revisiting Corporate Rescue' [2004] Conv 89.
[81] [1992] Ch 505 at 530.
[82] [1992] Ch. 505 at 541-542.
[83] See Recital 34 referring also to uncompensated loss or depreciation of collateral.
[84] *United Timbers Association of Texas v Timbers of Inwood Forest Associates Ltd* (1988) 484 US 365.
[85] For criticism of the pre *Inwoods* state of affairs see D Baird and T Jackson 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 *U Chi L Rev* 97 at 126-127: 'A Chapter 11 proceeding typically buys

Supreme Court said that once the creditor establishes that the debtor has no equity in the collateral, the debtor has the burden of establishing that the collateral is necessary to an effective reorganisation. This requires not merely a showing that if there is conceivably to be an effective restructuring, this property will be needed for it, but also that the property is essential for an effective restructuring that is in prospect. This means that there must be a reasonable possibility of a successful restructuring within a reasonable time.[86]

If the debtor fails to show either that the property is necessary or that a successful reorganisation is a realistic possibility, then the secured creditor should be given permission to enforce the security and lift the stay. In virtually all Chapter 11 cases, the debtor needs to retain and use its property to improve the prospects of a successful restructuring. It is usually self-evident that the debtor needs the use of the property but, nevertheless, the feasibility of a successful restructuring may be hotly contested. The court in a US Chapter 11 context will require actual evidence on restructuring prospects rather than merely a statement of the debtor's hopes and dreams for a better future.[87] A secured creditor may be able to prevail on the feasibility issue if it can establish that the debtor will never be able to confirm a restructuring plan since it will not be able to obtain the required consents. Likewise, a creditor in a European restructuring context should be able to get a stay lifted if he or she can convince a relevant judicial or administrative authority that a majority of creditors whose consent to the restructuring plan is vital do not support continuation of the negotiations.[88]

4. Executory/ongoing contracts

Article 7 of the Directive obliges Member States to ensure that creditors may not withhold performance or terminate, accelerate or in any other way modify executory contracts to the detriment of the debtor during the stay period.[89] This policy extends to creditors relying on contractual clause that provide for such measures, solely by reason of the debtor's entry into restructuring proceedings or requesting the opening of such proceedings or the requesting or granting of a stay of individual enforcement actions.[90] Executory contracts are defined in Article 2(5) as contracts between debtors and counterparties under which both sides still have

time for the managers, the shareholders, and other junior owners at the expense of the more senior ones.'

[86] (1988) 484 US 365 at 375-376.
[87] See *Pegasus Agency Inc v Grammatikakis* (1996) 101 F 3d 882.
[88] Article 6(9)(a).
[89] Article 7(4).
[90] Article 7(5).

obligations to perform at the time the stay of individual enforcement actions is ordered or applied for.[91]

According to recital 41, early termination endangers the ability of the business to continue to operate during restructuring negotiations and it references in this connection contracts for the supply of utilities, telecoms and card payment services. Recital 40 instances the fact that some suppliers may have so-called 'ipso facto' clauses in their supply contracts giving them contractual rights to terminate the supply contract by reason of insolvency or relating proceedings affecting the debtor. It suggests that creditors should not allowed to rely on ipso facto clauses that make reference to negotiations on a restructuring plan; a stay or an event that is linked to the stay.

a. International parallels

In terms of the broad thrust of Article 7, there are certainly some general international precedents to rely upon.[92] For instance, the US Bankruptcy Code in s 365(e) has an invalidating provision in respect of 'ipso facto' clauses in executory contracts. The provision covers clauses that provide for the termination of the contract conditional on the insolvency or financial condition of the debtor and is part of a more general set of provisions allowing a debtor in US insolvency proceedings to 'cherrypick' executory contracts.[93] The debtor may assume or reject such contracts effectively deciding to continue contracts that are advantageous to the debtor's business, but rejecting contracts that are actually or potentially unprofitable and leaving counterparties with an unsecured damages claim against the debtor.

[91] For the classic definition in the US see V Countryman, 'Executory Contracts in Bankruptcy' (1972) 57 *Minnesota Law Review* 439; (1973) 58 *Minnesota Law Review* 479. For a general discussion see also American Bankruptcy Institute (ABI) *Commission to Study the Reform of Chapter Full Report* at pp 112-115 and available at www.commission.abi.org/full-report/. The Commission at p 112 proposed a codification of the Countryman definition: 'The Bankruptcy Code should define the term "executory contract" for purposes of section 365 as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other," provided that forbearance should not constitute performance.'

[92] For a detailed cross-country comparison of this issue see D Faber, N Vermunt, J Kilborn and K van der Linde, *Treatment of Contracts in Insolvency* (Oxford, Oxford University Press, 2013); J Chuah and E Vaccari eds *Executory Contracts in Insolvency Law: A Global Guide* (Cheltenham, Edward Elgar, 2019).

[93] See also recommendations 69-86 of the UNCITRAL Legislative Guide.

Both the UK[94] and Australia[95] have now also adopted similar legislative reforms. In Australia the reforms were introduced by the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017. The Act includes the stated purpose of 'enabling businesses to continue to trade in order to recover from an insolvency event instead of …[ipso facto] clauses preventing their successful rehabilitation'. However, the Act has been criticised on the basis that it does not exactly achieve its stated purpose.[96] The argument is that 'exceptions and carve-outs draw artificial and arbitrary distinctions between common forms of commercial transactions, with the result that creditors with similar transactions may have very different contractual rights during a restructuring effort.'[97]

In the UK,[98] the Corporate Insolvency and Governance Act 2020 Act added a new s233B to the UK Insolvency Act 1986 with a general set of provisions on termination and ipso facto clauses in contracts for the supply of goods and services.[99] The new provisions apply when a company becomes subject to a 'relevant insolvency procedure', which includes also two new procedures established by the 2020 Act, i.e. the statutory moratorium and the restructuring plan.

The provisions apply to any clause in a contract for goods and services, which either automatically terminates the contract or entitles the supplier to terminate the contract upon a company becoming subject to a relevant insolvency procedure. The Act also attempts to prevent suppliers from doing '*any other thing*' upon a company becoming subject to relevant insolvency procedure and the explanatory notes to the Act indicate that this is aimed at preventing suppliers from changing payment terms.[100] There is an express provision that

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[94] The original UK reform proposals were referenced at p 62 of SWD (2016) 357 final.

[95] On background to the Australian reforms see '*Improving Bankruptcy and Insolvency Laws*' (29 April 2016) including provisions for the invalidation of 'ipso facto' clauses during a restructuring attempt. The reform proposals are available at https://treasury.gov.au/consultation/national-innovation-and-science-agenda-improving-bankruptcy-and-insolvency-laws

[96] See generally the comments by C Symes and J Harris available on the Oxford Business Law Blog https://www.law.ox.ac.uk/business-law-blog/blog/2019/09/be-careful-what-you-wish-evaluating-ipso-facto-reforms

[97] *Ibid.* and see also J Harris and C Symes, 'Be Careful What You Wish For! Evaluating the Ipso Facto Reforms' (2019) 34 Australian Journal of Corporate Law *84-102.*

[98] See para 5.97 *Insolvency and Corporate Governance Government Response* available at https://www.gov.uk/government/consultations/insolvency-and-corporate-governance 'the Government will legislate to prohibit the enforcement of 'termination clauses' by a supplier in contracts for the supply of goods and services where the clause allows a contract to be terminated on the ground that one of the parties to the contract has entered formal insolvency. This is an approach that is common among a number of other states with highly-ranked insolvency regimes.'

[99] For a detailed analysis see generally Felicity Toube QC and Georgina Peters 'Ipso Facto reform' South Square Digest special issue on Corporate Insolvency and Governance Act 2020 at p 54 and available at https://southsquare.com/wp-content/uploads/2020/07/Digest_Magazine_Mini_Digital-CIGA.pdf

[100] See the explanatory notes available at

precludes the supplier from making the payment of pre-insolvency debt arrears a condition of continuing supply and that there is no mechanism whereby an insolvency practitioner could be held personally to guarantee the payment of ongoing supplies.[101] This is in contrast to the provisions on 'essential suppliers', which enable a supplier to hold an office holder (insolvency practitioner) personally liable for the payment of ongoing supplies.[102]

However, there are certain circumstances where the supplier is able to terminate the contract including where the court is satisfied that the continuation of the contract would cause the supplier hardship and grants permission.[103] Moreover, the restriction on termination provisions only applies upon a company becoming subject to a relevant insolvency procedure. The supplier still has the right to terminate the contract on other grounds, unless these grounds arose before the relevant procedure commenced; but if the supplier had not exercised the right to terminate before the event, the supplier will be unable to exercise it for the duration of the insolvency.

It should be noted that the new regime does not apply to a large group of 'exempted contracts' including those in favour of financial services providers.[104]

b. Criticisms of the detailed provisions in Article 7 of the Directive on termination provisions in executory contracts

The provisions in Article 7 of the Directive termination provisions may be open to criticism on at least five grounds.

Firstly, the proposal has not been heralded to any greater extent in the earlier Commission Recommendation.[105] Recommendation 10 provided that the stay or moratorium envisaged should not 'interfere with the performance of on-going contracts', but there were no other provisions on the matter. Secondly, while designed to enhance the viability of the debtor's

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https://publications.parliament.uk/pa/bills/lbill/58-01/113/5801113en.pdf

p 8 para 34 and also the statement 'Where an event permitting the exercise of the right occurred before the restructuring or insolvency procedure commenced but the supplier had not exercised the right to terminate before the restructuring or insolvency event, the supplier will be unable to exercise it for the duration of the insolvency'.

[101] See the new s 233B(7).

[102] Insolvency Act 1986, s 233(2)(a).

[103] New s 233B(8).

[104] See the new s 233B(10) which inserts a new Schedule 4ZZA into the Insolvency Act and which provides for exclusions from the operation of s 233B. The content of the new schedule is set out in schedule 12 of the 2020 Corporate Insolvency and Governance Act. The exclusions cover financial contracts meaning a contract for the provision of financial services consisting of (i) lending (including the factoring and financing of commercial transactions), (ii) financial leasing, or (iii) providing guarantees or commitments.

[105] SWD (2016) 357 final refers at p 55 to the assistance of a specially created representative group of restructuring and insolvency experts from across the EU and it says 'a new rule on the effects of the stay on early termination clauses in contracts was suggested by this group'.

business, it represents a much greater encroachment on freedom of contract. Thirdly, it is also not hedged about with some of the detail that is found in the US Bankruptcy Code on this issue.[106] Fourthly, the application of the Directive provisions to lease and licence agreements gives rise to certain controversies that have not been fully resolved. Fifthly, the possible limitation to 'essential contracts' produces uncertainty.

On the (second) freedom of contract point generally, it is expected that the debtor would continue to meet its post-stay obligations, i.e. it would make payments for further supplies according to standard contractual terms.[107] But what if the counterparty wishes to terminate the contract because of pre-stay arrears by the debtor? This would appear to be prohibited by Article 7.5 which specifically precludes the modification of executory contracts to the detriment of the debtor for debts that came into existence before the stay. The language also seems sufficiently broad to encompass moving the debtor on to a higher cost tariff during the stay period by reason of existing arrears in payment since this action is clearly to the detriment of the debtor. But the language may not sufficiently watertight to counteract all possible strategies by the counterparty. The ban only covers actions 'solely by reason of' and if there is another justification for the counterparty action, then this would not seem to be covered.

On the third issue, the executory contracts regime in the US Bankruptcy Code – s 365 – contains carve outs for particular types of transaction such as financial markets contracts and intellectual property licenses.[108] Section 365(n), for instance, contains specific provisions on intellectual property rights. If the debtor chooses to reject a contract under which it is the licensor of intellectual property rights, the licensee may elect to retain its rights under the license agreement, including the benefit of any exclusivity provision, by continuing to make royalty payments due under the agreement. The public policy basis of this carve out was considered by the US Bankruptcy Court[109] and at appellate level[110] in *Re Qimonda*. It was acknowledged that terminating the licenses would enhance the value to the debtor's estate, but this legitimate interest had to be weighed in the balance against the risk to licensees who had relied on the design freedom provided by the licensing agreements and invested

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[106] Section 365.

[107] See Recital 39: 'This Directive should not prevent debtors from paying, in the ordinary course of business, claims of unaffected creditors, and claims of affected creditors that arise during the stay of individual enforcement actions. To ensure that creditors with claims that came into existence before the opening of a restructuring procedure or a stay of individual enforcement actions do not put pressure on the debtor to pay those claims, which otherwise would be reduced through the implementation of the restructuring plan, Member States should be able to provide for the suspension of the obligation on the debtor with respect to payment of those claims.'

[108] For discussion see generally American Bankruptcy Institute (ABI) *Commission to Study the Reform of Chapter Full Report* at pp 122-129 and available at www.commission.abi.org/full-report/.

[109] (2011) 462 BR 165.

[110] (2013) 737 F3d 14.

substantially in research and manufacturing facilities as a result. The court spoke of a concern that terminating intellectual property licenses in a bankruptcy or restructuring context could create uncertainty and lead to a slower pace of innovation with detriment for the US economy.[111]

It may be that that the less detailed EU executory contracts regime in Article 7 was not intended to apply to such specialised contracts. Nevertheless, the definition of 'executory contracts' in Article 2(5) seems sufficiently comprehensive to encompass these contracts. Article 1(2) provides that the Directive should not apply where the debtor is a financial institution of various types such as credit institution, insurance undertaking, investment firm, collective investment undertaking, central securities depositary etc. However, the disapplication does not operate where the financial institution is merely a counterparty to the transaction.[112] Yet, the protection afforded by the Directive to netting agreements and financial collateral agreements has been beefed up.

Article 31 provides that the Restructuring Directive is overridden by the Financial Collateral Directive[113] (as well as the Settlement Finality Directive[114] and the European Markets Infrastructure Regulation[115]). The rationale for this is explained in Recital 94 of the Restructuring Directive. It is said that the stability of financial markets relies heavily on financial collateral arrangements. The value of financial instruments given as collateral security may be very volatile and it is crucial to realise their value quickly before it goes down. Accordingly, the Financial Collateral Directive would continue to apply notwithstanding the provisions of the Restructuring Directive. Moreover, Member States are allowed to exempt netting arrangements, including close-out netting, from the effects of the stay of individual enforcement actions.[116]

The fourth point concerns the application of the executory contracts provision to leases. There is no specific provision on this in the Directive as such. However, Recital 41 refers to the fact that the debtor should comply with its obligations under executory contracts which fall due during the stay and that lease and licence agreements, and franchise agreements, are examples of executory contracts. But what if the debtor fails to meet his or her payment obligations etc? One obvious solution is for the lessor to seek possession of the leased

[111] (2011) 462 BR 165 at 185 .It should be noted that at appellate level the case was decided in the same way but the grounds for decision were different.
[112] SWD (2016) 357 final at p 110 refers to the need for 'certain clarifications in order to remove uncertainty and ensure compatibility with the Financial Collateral Directive.'
[113] Directive 2002/47/EC.
[114] Directive 98/26/EC.
[115] Regulation (EU) No 648/2012.
[116] Article 7(6).

property and to apply for a lifting of the stay on the ground of unfair prejudice. The question arises how lease and other payments should be treated in the meantime? Should they be entitled to a form of 'super-priority' status certainly ranking in priority to ordinary unsecured debts incurred before the debtor entered the restructuring process and perhaps even higher than certain claims by secured creditors and certain post-restructuring debts?

The Restructuring Directive does not provide any direct or definitive answer to this question. However, it has been a contentious question when considering analogous procedures in the UK. The *Atlantic Computers* case suggests a discretionary approach as to whether the own owner of equipment leased to a company in administration and who was precluded from recovering possession of the equipment by virtue of the statutory moratorium should be entitled to payment of the rental amounts during the currency of the administration as an expense of the administration.[117] The court distinguished administration from liquidation on the basis that administration was intended only as an interim and temporary regime allowing the administrators to seek certain statutory objectives.

More recent cases have concerned leases of real property rather than leases of computers or other equipment, and the 'discretionary approach' appears to have hardened into a 'hard and fast' rule. There is considerable controversy, though it may be that the controversy has been put to bed by the decision in *Re Games Station Ltd*[118] where the Court of Appeal considered the matter afresh. This case raised the issue of the extent to which rent and service charges falling due both before and after the appointment of administrators are to be treated as expenses of the administration. Unlike the court in *Atlantic Computers*, the court did not distinguish between administrations and liquidations and applied the 'salvage' principle which had been applied in the context of liquidations in *Re Lundy Granite*[119]. The court said that an administrator or liquidator must make payments of the rent for any period during which he retained possession of the demised property for the benefit of the liquidation or administration. The rent would be treated as accruing from day to day and those payments were payable as expenses of the liquidation or administration. The duration of the period was a question of fact and was not determined by reference to when rent was payable under the lease. The court suggested that common sense and ordinary justice required that the landlord should receive

[117] See also the decision of the House of Lords in *Centre Reinsurance International Co v Freakley [2007] Bus LR 284*.

[118] [2014] ECCA Civ 180; [2015] Ch 87. The case is also known as *Jervis v Pillar Denton Ltd*.

[119] *Re Lundy Granite Co* (1870-71) LR 6 Ch App 462.

was the 'full value' of the property i.e. the rate of rent reserved by the lease for the period in question.

In US law the matter is more extensively regulated and there are elaborate rules protecting property owners where a debtor is the lessee of property and is in a Chapter 11 restructuring.[120] In such circumstances, the debtor may assume or reject the unexpired lease, or indeed an executory contract more generally, at any time before confirmation of a restructuring plan.[121] However, on the request of any party to such a lease or contract, the court may order that the determination to assume or reject should be made within a specified period[122] and the effect of assumption means that the rental payments become entitled to administrative expense priority.[123] If the debtor is in default of its obligations at the time of assumption, he or she must cure the default or provide adequate assurance of prompt cure; compensate the other contracting party for any actual pecuniary loss resulting from the default, or provide adequate assurance of prompt compensation; and finally, provide adequate assurance of future performance under the contract.[124]

The position of property owners is less satisfactory with respect to payments due in the limbo period prior to assumption or rejection. In a leading authority is *In re Thompson*[125] the court said:

'When a lease is ultimately rejected but its interim continuance was an actual and necessary cost and expense of the estate, the allowable administrative expense is valued not according to the terms of the lease … but under an objective worth standard that measures the fair reasonable value of the lease….The rent reserved in the lease is presumptive evidence of fair

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[120] For discussion see generally American Bankruptcy Institute (ABI) *Commission to Study the Reform of Chapter Full Report* at pp 129-135 and available at www.commission.abi.org/full-report/.
[121] Section 365. Amendments made by the Bankruptcy Abuse Prevention and Consumer Protection Act 2005 have significantly strengthened the position of landlords of nonresidential real property occupied by debtors in possession. On this see s 365(d)(4) and for discussion and possible reforms see American Bankruptcy Institute (ABI) *Commission to Study the Reform of Chapter Full Report* at pp 130-131.
[122] Section 365(d)(2).
[123] See the comments of US Circuit Judge Calabresi in *Re Klein Sleep Products Inc* (1996) 78 F3d 18: ' Although the Code offers no magical potion to restore a debtor's financial health, it does provide some useful medicine designed to help a debtor get back on its feet and heading towards convalescence. It does this by allowing a debtor to attempt to reorganise rather than fold and by creating incentives for creditors to continue to do business with the debtor while reorganisation proceeds…. Special priority is therefore accorded to expenses incurred under new contracts with the debtor, as "administrative expenses" of the estate. The same priority is given to expenses arising under pre-existing contracts that the debtor "assumes" – contracts whose benefits and burdens the debtor decides, with the bankruptcy court's approval, are worth retaining.'
[124] Section 365(b)(1)(C).
[125] (1986) 788 F2d 560 at 563.

and reasonable value … but the presumption may be rebutted by demonstrating that the reasonable worth of the lease differs from the contract rate….'

The position of lessors was strengthened somewhat by Bankruptcy Code amendments which require companies to make, on a timely basis, rental payments which become due 60 days or more after the company enters Chapter 11.[126] However, the court can order otherwise 'based on the equities of the case' and the legislation is silent about the status of rental payments that fall due within the 60 day grace period.

On the fifth point – possible limitation of the executory contracts regime to essential contracts necessary to the day to day operations of the debtor's business – , there is no definition of this term and this lack of detail may be disconcerting for some. One might argue that most well run businesses will not want to purchase non-essential supplies – a wasted expense. Therefore, unless it was decided as part of the restructuring, that certain aspects of the business should not survive, then all or most suppliers could be considered to be essential. On the other hand, a narrow definition would confine the definition of 'essential contracts' to contracts for the supply of water, gas and electricity.
In the UK the provision designed to secure continuity of supplies – s 233 of the Insolvency Act 1986 – was originally so limited. Changes in the business world however, revealed the limitations of this approach and s. 233 was widened in 2015 by the Insolvency (Protection of Essential Supplies) Order 2015[127] to ensure continuity in the supply of a wider range of utilities, including IT goods or services, to insolvent businesses. A UK Insolvency Service consultation, took the process a stage further[128] and it should be noted that the Corporate Insolvency and Governance Act introduced a new s 233B into the Insolvency Act with a wider set of restrictions on termination clauses in supply contracts and not limiting the reforms to 'essential contracts'.

5. Conclusion

The consensus view in the EU seems to be that to allow recovery procedures by creditors to operate without restraint could frustrate the overall socially desirable goal of rescue. Since going concern value may be a lot more that breakup value, restructuring proceedings are designed to keep a business alive so that this additional value can be captured. These

[126] Section 365(d)(5).
[127] SI No 2015/989 made under sections 92-95 of the Enterprise and Regulatory Reform Act 2013.
[128] *Review of the Corporate Insolvency Framework: A Consultation on Options for Reform* (UK Insolvency Service, 2016) at para 8.8 but see later para 5.97 *Insolvency and Corporate Governance Government Response* available at https://www.gov.uk/government/consultations/insolvency-and-corporate-governance stating that the UK government no longer intended to apply the designation of essential supplies as the basis for legislative reform.

legislative goals will be compromised however, if creditors are able to seize assets that are essential to the carrying on of the debtor's business Consequently, we have a stay on actions by creditor to collect debts or repossess property that is in the ailing debtor's possession. The restructuring strategy seems to be founded upon a utilitarian premise that the interests of a few may need to suffer in the service of the needs of the many and this premise is transformed into a legal mechanism through the stay.[129]

Property rights are sacrificed to a degree but, at the same time, protected to a degree. There are counter-balancing measures in place to protect those who may be affected by the stay. In the US, there is an unambiguous statutory statement that secured creditors are entitled to receive 'adequate protection' of their proprietary rights. US law has a tight, clearly defined requirement of 'adequate protection'. But relief from the stay is available where the property is not needed for a successful reorganisation

In the European Restructuring Directive context, there is nothing specific about compensating secured creditors for a decline in the value of the secured property during the stay period and while, no doubt, this would be factored into the equation in an appropriate case it is not a decisive factor. Clearly, one's views on the purposes underlying business restructuring law will shape one's views of the statutory stay and whether the holders of proprietary rights should be compensated for the delay occasioned by the stay in enforcing their property rights. A strict supporter of the principle that pre-insolvency entitlement should be upheld absolutely would answer that holders of proprietary rights should undoubtedly be compensated in full.[130] Supporters of more inclusive theories would respond that the question must depend on a complex of different factors including the length of the stay, the immediacy of the prospect for business rehabilitation, the necessity for use of the property and the impact on other creditors. This, broadly speaking, is the EU position given the protection afforded employee rights, but, at the same time, there is also protection for financial markets transactions including close out netting agreements.

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[129] See generally David Milman, 'Moratoria on Enforcement Rights: Revisiting Corporate Rescue' [2004] Conv 89.

[130] See TH Jackson, *Logic and Limits of Bankruptcy Law* (Cambridge MA, Harvard University Press, 1986) at p 189: 'A rule that forces general creditors and shareholders to give secured creditors the full value of their claims (including compensation for the time value of money) imposes the cost of a decision to reorganize the firm entirely on the junior classes, who already stand to benefit if the firm succeeds. As a consequence, they have incentives that approximate those of a sole owner, and their decision about how to deploy the debtor's assets will not be distorted by self-interest.'