

# Insolvency and Restructuring International

The Journal of the IBA Insolvency Section

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English anti-suit injunctions in  
Russian bankruptcy – evolution or  
revolution?

Legislative changes to the  
Brazilian Bankruptcy Law on  
the sale of assets in judicial  
reorganisation proceedings

Management agreements of  
capital companies in insolvency  
proceedings as per Bulgarian  
case law



# International Bar Association



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16 November 1400 – 1530 GMT

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16 November 1400 – 1500

**Tracking the evolution of safe harbour law in India: IT rules in 2021 and beyond**

18 November 1130 – 1245 GMT

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18 November 1400 – 1515 GMT

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19 November 0830 – 1000 GMT

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24 November 1300 – 1430 GMT

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26 November 0830 – 0930 GMT

**Masterclass on the protocol on dispute resolution under AfCFTA**

29 November 1300 – 1500 GMT

**Taking stock of global challenges to the rule of law: threats to the independence of lawyers and judges**

3 December 1300–1400 GMT

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**Beyond Covid19: impact on construction contracts and projects**

7 December 1300 – 1415 GMT

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10 December 1100 – 1200 GMT

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10 December 1300 – 1400 GMT

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10th December 1500 – 1600 GMT

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# CONTENTS

Vol 15 ISSUE 2 October 2021

Insolvency and  
Restructuring  
International



The Journal of the IBA Insolvency Section

## FEATURE ARTICLES

### 6 English anti-suit injunctions in Russian bankruptcy – evolution or revolution?

Dmitry Kuptsov and Yuri Knyazev

### 10 Legislative changes to the Brazilian Bankruptcy Law on the sale of assets in judicial reorganisation proceedings

Guilherme Fontes Bechara and Andressa Scorza

### 14 Management agreements of capital companies in insolvency proceedings as per Bulgarian case law

Yavor Kambourov

### 17 Recent decisions in the highest courts in the UK and the Cayman Islands involving insolvent claimants on the rule which bars a shareholder from bringing a claim for loss which is a consequence of loss sustained by the company

Peter Hayden and Jonathan Moffatt

### 20 Recognition and enforcement of a foreign plan of reorganisation in Mexico

Francisco José Rodríguez Nepote

### 24 Restructuring – a key pillar of the global commitment to ‘build back better’

Scott Atkins and Kai Luck

### 26 A new era of mutual recognition of insolvency proceedings between Hong Kong and Mainland China

Bryan O’Hare, Pui Yip Leung and Soony Tang

### 34 Transposing the new EU Restructuring Directive into Belgian law, focusing on debt-to-equity conversions

Bart De Moor and Angélique Daponte

### 39 General overview of and recent developments in Japanese rescue-type insolvency proceedings

Masaki Fujita and Sayuri Tago

### 44 Has Gategroup raised the gate for the WHOA?

Vincent Vroom and Joris Dunki Jacobs

Co-Editors note

4

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# Co-Editors note

October 2021

## Vincent Vroom

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Welcome to this edition of *Insolvency and Restructuring International*, our second as Co-Editors and one which again reflects, among many other developments, the fast pace of change to insolvency legislation which continues to occur as jurisdictions across the globe respond to the challenges to corporates and individuals, arising from the continuing effects of the global pandemic.

For this edition we have received a wide range of contributions from Central and South America, Europe, Asia and Australia. We would like to thank all of our contributors for the very high standard of these contributions which we are sure our subscribers will find stimulating and thought-provoking.

From Moscow, Dmitry Kuptsov and Yuri Knyazev discuss the Russian jurisdiction's approach to anti-suit injunctions granted in England in relation to Russian bankruptcy proceedings, while Yavor Kambourov of Sofia analyses the treatment of management agreements of companies in Bulgarian insolvency proceedings.

Guilherme Fontes Bechara and Andressa Scorza of Sao Paulo analyse recent legislative developments in the bankruptcy law of Brazil which they consider will improve the efficiency of sales of assets in judicial reorganisation proceedings by stimulating transactions and affording protections for investor purchasers.

The recent decisions in the Cayman Islands and the UK in the cases of *Marex* and *Primeo* on reflective loss claims and the effect of those decisions on the rule in *Prudential v Newman* are considered by Peter Hayden and Jonathan Moffatt of the Cayman Islands, and Bryan O'Hare, Pui Yip Leung and Soony Tang of Hong Kong explain the current position and recent developments

with respect to the mutual recognition of insolvency proceedings between Hong Kong and Mainland China.

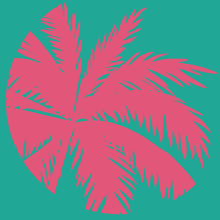
From Guadalajara, recognition and enforcement are also the themes of Francisco Jose Rodriguez Nepote's article on the recognition and enforcement in Mexico of a foreign plan of reorganisation while Masaki Fujita and Sayuri Tago from Tokyo provide us with an overview analysis of recent developments which have taken place in Japan with regard to insolvency proceedings of a rescue nature.

Scott Atkins and Kai Luck from Sydney, Australia discuss the key role which they expect restructuring to play in the commitment globally to 'Build back better' following on from the pandemic, and Bart De Moor and Angelique Daponte from Brussels discuss the issues arising in relation to transposing the new EU Restructuring Directive into the law of Belgium with a particular focus on debt-to-equity conversions.

Last and by no means least our own Vincent Vroom and his colleague Joris Dunki Jacobs discuss the effect on the newly introduced WHOA, or Dutch scheme, of the *Gategroup* decision.

We hope that you will find these articles of great interest and would be very interested to have your feedback. We also welcome your suggestions for contributions for the next edition to be published in April 2022.

Finally we are very much looking forward to seeing as many of our readers as can possibly attend the 26th Annual IBA Global Insolvency and Restructuring Conference in Edinburgh, Scotland on 28–30 November 2021. It has been far too long since we were all together!



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# English anti-suit injunctions in Russian bankruptcy – evolution or revolution?

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Over the past few months, Her Majesty's High Court of Justice in England has issued a number of landmark judgments relating to the application of anti-suit injunction to claw back actions pending in Russian bankruptcy proceedings.<sup>1</sup> While, in general, Russian courts tend not to recognise any interference from foreign courts, it appears that these judgments will have important legal implications for all clawback actions in Russia which are based on English law contracts with arbitration or exclusive jurisdiction clauses.

Since the authors are not qualified in English law, and are not in a position to comment on the purely English law aspects of the injunctions, this article focuses on the Russian view of the approach taken by the High Court of Justice and its reflection in the local proceedings. Using an example of one Russian bankruptcy case, we will briefly consider the effect of anti-suit injunctions and the problems that this development brings.

## Clawback actions in Russian bankruptcy – jurisdictional issues

In line with the general approach employed in many jurisdictions, the Russian bankruptcy law provides for a number of special bankruptcy-related grounds for challenging a debtor's suspicious transactions (the so-called 'clawback action'), which differ from the general civil grounds for invalidity. Without going into details, the entire set of grounds for challenging transactions in Russian bankruptcy legislation comes down to the prevention of actions aimed at the illegal withdrawal of the debtor's assets prior to its bankruptcy. The main difference between the special grounds of the bankruptcy law and the general civil grounds for challenging a transaction is that, through bankruptcy grounds, a type of public interest pertaining to the institution of bankruptcy as such is secured.<sup>2</sup>

Article 61.8 of the Russian Bankruptcy law sets the following fundamental rule establishing competence of the Russian arbitrazh (state commercial) courts over

disputes for invalidation of the debtor's transactions:

'An application for invalidation of the debtor's transaction must be submitted to the arbitrazh court, which considers such debtor's bankruptcy case, and shall be considered within this bankruptcy case.'

In other words, the Russian bankruptcy law establishes the principle of concentration of the specific disputes within a bankruptcy case, which includes inter alia disputes on debtor's transaction invalidation. From a Russian judge's perspective, all cases challenging debtor's transactions must be considered by the same court, which supervises the whole bankruptcy case. In practice, this rule (with rare exceptions<sup>3</sup>) is understood as setting exclusive jurisdiction of Russian arbitrazh courts over the disputes for invalidation of the debtors' transactions on the grounds provided by bankruptcy law. A direct consequence of this approach is that Russian courts tend to ignore arbitration (prorogation) clauses that are included in the agreements being invalidated.

The general approach of the Russian courts is that the provisions of bankruptcy law setting special grounds for invalidation of transactions have a specific public policy background, especially when such claims are brought in the bankruptcy proceedings of the banks and other financial institutions by the Deposit Insurance Agency (DIA) in its capacity as official receiver. One of the fundamental Russian authorities dealing with this issue is the *Phosint Limited* case,<sup>4</sup> where the Supreme Court of Russia ruled as follows:

'Thus, a bankruptcy prevention procedure was initiated against the bank – a rehabilitation carried out by the DIA in accordance with the requirements of a special law and regulations of the Bank of Russia issued in its development, which implied public interference in private-law relations in the credit sphere, aimed, inter alia, at protecting the rights of depositors, during which the existence of a disputed contract was established, the claim for invalidation of which was lawfully submitted by the bank to the arbitrazh court.'



‘Due to the fact that the financial activities carried out by the state in the person of the Agency in the organisational and legal form of a state corporation, for the implementation of measures to prevent the bankruptcy of a credit institution, are state activities of a public nature, economic and social orientation, the dispute was not subject to transfer to the arbitration.’

A similar approach was taken by the Russian courts in the *Figebor Consulting* case,<sup>5</sup> the *Russian Investment Bank* case<sup>6</sup> and other cases where the defendants raised objections to the competence of Russian arbitrazh courts. Russian courts disregard arbitration clauses and ignore the will of the contracting parties for the above reasons – which are occasionally complemented by further considerations of the bankrupt’s lack of funds to pay the arbitration fees or simply because the concentration of public interest in bankruptcy cases does not allow any disputes to be referred to arbitration.<sup>7</sup>

This is widely used by Russian bankruptcy receivers or creditors (subject to certain conditions), who are entitled to apply for invalidity of the debtor’s transactions. As a consequence, some foreign counterparties of the Russian debtors find themselves in very uncomfortable situations, dealing with multi-million claims in a non-contractual forum. Until recently, there was little hope for improvements and a more pro-arbitration approach.

### **The IBSP case – a new hope...**

The winds of change have blown from the city of Saint Petersburg, where the local arbitrazh court is considering the huge bankruptcy case of the International Bank of Saint Petersburg (IBSP) – formerly one of the largest banks in the north-west region of Russia. In this case, the DIA, being the official receiver of IBSP, is challenging a number of transactions with IBSP’s foreign counterparties on special grounds provided for by the bankruptcy law. The contracts that give rise to the DIA’s claims are governed by foreign (mostly English) law, and contain arbitration clauses in favour of the London Court of International Arbitration (LCIA) and other reputable arbitration centres.

Despite the aforementioned uniform approach that has been established in Russian court practice, a number of respondents in the IBSP bankruptcy case – namely RiverRock Securities Limited and Louis Dreyfus Company Suisse S.A. – have applied to the High Court of Justice for an anti-suit injunction. In the English proceedings, the DIA constructed its objections to the application for anti-suit injunction essentially on the following three basic grounds:

- the proceedings in the Russian arbitrazh court are not being pursued by IBSP but by the DIA, which is not a party to the agreement containing an arbitration clause;
- the arbitration agreement does not cover the claims brought in the arbitrazh court in a bankruptcy case while such claims are guided by special provisions of the bankruptcy law; and
- in any event, the claims brought in the arbitrazh court are non-arbitrable.

The High Court of Justice did not find these arguments convincing and granted the anti-suit injunction, by which the DIA, IBSP, their agents and representatives were prohibited from advancing in front of the Russian court any claims arising from the agreements containing arbitration clauses. We will not go into detailed discussion of the approach taken by the English court (which has been dealt with in numerous publications by our English colleagues), but will touch upon the actual effect of the injunction in Russia. For the sake of completeness, it will be sufficient to say that the judge did not find a ‘good reason to imply a limitation to the effect that the clause does not extend to a claim in insolvency proceedings’.<sup>8</sup> The court also found that the DIA’s claims are contractual in nature, and therefore are covered by the arbitration clause.

In this context, it is worth mentioning that, until recently, the prevailing approach of Russian courts towards anti-suit injunctions was dominated (although with some exceptions<sup>9</sup>) by the widely discussed *Nori Holding and others v PJSC Bank Otkritie Financial Corporation* case.<sup>10</sup> As a result of the English High Court decision granting the application of Nori Holding, the representatives of Bank Otkritie (ie, the DIA as its receiver) filed an application on withdrawal of their claims. However, considering that the bank was placed under the temporary administration of the Central Bank of Russia, the arbitrazh court dismissed this application and held that the claimant acted under the threat of criminal liability; in any case, such actions shall be deemed as the waiver of constitutional right to judicial protection, which as a matter of Russian law is null and void.<sup>11</sup> Moreover, the court ruled as follows:

‘This being so, the court believes that the motion on partial withdrawal of the claims may affect rights and legitimate interests of the third parties – bank’s creditors, since ... it may affect composition of the bank’s assets, and is therefore the ground for dismissal of the said motion.’

In IBSP’s case, the DIA chose different tactics. It completely abstained from the proceedings without making any specific motions related to the effect of the injunction (eg, motion on withdrawal of claims). By virtue of express provisions of applicable procedural

rules, this automatically results in termination of the proceedings in the DIA's claim, since the failure to represent oneself in court and plead the case invokes the presumption of the claimant's losing interest in its own case. In such circumstances, the judge in IBSP's case, being bound by express provisions of procedural legislation, apparently found no other solution but to leave the claim without consideration. It is not clear what the outcome would have been, had there been an active creditor supporting the DIA in the proceedings.

Most probably in the given circumstances, the tactics of complete abstention from the proceedings, forcing the court to terminate them based on an imperative requirement of the procedural law, was intentionally employed by the DIA in order to prevent the risks associated with the court's refusal to accept withdrawal of the claim, as happened in *Nori Holding* case some time ago.

### ... or new challenges?

The IBSP case aggravated the problem of conflict between the bankrupt's counterparties' private interests and the DIA's public function aimed at serving the best interests of the respective bankrupt's creditors. Future cases will have to address these new challenges and give answers to the new tactics that the DIA and its procedural allies (eg, loyal creditors) may (and most probably will) employ in order to overcome the effect of anti-suit injunctions.

One of the central questions that remains without answer is whether the creditors of the bankrupt entity shall be bound by the anti-suit injunctions. From the Russian perspective, the answer to this question may be found in consistent findings made by the Russian supreme judiciary.

In particular, while exercising its rights and taking actions to replenish the bankruptcy estate the creditor similarly to the bankruptcy receiver acts:

- on behalf of the debtor/bankruptcy estate; and
- on behalf of all the debtor's creditors that represent a united group in terms of class action, and whose interests are indirectly ensured by such derivative class actions as a challenge of the debtor's transactions or by bringing the debtor's controlling persons to the subsidiary liability.<sup>12</sup>

This is also reflected in the position of Russian courts in respect of the creditor's status in disputes related to the imposition of subsidiary liability on the debtor's controlling persons. In accordance with the legal position of the Supreme Court of the Russian Federation, a claim for bringing to subsidiary liability is a derivative class action as well, since it implies the submission of such a claim by an authorised person in the interests of a group of persons uniting the legal community of the debtor's creditors.<sup>13</sup> This approach is

upheld by the position of Russian legal academics, who note that the creditor, challenging the transactions or pleading about bringing to subsidiary liability, acts not in its own interests but in the interests of the civil-law community – uniting all creditors and carrying out the functions assigned to the bankruptcy receiver.<sup>14</sup>

This logic typically leads to a legitimate conclusion: that creditors, along with the bankruptcy receiver, act on behalf of the debtor and therefore are bound by the debtor's agreements containing arbitration or exclusive jurisdiction clauses. It is also clear that the alternative argument is possible with reference to the existence of the creditors' own interests, which are not always congruent with those pertaining to the debtor and its official receiver. All this leaves a lot of room for discussion, such as: (1) whether an approach shall be differentiated depending on the independent character of the creditor's action or existence of the signs that such action is inspired by the DIA with a view to overcome the effect of the anti-suit injunction; (2) how the statute of limitation shall apply to the creditors; (3) whether the previous behaviour and statement of the receiver shall somehow affect the rights of the creditors; and so on.

Resolving these problems is an even more complex task, taking into account the lack of any cross-border treaties on bankruptcy issues where Russia is a signatory, as well as the very controversial and unpredictable practice of local courts.

At the same time, this distinguishes such cases for their unprecedented interest from a legal point of view. It also (based on this article's authors' own experiences) opens up a lot of room for creativity and opportunities for lawyers to influence the landscape of cross-border bankruptcy issues involving Russia and foreign jurisdictions.

### Notes

- 1 *RiverRock Securities Ltd v International Bank of St Petersburg* (JSC) [2020] EWHC 2483 (Comm); *Louis Dreyfus Company Suisse SA v International Bank of St. Petersburg (Joint-Stock Company)* [2021] EWHC 1039 (Comm).
- 2 See: SV Usoskin, 'International arbitration and bankruptcy: a claim to invalidate a transaction. Commentary on the Ruling of the Judicial Collegium for Economic Disputes of the Russian Supreme Court', 2016, No 305-ES16-4051, Bulletin of Economic Justice of the Russian Federation, 18–20.
- 3 See: Ruling of the Supreme Court of the Russian Federation No 304-ES16-3766, 16 May 2016, in the matter No A67-4741/2015.
- 4 Ruling of the Judicial Collegium for Economic Disputes of the Russian Supreme Court No 305-ES16-4051, 16 August 2016, on case No A40-117039/2015.
- 5 Resolution of the Arbitrazh Court of the Moscow Circuit No F05-9073/2019, 29 July 2019, on case No A40-184814/2018.
- 6 Resolution of the Ninth Arbitrazh Court of Appeal No 09AP-3989/2018-GK, 14 March 2018, on case No A40-69796/2017.

- 7 See: Resolution of the Arbitrazh Court of the Moscow District, 28 February 2017, in case No A40-113033/16; Resolution of the Arbitrazh Court of the North-Western District, 19 October 2015, in case No A56-86904/2014.
- 8 *RiverRock Securities Ltd v International Bank of St Petersburg* (JSC) [2020] EWHC 2483 (Comm), para 44 (i).
- 9 See: *Mace (Russia) Ltd v Retansel Enterprises Ltd & Anor* [2016] EWHC 1209 (Comm).
- 10 *Nori Holding and others v Public Joint-Stock Company Bank Otkritie Financial Corporation* [2018] EWHC 1343 (Comm).
- 11 Ruling of the Arbitrazh Court of Moscow City, 3 August 2018, on case No A40-204393/17.
- 12 See the Ruling of the Judicial Chamber on Economic Disputes of the Supreme Court of the Russian Federation No 02-ES20-19914, 17 March 2021, on case No A19-14083/2015: 'Acting on behalf of the debtor (its bankruptcy estate) by virtue of the authority based on the law (paragraphs 1, 2 of Article 61.9 of the Bankruptcy Law), the initiator of a separate dispute essentially acts as a representative of the debtor, and indirectly – a group of its creditors'. In this regard, the Supreme Court of the Russian Federation concluded that it is necessary to apply the regime of class actions to such disputes (namely the rules of Chapter 28.2 of the APC governing class actions in Russian law) and recognised for the bankruptcy creditor the same status of the debtor's representative as that of the bankruptcy receiver in terms of the challenge of the debtor's transaction.
- 13 See para 57 of Resolution No 53. Also see the Rulings of the Judicial Chamber on Economic Disputes of the Supreme Court of the Russian Federation No 308-ES17-6757 (2,3), 6 August 2018, on case No A22-941/2006; No 305-ES19-17007 (2), 3 July 2020, on case No A40-203647/2015; No 310-ES20-7837, 28 September 2020, on case No A23-6235/2015.

- 14 See: DA Petrov, 'Problems of Calculating the Limitation Period When a Bankruptcy Creditor Challenges the Debtor's Transactions on Special Grounds Provided for by the Bankruptcy Legislation', 2018, 2 Arbitrazh Disputes, 89–96; OV Gutnikov, 'Corporate Liability in Civil Law' (Monograph, 2019), 488; DV Dobrachev, 'Judicial Practice Problems of Bringing the Debtor's Controlling Persons to Subsidiary Liability in Bankruptcy Proceedings' (Infotropic Media, 2019), 172; IV Gorbachev, 'On Some Legal Material Issues in the Ruling of the Supreme Court of the Russian Federation Regarding the Invocation for Subsidiary Liability', 2018, 4 Bulletin of Civil Law, 154–202.

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# Legislative changes to the Brazilian Bankruptcy Law on the sale of assets in judicial reorganisation proceedings

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The Brazilian Bankruptcy Law (Federal Law no 11.101/2005) was recently amended by Federal Law no. 14.112/2020 (the ‘Reform’). The main driver of the Reform was to improve the efficiency of the Brazilian insolvency regime, expedite insolvency-related court proceedings – notably the judicial reorganisation (*Recuperação Judicial* or RJ) – and create a safe and reliable environment for investors to deploy capital in debtors undergoing insolvency proceedings.

Among other issues, the Reform introduced to the Brazilian Bankruptcy Law several provisions concerning the sale of assets in RJ proceedings. These provisions, which seek to settle certain issues that have been debated since the enactment of the Brazilian Bankruptcy Law, afford additional protections for investors and foster the efficiency and expeditiousness of asset sale transactions in RJ proceedings. It is indisputable that asset sales have historically been of paramount importance for debtors to reorganise and raise new money necessary to successfully implement the intended restructuring.

Although the Brazilian Bankruptcy Law already afforded relevant protections for certain types of asset sales, and numerous transactions have been successfully implemented, certain issues still pose uncertainties that prevent a larger number of sales in RJ proceedings. This has emphasised the need for modifications in the Brazilian Bankruptcy Law.

This article highlights the main points of the Reform dealing with the sale of assets in RJ proceedings.

## General framework under the Brazilian Bankruptcy Law

As typically occurs in insolvency legislation (eg Section 363(b)(1) of the US Bankruptcy Code and Article 62 of the Italian Bankruptcy Code (*Codice Amministrazione Straordinaria*)), the Brazilian Bankruptcy Law imposes

restrictions on sale of non-current assets undergoing an RJ proceeding. Any sale either requires a specific court approval or to be part of the reorganisation plan approved by creditors and confirmed by the court.

Further, prior to the Reform, the Brazilian Bankruptcy Law provided sales of ‘isolated business units’ (*Unidade Produtiva Isolada* or UPI) would be concluded free and clear of liens and successor liability. Sales of UPIs, however, were and still are performed pursuant to a reorganisation plan and require a court-supervised competitive process.

On the other hand, the Brazilian Bankruptcy Law did not expressly afford investors the same benefits for sales that did not qualify as ‘sales of UPIs’ and were performed upon court approval. Neither was there was a streamlined process for such sales; therefore, any stakeholder involved in the RJ proceeding could object to the motion requiring court approval for a transaction and further litigate the issue.

## Relevant modifications

### Clear definition of UPI and sale of entire business of the debtor

Neither the Brazilian Bankruptcy Law nor any other statute provided clear guidance on the meaning of UPI, and which assets could or could not be sold under the structure of a UPI sale.

Some academics and practitioners supported the contention that the UPI should correspond to an establishment of the debtor. Therefore, sales of UPIs that resulted in a de facto liquidation would not be permitted since the debtor would need to maintain a certain level of operational activity to support payments to creditors following the intended transactions.

Despite that understanding, debtors and creditors typically had wide discretion to create UPIs under reorganisation plans. The lack of an express concept of

the UPI, and the Brazilian Bankruptcy Law's drivers of the preservation of the business enterprise as a going concern and maximisation of value, supported the case for the view that the UPI could essentially consist of any asset of the debtor.

In the early years of the Brazilian Bankruptcy Law, the Court of Appeals of São Paulo set an important precedent,<sup>1</sup> authorising the sale of a piece of land from the debtor's non-operating assets as a UPI. Likewise, the same Court of Appeals decided in the *Pantanal* case that all assets related to Pantanal's airline business could be incorporated into a UPI, including certain contractual and regulatory rights.<sup>2</sup>

Further, although not expressly provided for in the Brazilian Bankruptcy Law, equity interests of debtors have also been sold as UPIs. This happened, for instance, in the *Abengoa* and *Sete Brasil* cases. A similar provision was included in the OAS reorganisation plan, but the transaction ultimately did not go through. However, in a previous decision, the Court of Appeals of São Paulo had not afforded the protection of UPI sales to a sale of the shares of a newly incorporated entity to which certain assets were contributed, even though the reorganisation plan expressly provided that the transaction was to be considered a UPI sale.<sup>3</sup>

To settle the issue and avoid uncertainties as to which assets could be sold as UPIs, the Reform added Section 60-A to the Brazilian Bankruptcy Law, which expressly states that UPIs may comprise any tangible and intangible assets or rights of the debtor (segregated or sold as a block), including equity interests. The requirements for a sale of UPI have not been modified; therefore, sales of UPIs still require:

- specific treatment in the reorganisation plan approved by creditors and confirmed by the court; and
- a court-supervised competitive process.

However, the Brazilian Bankruptcy Law now provides that the competitive process may take the form of either:

- a court-supervised electronic or physical auction; or
- an extrajudicial process organised by a specialised agent, whose procedure should be detailed in the reorganisation plan (or the asset sale plan in sales in liquidation proceedings).

This procedural modification seeks to increase flexibility around the current necessity of an in-court process for all sales of UPIs – modernising the competitive process for sale of UPIs, notably in cases of sophisticated and complex sale of assets.

The Reform also eliminated the discussions about the possibility of the sale of the entire business of the debtor as a UPI. Despite specific provisions of the Brazilian Bankruptcy Law that suggested that this would

not be permissible, the main concern was that the sale of all (or substantially all) of the assets of the debtor pursuant to a reorganisation plan would render the debtor incapable of making payment of claims that, by operation of law, are not impaired by RJ proceedings. These include tax claims and claims collateralised by certain types of security interest.

The Reform included in the Brazilian Bankruptcy Law the possibility of the sale of the entire business of the debtor, in which case the sale will be considered a sale of a UPI for the purposes of affording the purchaser the protections of sales free and clear from successor liability.

To come up with an alternative to protect creditors not impaired by the RJ, the Reform also states that the sale must guarantee to creditors not subject to or impaired by the RJ 'conditions at least equivalent to the ones they would have in a liquidation proceeding'. Consequently, the Reform sets out that the debtor may be subject to involuntary liquidation if there is proof of disposal of substantially all of its assets in detriment to creditors not subject to RJ proceedings, including tax claimants.

The liquidation ruling based on this provision, however, does not render the sale transaction void or result in the unwinding of the sale, but the proceeds of the sale will be seized by the court so that it may release them in accordance with the corresponding rules that apply to liquidation proceedings.

This newly incorporated provision is of paramount importance. It grants investors protection against a transaction being adversely affected by a finding of the court that the transaction would be detrimental and/or violate the rights of specific bankruptcy-remote creditors, who do not necessarily participate in the RJ.

#### *Extension of the protection against successor liability*

Generally speaking, Brazilian courts have widely tested and confirmed the protection against successor liability provided for in the Brazilian Bankruptcy Law. On this topic, the Brazilian Supreme Court has already recognised the constitutionality of the no-successor liability rule, the ultimate goals of which are the preservation of the business enterprise and the creation of incentives for investors to purchase assets in RJ proceedings.<sup>4</sup>

The Reform, however, addressed two relevant issues concerning issues related to the extension of protection against successor liability.

Firstly all assets – not just UPI sales – are afforded protection against successor liability provided that the sale is performed under a court-supervised competitive process provided for in the Brazilian Bankruptcy Law.

Although this category of sale also requires court approval and a competitive process, it does not require that the transaction be made pursuant to a plan, which is relevant from a timing perspective. In other words, in contrast with a UPI sale, a given asset sale may take place at the outset of the case and be afforded the same protections, as long as it meets the aforementioned requirement.

Second, the former wording of the Brazilian Bankruptcy Law gave room for debate on whether the protection against successor liability would apply to any and all type of liability of the seller, particularly because the language of the relevant provision only expressly mentioned labour and tax liabilities. The issue was particularly relevant with respect to regulatory, environmental and corruption-related liabilities, all of which are governed by a specific set of rules that are typically more restrictive. Particularly, the corruption-related liabilities were subject to several debates in the context of the numerous bankruptcy proceedings that were filed in connection with car wash operations. Courts, however, have not tested the matter.

Pursuant to the Reform, the protection against successor liability applies to all liabilities, including, but not limited to, environmental, regulatory, administrative, anti-corruption, tax and labour liabilities. The wording also protects the buyer from certain rules related to successor liability set out in the Brazilian Anticorruption Law (Federal Law no. 12.846) sanctioned in Brazil on 1 August 2013.<sup>5</sup>

It is clear that the Reform sought to reinforce the protections to investors in the spirit of fostering transactions in RJ Proceedings.

### *Protection against litigation and restrictions to objections*

The Reform included in the Brazilian Bankruptcy Law a provision stating that the sale of assets, or the granting of a security interest by the debtor to a good-faith purchaser or new money provider, will not be rendered void or unenforceable following conclusion of the transaction and receipt of proceeds by the debtor, provided that the transaction is authorised by the court or provided for in a reorganisation plan. Likewise, similar protection is granted to the sale of the entire business of the debtor as a UPI, as mentioned above.

This is a relevant and welcome modification to the Brazilian Bankruptcy Law. Protections to good-faith investors against uncertainty related to the outcome of potential litigation arising from RJ has been historically seen as necessary to encourage investments in distressed companies in Brazil. The prospect of endless litigation or the risks of the transaction being further unwound because of pending litigation against confirmation of the plan, the transaction or any other issue has

consistently been highlighted as a significant legal risk that discouraged investors, particularly foreign ones, from pursuing asset sale transactions in Brazilian RJs.

Hence, the legal provision protecting investors from the risk of future avoidance, or the unenforceability of the asset sale or financing transaction, tends not only to increase the number of asset sales but also to maximise prices and capital availability to the debtor.<sup>6</sup> This potentially promotes better alternatives for a successful restructuring, which is clearly consistent with the scope and the ultimate goals of the Reform and the policy underlying the Brazilian Bankruptcy Law.

Likewise, to avoid baseless litigation over asset sale transactions, the Reform also included provisions in the Brazilian Bankruptcy Law restricting creditors' (or other interested parties') ability to object to transactions.

In case of a sale subject to court approval, creditors representing at least 15 per cent of the value of claims subject to the RJ may request that the court convene a creditors' meeting to put the transaction to a vote, provided that the objecting creditors post a bond in the amount of the transaction and pay all expenses related to the creditors' meeting.

On the other hand, in the event of a sale under a court-supervised competitive process, objections based on the valuation/purchase price of the assets must be supported by a third party offer in a net present value higher than the winning bid and require a cash deposit (bond) in an amount equivalent to ten per cent of the offered price. Any frivolous objection subjects the objector to penalties under both the Brazilian Bankruptcy Law and the Brazilian Code of Civil Procedure.

These two provisions also confirm the goal of the Reform to streamline the asset sale processes in bankruptcy proceedings, avoid uncertainties, and grant additional protections and incentives to investors seeking to acquire assets from debtors undergoing insolvency proceedings.

### *Conversion of debt into equity*

Although no provision of the Brazilian Bankruptcy Law prevented creditors and debtors from agreeing on reorganisation plans providing for debt-to-equity conversions, there was no specific provision dealing with the topic in the context of the RJ proceedings.

Pursuant to the Reform, debt-to-equity conversions are now expressly included among the 'means of reorganisation' set forth in the Brazilian Bankruptcy Law. Additionally, creditors may propose debt-to-equity workouts in the context of creditor-proposed plans pursuant to new rules that mitigate the exclusivity of the debtor to propose a plan.

More importantly, the Reform introduced a provision expressly stating that there should be no successor liability or liability for debts of any nature to creditors, investors or new officers of the debtor as a result of the mere conversion of debt into equity, new funding or replacement of management of the debtor.

### ‘Stalking horse’ protections

The Reform did not expressly deal with compensations or bidding protections for investors willing to submit ‘stalking horse’ offers that backstop and set the floor for asset sales under RJ proceedings. Consequently, the Brazilian Bankruptcy Law remains silent on the availability and legality of protections for investors who spend time and energy to deploy resources to present a stalking horse to anchor and backstop the competitive process for the sale of assets.

Although Brazilian courts have not widely tested the issue, stalking horse protections have increasingly been adopted in asset sales under RJ proceedings in Brazil.

In the *OAS* case, the reorganisation plan provided certain investors a right to top any competing offer and a break-up fee in the event another bidder was declared the winner of the competitive process. In the *Abengoa* case, both the right to top and the break-up clause were litigated. The court confirmed the enforceability of the right to top, but it refused the break-up fee since it would likely hinder competition. During the competitive process, the investor exercised the right to top since a competing offer was presented during the competitive process. More recently, similar structures were successfully implemented in the RJ proceedings of Oi Group, Renova Energia and Estre Ambiental.

Stalking horse structures have been welcomed by courts to the extent that the binding offer presented by the anchor investor grants certainty to the successful outcome of the transaction sale. Naturally, there should be balance between the competitive nature of the sale process and the need to protect an investor who undertook diligence efforts, spending time and money on the transaction. Therefore, the transactions should not be structured in such a way as to make competition impossible or untenable in practice.

Despite the above, the lack of guidance on the protections granted to stalking horse bidders gives room for litigation over the issue, and corresponding uncertainty to the stalking horse or the process as a whole, since the granting of such protections are typically conditions precedent for the validity of any binding offer, which would be ultimately inconsistent with the goals of the Brazilian Bankruptcy Law.

## Conclusions

The modifications to the Brazilian Bankruptcy Law implemented by the Reform with respect to the sale of assets are welcome. They are likely to stimulate new transactions in existing or yet-to-be-filed RJ proceedings to the extent that the rules enhance legal certainty and confirm and expand the needed protections for investors willing to acquire assets in an insolvency environment.

Naturally, given that the Reform is quite recent, the provisions have not yet been tested in such a way as to give rise to peremptory conclusions. However, they are consistent with the goal of making bankruptcy proceedings – primarily the RJ – more dynamic and attractive to investors, which ultimately promotes the underlying goals and policies of the Brazilian Bankruptcy Law.

### Notes

- 1 Interlocutory Appeal No 624.330-4/0-00, 5 May 2009.
- 2 Interlocutory Appeal No 994.09.316372-9, 26 January 2009.
- 3 Interlocutory Appeal No 2029620-72.2013.8.26.0000, 29 May 2014.
- 4 See ADI (*Ação Direta de Inconstitucionalidade*) 3934, 25 May 2009.
- 5 In this matter, the Brazilian National Counsel of Justice (CNJ) had already ruled that there is no succession of the acquirer of assets concerning pecuniary penalties applied to the debtor based on Anticorruption Law, on the hypothesis of Art 60 of Federal Law No 11.101/2005 (Enunciation No 104, *III Jornada de Direito Comercial*).
- 6 Marcelo Barbosa Sacramone, *Comentários à Lei de Recuperação de Empresas e Falência*, 2nd ed. (Saraiva, 2021).

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# Management agreements of capital companies in insolvency proceedings as per Bulgarian case law

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This article analyses the treatment of the management agreements of capital companies in insolvency proceedings in Bulgaria. The article focuses on the applicable Bulgarian legal provisions and examines relevant judicial practice to justify a conclusion that such management agreements are not to be treated as commercial transactions, which may entitle managers or directors of capital companies to lodge applications for insolvency.

The legal relationships between Bulgarian capital companies (limited liability company, joint-stock company or partnership limited by shares) with the members of their management bodies (managing directors, board of directors or management board) are subject to management agreements.

In accordance with Article 141, paragraph 7 of the Bulgarian Commerce Act (the 'Commerce Act'), the relationship between a limited liability company and its managing director is governed by a management agreement. This is to be executed in written form on behalf of the company by an explicitly authorised person or by the single shareholder.

By virtue of Article 241, paragraph 6 of the Commerce Act, the relationship between the company and a member of the management board (under the two-tier management system, consisting of management board and supervisory board) is to be regulated by a management agreement in writing. This is to be executed between the relevant board member and on behalf of the company by the chair of the supervisory board or by a person explicitly authorised.

On the legal grounds of Article 242, paragraph 6 of the Commerce Act, the relationship between the company and a member of the supervisory board is subject to an agreement in writing executed by the respective board member and on behalf of the company by a person authorised by the general shareholders meeting or by the single shareholder.

As per Article 244, paragraph 7 of the Commerce Act,

the relationship between an executive member of a board of directors (under the one-tier management system) are subject to a management agreement, executed in written form by the chair of the board of directors on behalf of the company. The relationship between the company and the other members of the board of directors may be subject to agreement, which is to be executed on behalf of the company by a person explicitly authorised.

In accordance with Article 256 of the Commerce Act, the management bodies of a partnership limited by shares are the management bodies of a joint-stock company under the one-tier management system, such as the board of directors.

The management agreement can be defined as an agreement between a capital company and a managing person, under which the latter undertakes to effectively manage the company, and the company undertakes to create and maintain favourable conditions for management and pay periodically the remuneration provided for in the agreement. Under the management agreement, a complex civil legal relationship arises, which incorporates a system of two interdependent and functionally related legal relationships:

- corporate legal relationship, which contains the right of the management body to manage and represent the company and its obligation to comply with confidentiality and non-compliance of competitive activity; and
- a mandate legal relationship, which arises from the management agreement and contains as its essential element the obligation to perform the managerial



and representative powers.

There is no dispute on the nature of the management agreements as mandate agreements in terms of Articles 280–292 of the Bulgarian Obligations and Contracts Act. This conclusion is also supported by the provision of Article 4, paragraph 1, item 7 of the Bulgarian Social Insurance Code, where the managing directors and procurators (commercial managers) of companies, sole traders, their branches and branches of foreign legal entities, the members of the boards of directors, management and supervisory boards are listed as persons who are to be insured mandatorily against common disease and maternity, disability due to a common disease, old age or death, industrial incidents and occupational diseases, and unemployment, separately from the persons who are employees under contracts of employment (listed in Article 4, paragraph 1, item 1 of the Social Insurance Code).

While there is no dispute on the nature of the management agreements as mandate agreements and not contracts of employment, in some agreements the parties agree on penalties, which are to be paid upon termination of the relevant management agreement. This is because a question arises whether the management agreement may be treated as a commercial transaction in terms of the Commerce Act and, if so, whether a person to whom the management of a company is assigned pursuant to such management agreement shall be entitled to lodge an application for insolvency proceedings against the respective company, claiming that there are liabilities of the company which are due and payable as penalties under a management agreement.

In accordance with Article 625 of the Commerce Act, insolvency proceedings shall be initiated upon written application lodged with the court by:

- the debtor;
- the liquidator;
- a creditor of the debtor under a commercial transaction;
- the National Revenue Agency for a public law obligation to the state;
- municipalities related to the debtor's business or an obligation under a private state receivable; or
- the General Labour Inspectorate Executive Agency in the event of wages due to at least one-third of the workers and employees of the merchant, which are payable but are not discharged for more than two months.

Under Bulgarian law, commercial transactions are absolute commercial transactions, as defined in Article 1, paragraph 1 of the Commerce Act as follows:

- purchasing goods or other things for the purpose of reselling them in their original, processed or finished form;
- sale of one's own manufactured goods;
- purchasing negotiable securities for the purpose of reselling them;
- commercial agency and brokerage;
- commission, forwarding and transportation transactions;
- insurance transactions;
- banking and foreign exchange transactions;
- bills of exchange, promissory notes and cheques;
- warehousing transactions;
- licence transactions;
- supervision of goods;
- transactions in intellectual property;
- hotel operation, tourist, advertising, information, entertainment, impresario and other services;
- purchase, construction or furnishing of real property for the purpose of sale; or
- leasing.

They can also be presumptive commercial transactions in terms of Article 286, paragraph 1 of the Commerce Act, which reads as follows: 'any transaction concluded by a merchant in relation to their business shall be a commercial transaction'.

The provisions of Article 286, paragraph 1 of the Commerce Act and its misinterpretation created reasons for the managing directors and/or board members of Bulgarian capital companies to see a basis for lodging applications for insolvency of the relevant company, claiming sums payable under management agreements purportedly treating them as commercial transactions.

However, the Bulgarian case law is clear in its terms that the management agreements are not to be treated as commercial transactions, but as pure mandate agreements, which are subject to the Bulgarian civil and commercial law.

In light of the above, the following judgment of the Sofia City Court must be taken into account. Judgment No. 22 of 31 January 2017, under commercial case No. 4066/ 2016 of Sofia City Court, reads as follows:

'There is a management agreement between the debtor and the applicant. As per the mandatory case law (judicial practice of the Supreme Court of Cassation) ruled in accordance with Article 290 of the Civil Procedure Code, where this case law is formed on the basis of Judgment No. 88 of 22 June 2010 under commercial case No. 911/ 2009 of the Supreme Court of Cassation, Commercial Collegium, I Commercial Department under commercial case No. 911/ 2009; Judgement No. 306 of 25 June 2012 of the Supreme Court of Cassation, IV Civil Department under civil case No. 1387/ 2011; Judgement No. 204

of 24 July 2014 of the Supreme Court of Cassation under civil case No 983/ 2014; Judgment No. 150 of 28 May 2015 of the Supreme Court of Cassation, Civil Collegium, IV Civil Department; Judgment No. 150 under commercial case No. 3471/ 2014, Commercial Collegium, I Commercial department, the legal relationship, which occurs pursuant to an agreement for assigning the management of a company is not a contract of employment, but it has the nature of a mandate and it is to be regulated by the provisions of the civil and commercial law. The relationship between the managing directors, respectively the members of the Board of Directors and the members of the Supervisory Board, on the one hand, and the company on the other hand, are governed by an agreement for assigning the management, which is a mandate agreement, hence the person to whom the management does not have the capacity of an employee in terms of the Labour Code. The remuneration owed by the company is remuneration under civil contract and it is not relevant how it is named and how it is accounted, and what deductions and calculations are made. In accordance with Judgment No 16 of 22 November 2010 under commercial case of the Supreme Court of Cassation, Commercial Collegium, II Commercial Department, as per its legal nature, the agreement for assigning the management is a type of a mandate agreement, where the powers and liabilities of the managing director to represent the company arises directly out of the resolution of the owner of the capital / its appointment as a managing director. The same

[mandate agreement] is a secondary obligational legal relationship, which establishes rights and obligations between the principal of the company and the managing director. However, the nature of a commercial transaction – absolute in terms of Article 1, paragraph 1 of the Commerce Act, or presumptive as per Article 286, paragraph 1 of the Commerce Act, is not present. Therefore, non-performance of duties under a management agreement does not fall into the scope of the receivables on the grounds of which it may be permissible to lodge an application for initiation of insolvency proceedings due to insolvency – Article 608, paragraph 1, item 1 of the Commerce Act, respectively due to overindebtedness.’

In conclusion, management agreements (as mandate agreements) are not to be treated as commercial transactions, hence no insolvency proceedings are to be initiated pursuant to applications lodged by managers alleging claims on the legal grounds of claims due and payable under such agreements.

### About the author

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# Recent decisions in the highest courts in the UK and the Cayman Islands involving insolvent claimants on the rule which bars a shareholder from bringing a claim for loss which is a consequence of loss sustained by the company

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## Introduction

Reflective loss has become a significant issue over the past few decades for those dealing with shareholder claims, particularly in insolvency scenarios involving a group of companies. It has been increasingly important for claims to be brought by the correct claimant, and only the correct claimant, as the courts have extended the scope of reflective loss and used it to bar an increasingly broad range of claims. Recent decisions of the UK Supreme Court and Judicial Committee of the Privy Council have sought to clarify and restrict the application of what was previously known as the reflective loss rule.

The starting point for any consideration of reflective loss under English law is the rule in *Foss v Harbottle* (1843) 2 Hare 461, which provides that the only person who can seek relief for an injury done to a company, where the company has a cause of action, is the company itself. This prevents a shareholder from enforcing a cause of action belonging to the company. A shareholder's rights are to participate in the decision-making organs of the company. This preserves the rights of majority shareholders to bind the company (such as by voting to ratify an irregularity or wrong committed by the company's directors) and is the bargain which is made when becoming a shareholder: to follow the fortunes of the company.

For a long time, the practical application of the rule in *Foss v Harbottle* did not appear to give rise to

any real difficulties. It was only almost 140 years later that the practical application of the rule started to give rise to issues. In *Prudential v Newman* [1982] Ch 204, the English Court of Appeal was faced with a personal claim brought by a shareholder for fraudulent misrepresentation to recover for a diminution in the value of its shareholding in a company. It held that the personal claim would circumvent the purpose of the rule in *Foss v Harbottle*, even though it belonged to the shareholder and not to the company, because it was merely a reflection of the loss suffered by the company and recovery of that loss by the shareholder should therefore be barred. Although consistent with *Foss v Harbottle*, *Prudential* paved the way for what became known as the reflective loss rule.

The reflective loss rule was considered by the highest court in the UK (then the House of Lords) in *Johnson v Gore Wood & Co (No.1)* [2002] AC 1. The ruling became particularly significant because of the contrasting approaches adopted by Lord Bingham and Lord Millett in defining the purpose and ambit of the rule. Lord Bingham explained the rule by referring to the preservation of company autonomy and preventing one party recovering for another's loss. His approach was arguably consistent with the reasoning in the *Prudential* decision and he envisaged some flexibility when applying the rule, 'the court must be astute to ensure that the party who has in fact suffered loss is not arbitrarily denied fair compensation'. Lord Millett,

however, referred to a broader policy basis for the rule, including the avoidance of double recovery, and took a firmer approach by deciding that the automatic bar on recovery by a shareholder was a ‘matter of principle and there is no discretion involved’. Lord Millett also suggested that the rule could extend beyond claims by shareholders to, for example, claims by employees.

The reflective loss rule was then expanded well beyond its company autonomy roots and by reference to supposed policy justifications. For example, in *Gardner v Parker* [2004] 2 BCLC 554, the English Court of Appeal – relying on Lord Millett’s views in *Johnson* – extended the reflective loss rule to bar a creditor claim brought by a shareholder and stated that the foundation for the rule was to avoid double recovery. The courts began to treat the reflective loss rule as being based primarily on the avoidance of double recovery and the protection of the company’s unsecured creditors, being applicable in all situations where there are concurrent claims and one of the entities pursuing a claim is a company.

Other policy justifications were also identified by the courts during this expansionary period, including causation, conflicts of interest and company autonomy in the broader sense of prejudice to other creditors and shareholders of the company. The causation point was said to be justified on the basis that any loss suffered by the claimant/shareholder principally arose not from the wrongdoer’s conduct but from any decision by the relevant company not to pursue its claim, which cut the causal link between the wrongdoing and the claimant’s loss. The ‘conflicts of interest’ point arose because the existence of the other claim may hinder the ability of the company to settle its own claim. The ‘prejudice to others’ point aimed to prevent the claimant recovering before the company could make a recovery, in a situation where the defendant was insolvent and unable to pay both claims. The reasoning underlying all of these supposed policy justifications was far from compelling and tended to lead to unjust outcomes.

The broadening of the reflective loss rule eventually culminated in the decisions of the English Court of Appeal in *Sevilleja v Marex Financial Ltd* [2018] EWCA C iv 1468 and the Cayman Islands Court of Appeal in *Primeo Fund v Bank of Bermuda (Cayman) Ltd and HSBC Securities Services (Luxembourg) SA* [2019] (2) CILR 1].

In the *Marex* case, Marex had obtained a judgment against two companies owned and controlled by Sevilleja for US\$5.5m. Sevilleja, in breach of his duties to the companies, transferred away the companies’ assets, leaving them insolvent and without funding to pursue any claims they had against Sevilleja. Marex brought a claim in tort against Sevilleja for inducing or procuring the violation by the companies of its rights under the judgment and intentionally causing it to

suffer loss by unlawful means. The English Court of Appeal held that the reflective loss rule barred Marex from pursuing its claim against Sevilleja and endorsed the four-fold policy justifications which had emerged from the authorities since *Johnson*. The decision enabled Sevilleja to escape liability for fraudulently stripping the companies of their assets.

In the *Primeo* case, Primeo had brought claims against its administrator and custodian, both entities in the HSBC group, for losses arising out of the fraud perpetrated by Bernard L Madoff Investment Securities LLC (BLMIS). The Ponzi scheme collapsed in 2008 and caused various feeder funds, including Primeo, to be placed into liquidation. Primeo had initially invested directly in BLMIS but later restructured its BLMIS investments into indirect investments through another fund, with Primeo becoming a shareholder in that other fund, which also had claims against HSBC entities. Primeo’s liquidators pursued claims against its administrator and custodian for breaches of their contractual duties in the period prior to the restructuring of the investments.

However, on the reflective loss issue, the lower courts held that all of Primeo’s claims were barred because the time at which to consider the application of the rule was the time at which the claim was issued, not the time at which the causes of action accrued. They also rejected the Primeo liquidators’ argument that the reflective loss rule could only apply where the shareholder’s claim and the company’s claim were against the same wrongdoer. Rather, they found that any claims brought by Primeo would ultimately pass through to the same wrongdoer by reason of interlocking claims within the HSBC group, and that the rule had to be assessed by reference to the economic effect of the claims rather than by reference to the legal entities involved.

### The UK Supreme Court’s decision in *Marex*

The *Marex* case then reached the UK Supreme Court. This was the first time since *Johnson* that the reflective loss issue had returned to the highest appellate level. The UK Supreme Court allowed Marex’s appeal and gave a landmark judgment on the basis and ambit of the reflective loss rule. The majority judgment overruled many of the earlier authorities and restated the reflective loss rule as the rule in *Prudential*, holding it to be a rule of substantive company law which should be confined to its narrow origin in that decision.

The majority stated that the rule in *Prudential* bars claims that are ‘brought by a shareholder in respect of loss which he has suffered in that capacity, in the form of a diminution in share value or in distributions, which is the consequence of loss sustained by the company, in respect of which the company has a cause of action

against the same wrongdoer'. Where a shareholder's loss falls within this description, it is 'not a loss which the law recognises as being separate and distinct from the loss suffered by the company. It is for that reason that it does not give rise to an independent claim for damages on the part of the shareholders'.

The focus was directed back to the corporate capacity in which the claimant's loss was suffered and the policy justifications were found to play no role in the application of the rule.

### The Privy Council's decision in *Primeo*

The UK Supreme Court's decision in *Marex* provided welcome guidance on the scope of the rule in *Prudential* and, in most situations, it should be relatively straightforward to identify whether a shareholder's claim falls within it. However, some uncertainty remained as to how the rule should be applied.

In the *Primeo* case, the liquidators had brought an appeal to the Privy Council, which is the highest appeal court for the British overseas territories. A panel, including the same judges who had heard *Marex*, addressed the specific issues raised, particularly the time at which the rule in *Prudential* is to be assessed and whether the claims by the shareholder and the company need to be against the same wrongdoer.

The Privy Council accepted the *Primeo* liquidators' arguments on the timing issue, concluding that the rule in *Prudential* did not apply to any of *Primeo*'s claims against the administrator and custodian. It reiterated that the rule is a substantive rule of law, to be assessed by reference to the capacity in which the loss is suffered (not at the time when the claim is issued). This approach was consistent with various statements by the UK Supreme Court in *Marex* and avoided the strange and unprincipled consequences which could follow if the application of the rule is assessed at the time proceedings are issued, such as shareholders selling their shares in an attempt to circumvent the rule. The Privy Council also explained that the rule is prospective in effect and applied to causes of action arising after the claimant became a shareholder, not those arising before. It was from this point that the shareholder would 'follow the fortunes' of the company and be precluded from asserting that it had suffered a separate loss. This protected the company's cause of action to the extent required by *Foss v Harbottle* and meant that a new shareholder could not be deprived of rights that it had already acquired.

The Privy Council also accepted the *Primeo* liquidators' arguments on the common wrongdoer issue, finding that the rule in *Prudential* only excludes a claim by a shareholder where the wrong is committed by the same person against both the shareholder and the company.

Extending the scope of the rule to include a claim against a different wrongdoer based on interlocking contracts would be contrary to the decision in *Marex* and ignore the critical importance of separate legal personality. There was nothing automatic or certain about liability passing through different wrongdoers in the same group and no assumption could be made about onward claims being brought. This would undermine the 'clear bright line' test laid down in *Marex*, which was designed to simplify the application of the rule. It would also magnify the scope of the rule to work injustice (such as the obvious injustice of wrongdoers escaping liability altogether). The general position is that a claimant is entitled to seek compensation for a wrong and the rule in *Prudential* is a highly specific exception to this.

### Conclusion

The recent decisions by the highest courts in the UK and the Cayman Islands in *Marex* and *Primeo* have reined the rule in *Prudential* back to its narrow company autonomy origin. It is likely that shareholder litigants in other jurisdictions will be encouraged to pursue claims falling outside the rule in *Prudential*, and defendants may be discouraged from taking technical arguments in an attempt to avoid liability by reference to the rule.

These recent decisions also provide reassurance to insolvency professionals who act for an entity in a group that they will be able to pursue the entity's cause of action where the loss does not fall within the restated rule.

#### About the authors

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Peter Hayden and Jonathan Moffatt successfully acted for *Primeo*'s liquidators in the Privy Council.

# Recognition and enforcement of a foreign plan of reorganisation in Mexico

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This article deals with an issue of private international law that arises when a debtor submits before a Mexican court, for its enforcement and recognition, a foreign judgment that approved a reorganisation plan. Since this issue does not relate to recognising a foreign proceeding, but rather a recognition of a foreign judgment, it is outside the scope of the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency (MLCBI), which has been adopted in Mexico.<sup>1</sup> Accordingly, the Mexican private international law regarding bankruptcy will govern this issue.

This article intends not to resolve private international law problems related to insolvency but rather to identify them through the Mexican perspective.<sup>2</sup> It will compare the rules derived from the Mexican private international law and those from the UNCITRAL Model Law on Recognition and Enforcement of Insolvency-Related Judgments (MLIRJ) – not yet adopted by Mexico – and the International Bar Association’s Cross-Border Insolvency Concordat (IBA Concordat).

## Sources of private international law in Mexico

The First Chamber of the Mexican Supreme Court holds that there are two sources of private international law in Mexico: the national and the conventional.<sup>3</sup>

National private international law is located in positive law. The principles of private international law contained in Article 121 (II) of the Mexican Constitution and the Federal Civil Code are *lex loci contractus*, *lex rei sitae*, *lex domicilii*, *locus regit actum* for substantive law and *lex fori* for procedural law.

Treaties are the sources for conventional private international law. According to Article 34 of the Vienna Convention on the Law of Treaties (of which Mexico is a party), and notwithstanding the several treaties that Mexico is a party to, those treaties do not create either obligations or rights for a third state.

Courts are authorised to apply foreign law as long as it is not contrary to public policy or constitutes fraud to the law.<sup>4</sup>

## Private international law related to insolvency in Mexico

There is no express rule in any legal text in Mexico relating to private international law in the field of bankruptcy. General rules of private international law, both national and conventional, will apply. If insolvency is a question of status, it should be governed by the law of the debtor’s domicile,<sup>5</sup> and if a reorganisation plan is a contract approved by a court, it should be governed by the *lex fori*.<sup>6</sup> The only conventional source of private international law relating to insolvency issues in Mexico is the C173 – Protection of Workers’ Claims (Employer’s Insolvency) Convention, 1992 (No 173).

## Recognising and enforcing the foreign judgment that approved a foreign plan

In February 1986, Mexico signed the Inter-American Convention on extraterritorial validity of foreign judgments and arbitral awards and the Inter-American Convention on jurisdiction in the international sphere for the extraterritorial validity of foreign judgments. In January 1988, Mexico subsequently amended the Federal Code of Civil Procedure (FCCP) regarding international judicial cooperation.

Foreign judgments may be utilised in Mexico either as evidence, as a binding resolution or as a resolution to be enforced. In the first case, the foreign resolution is utilised as evidence of facts but not of law and, in the second, as evidence of law (*res judicata*). The First Chamber of the Mexican Supreme Court stated that an *exequatur* proceeding is needed only in the third case. The second case requires a verification by the national court that the foreign judgment does not contravene public policy.<sup>7</sup>

According to the FCCP, a foreign judgment shall be recognised and enforced through an *exequatur* if:

- the judgment is submitted before the Mexican courts through international letters of request;
- the judgment does not derive from an *actio in rem*;
- the competence of the foreign court derives from generally known rules of international law consistent with those adopted by the FCCP;
- the issue does not pertain to the exclusive jurisdiction of Mexican courts;
- the defendant was personally served in the foreign process;
- the judgment is conclusive or unappealable;
- the judgment does not involve an issue still pending by a Mexican court that was preempted;
- the judgment fulfills all the formal requirements necessary for it to be deemed authentic in the state of origin; or
- the judgment is not contrary to the public policy in Mexico.

Notwithstanding fulfilling those requirements, the Mexican court may still refuse the enforcement for lack of reciprocity. Additionally, if a foreign judgment cannot be executed in its entirety, the court may agree to its partial execution at the request of an interested party.

If the foreign judgment is submitted as a defence within the answer to a complaint, the Mexican court will recognise it if there is no contravention to public policy without the need of an *exequatur*.<sup>8</sup> If it is submitted to be recognised and enforced, then an *exequatur* must be started.

The *exequatur* process comprises:

- the filing of the complaint;
- the defendant's services of process;
- the answer to the complaint;
- the hearing of evidence;
- the first ruling sentence;
- the appeal before a Court of Appeals;
- the *Amparo* (constitutional trial, similar to a cassation) before a District Court; and
- the appeal from the *Amparo* before a Circuit Collegiate Tribunal.

There are a number of possible grounds to refuse recognition or enforcement of a foreign judgment that approved a reorganisation plan.<sup>9</sup>

### Competence

A Mexican court will recognise a foreign judgment if the foreign court had competence according to principles of private international law consistent with national private international law.

The debtor's domicile determines the competence of Mexican courts in a bankruptcy case. For legal entities, the competent court is the one located at the corporate domicile or place of main administration; for natural

persons, the place of main administration or personal domicile; and for branches of foreign companies, the place of main administration.

A plan approved by a foreign court that assumed jurisdiction based on rules other than those recognised by the national private international law would not be recognised or enforced by a Mexican court (eg, location of assets, contractual domicile). This is consistent with Article 14, subparagraphs (g) and (h) of the MLIRJ.

### Service of process

The Mexican court will not recognise the judgment that approved the plan if the creditor against whom the plan is invoked was not served process or notified to participate in the foreign proceeding. This is consistent with Article 14, subparagraph (a) of the MLIRJ.

### Preemption of a Mexican court

If the foreign judgment that approved the foreign plan derives from a bankruptcy proceeding started after the commencement of a bankruptcy proceeding in Mexico regarding the same debtor, it will not be recognised.

### Exclusive jurisdiction

Some matters are so strongly connected to a specific interest of the state, or even to its sovereignty, that the state declares itself to be to the exclusive jurisdiction of its courts.<sup>10</sup> This may include matters related to the state's territory, exclusive economic zone, or internal affairs of the government agencies.

There are certain debtors whose bankruptcy proceedings must be tried before Mexican courts and with the supervision of administrative agencies. The following types of bankruptcies are known as *special bankruptcy proceedings*:

- A debtor that, under a concession title, provides a federal, state, or municipal public service may be adjudicated in bankruptcy. In these special proceedings, the governmental agency that granted the concession constitutes another party in the proceeding. The granting agency appoints the insolvency officers, decides whether the debtor will retain possession and can veto the reorganisation plan.
- The financial institutions can also be adjudicated in bankruptcy but only through an involuntary petition filed by the supervising governmental agency that supervises them. These bankruptcy proceedings will always commence at the liquidation stage. In these special proceedings, the supervising governmental agency constitutes another party in the proceeding.

The supervising agency will ask the court to order the closing or suspension of the enterprise and will appoint the liquidation officer.

- In the case of mixed-economy debtors (state-owned companies), the functions of the visitor (the auditor that reports to the court whether the debtor is on general default), reorganisation officer or liquidation officer will be assumed by the Institute of Administration of Assets.

If, for any reason, a foreign court assumed jurisdiction to hear a bankruptcy case of those debtors, the foreign judgment that approved the plan would not be recognised by a Mexican court. However, it is debatable whether the bankruptcies of debtors under Mexican concessions are of the exclusive jurisdiction of Mexican courts (eg airlines, *apropos* the Chapter 11 case commenced by Aeromexico in the United States).

### Public policy

Since no nation can be justly required to yield its fundamental policy and institutions in favour of those of another nation,<sup>11</sup> foreign judgments will not be recognised in Mexico if they contravene public policy. This ground of refusal is consistent with Article 7 of the MLIRJ.

The First Chamber of the Mexican Supreme Court established the same standard to apply when determining the contravention of public policy in matters of arbitral awards or foreign judgments.<sup>12</sup> Hence, an arbitral award or a foreign judgment contravenes the public policy in Mexico when it alone represents an attack against the country's institutions, principles or and norms, making the award or judgment inadmissible or intolerable.

Certain matters constitute public policy in Mexico. However, the analysis of the contravention of the public policy when submitting a foreign judgment that approved a reorganisation plan must be narrowed to the public policy regarding bankruptcy in Mexico.

Bankruptcy in Mexico is a matter of public policy. A contravention of public policy in a bankruptcy proceeding occurs:

- at the liquidation stage, when the proceeds of the assets are not correctly allocated or distributed to the creditors; or
- at the reorganisation stage, when the plan does not comply with the best interest test.

A foreign judgment that approved a foreign plan would contravene the public policy in Mexico if it does not respect the best interest test. To decide if the best interest principle was respected, it needs to be determined:

- which assets are part of the estate and which are exempted; and
- which law will govern to determine which are the exempted assets.

Mexico has a domestic disposition with an extraterritorial effect since all assets, wherever located, are part of the bankrupt estate.<sup>13</sup> However, the estate of a foreign branch adjudicated in bankruptcy by a Mexican court will comprise only the assets and liabilities located in Mexico.

Movables follow the person (*mobilia sequuntur personam*), and immovables are part of the territory of the state.<sup>14</sup> However, in bankruptcy, the property is considered in special connection with a person.<sup>15</sup> The IBA Concordat's guiding principle is that all common creditors should be treated as creditors of a single 'world-wide estate'.

### Reciprocity

Lack of reciprocity is a ground for refusing the recognition or enforcement of a foreign judgment. Why should one country recognise foreign plans when foreign recognition of their own plans does not seem guaranteed?<sup>16</sup>

For instance, it is well known that there has been reciprocity between Mexico and the United States regarding the enforcement and recognition of judgments derived from civil or commercial affairs. In cases of a bankruptcy proceeding, there have been insolvency-related judgments from Mexico, as in the cases of *Philadelphia Gear Corp v Philadelphia Gear de México, SA*, 44 F.3d. 187 (3d Cir. 1994) and *In Re Banco Nacional De Obras y Servicios Públicos*, 91 B.R. 661 (Bankr. S.D.N.Y. 1988). *Vitro* in particular is a landmark case regarding a Mexican judgment that approved a reorganisation plan.

In the *Vitro* case, the US Court of Appeals for the Fifth Circuit affirmed a decision to refuse the enforcement of the reorganisation plan approved by a Mexican court. The ground for refusal was that the foreign plan contravened US public policy by imposing a non-consensual discharge on third parties.

Should the *Vitro* case be enough for Mexican courts to refuse recognition and enforcement of insolvency-related judgments coming from the US? Will the Mexican courts strike back when the US Aeromexico plan is submitted for enforcement or recognition?

In Mexico, reciprocity is presumed, and the one that invokes lack of reciprocity has the burden to prove it. There is no precedent in Mexico's jurisprudence or case law that states how many cases must be to determine a lack of reciprocity. Nevertheless, said ground of refusal to recognise and enforce a foreign



judgment depends exclusively on the court's judicial discretion. Notwithstanding the lack of reciprocity, the Mexican court may still recognise and enforce the foreign judgment.<sup>17</sup>

## Partially recognising and enforcing a foreign plan

Principle 2, subparagraph (f) of the IBA Concordat states that a discharge granted by the main forum should be recognised in any forum. That would hardly be the case in Mexico, since workers' claims and tax claims are not dischargeable. However, the FCCP authorises the partial recognition or enforcement of a foreign judgment, which is consistent with Article 14, subparagraph (f), and Article 16 of the MLIRJ.

It could be possible to enforce the foreign plan regarding the foreign debts but not the national debts (workers and tax), according to the *lex loci contractus*. Alternatively, it could be possible to enforce the foreign plan regarding the national debts but according to the *lex loci contractus* compatible with the national law.

## Parallel plans

Mexico adopted the MLCBI almost in its entirety but added that, upon recognition of a foreign proceeding (whether main or non-main), a national proceeding must be opened if the debtor has an establishment in Mexico. If recognising a foreign insolvency-related judgment constitutes recognition of a foreign insolvency proceeding, then, by recognising a foreign judgment that approved a plan of a debtor that has an establishment in Mexico, a bankruptcy case under Mexican law will be opened in the reorganisation stage.

Here is where the question arises: which plan would the Mexican court apply – the foreign one or the one approved under the Mexican insolvency proceeding? Principle 9 of the IBA Concordat suggests cooperation among courts so that the objectives of all relevant nations may, to the extent possible, be realised. A possible solution to the parallel plans would be to limit each plan to domestic assets.<sup>18</sup>

## Conclusion

The problems that arise from cross-border insolvency are yet to be resolved with a national source of private international law in Mexico. In a matter of international bankruptcy, the comity has proven wholly inadequate.<sup>19</sup> States must coordinate their proceedings to avoid juridical anarchy by a plurality of bankruptcies.<sup>20</sup>

## Notes

- 1 Francisco Rodriguez-Nepote, 'Cross-Border Insolvency: Recognition of Foreign Proceeding Under the Mexican Bankruptcy Law' (SSRN, 21 June 2020). See <https://ssrn.com/abstract=3638706> or <http://dx.doi.org/10.2139/ssrn.3638706>, accessed 27 September 2021.
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- 3 *Contradicción de tesis* 372/2015 and *amparo en revisión* 887/2005.
- 4 Alberto G Arce, *Derecho Internacional Privado*, (Universidad de Guadalajara, Guadalajara 1965), 114.
- 5 Burgin, Leslie, 'Private International Law and Bankruptcy and Liquidation of Companies', 1923, 9, *Transactions of the Grotius Society*, 71–88. See [www.jstor.org/stable/742961](http://www.jstor.org/stable/742961), accessed 19 August 2021.
- 6 Pasquale Fiore, *Del fallimento secondo il diritto privato internazionale*, (Tipografia Nistri, 1873), 88. Giuseppe Carle, *La natura giuridica del fallimento nel diritto privato internazionale*, (Stamperia Della R. Università, 1872) 81.
- 7 *Amparo en revisión* 578/2016.
- 8 Alberic Rolan, *Des conflits de lois en matière de faillite*, (Librairie Hachette, 1927), 135.
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- 11 Joseph Story, *Commentaries on the conflict of laws*, (Hilliard, Gray and Company, 1824), 26.
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# Restructuring – a key pillar of the global commitment to ‘build back better’

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### Introduction

As Stanford economist and Nobel laureate Paul Romer said, ‘a crisis is a terrible thing to waste’.

The current pandemic has served as something of a circuit-breaker for governments, businesses and all of us as individuals. It has provided a reminder about the importance of living in a responsible and sustainable manner, compelling us to reflect on our own mortality and what it really means to live and function in a community tied together by a common humanity.

Led by a global narrative and policy framework advocated by the United Nations, the Organisation for Economic Cooperation and Development (OECD) and the World Bank, the focus of governments across the world is now on how to ‘build back better’ from Covid-19. There is an emphasis on sustainable development, net zero emissions and zero waste, and committed action on important social and governance objectives to advance human rights, equality and anti-corruption measures. Indeed, the recent G7 summit saw global leaders commit to a ‘green’ recovery with infrastructure tied to carbon neutrality and biodiversity goals, as well as better opportunities for global education, inclusion and social equality.

Businesses are increasingly focused on environmental, social and governance (ESG) outcomes. They are setting targets for emissions reductions and changing their operational structures to promote better governance, integrity, diversity, labour protection and anti-discrimination practices, as well as contributions to global, regional and community anti-poverty measures and other social justice goals.

This has been driven in large part by changing social attitudes, and the growing expectation from employees, customers and investors that the businesses they deal with must behave in a responsible and ethical manner. The ‘purpose’ of a company has now been reimagined and it transcends the traditional shareholder primacy model which prioritises the

maximisation of shareholder wealth irrespective of the social context in which a company operates.

In this environment, companies need to change the way they do business, not only to remain competitive and relevant and ensure continued capital and revenue flows – but also to ensure basic compliance with complex, shifting regulatory and policy settings.

This will inevitably require companies to overhaul their existing operations and restructure their affairs to ensure their footprint is greener, fairer and simply better. In doing so, there will be considerable opportunities for companies to access sustainability bonds and finance in global and domestic debt and equity markets. Green financing in particular is seen to be a pillar of corporate debt restructuring, both from public sources and private financiers, as central banks have indicated a willingness to increase lending authorities and relax liquidity restrictions to support climate change mitigation, resilience and other environmental goals.

Indeed, many financiers have established cooperative measures to work together to align their lending and investment portfolios with net-zero emissions. For example, the UN Net Zero Banking Alliance, established in April 2021, brings together 53 banks from 27 countries (representing almost a quarter of global banking assets in the order of US\$37tn), with a commitment to align lending and investment portfolios with the goal of net zero emissions by 2050. This follows the adoption of the Principles for Responsible Banking (the ‘Principles’) by (currently) 240 international bank signatories from 69 countries. The Principles set out broad commitments for signatories to:

- align their business strategies;
- reduce negative impacts;
- work with clients, customers and stakeholders; and
- improve internal governance, culture, transparency and accountability in pursuit of certain agreed ‘societal goals’, including the Paris Agreement.

Likewise, in the insurance sector, the UN Net Zero

Insurance Alliance was launched by eight global insurance and reinsurance entities in July 2021 at the G20 Climate Summit, with the aim of moving towards net zero underwriting portfolios by 2050. The membership of this Alliance is expected to significantly expand in coming months and years to include a broad range of global insurance, reinsurance and brokerage bodies. Further, the UN Principles for Sustainable Insurance provide a roadmap for insurers globally to incorporate climate risks in their business decisions and to also specifically work with customers and one another to ensure climate and other risks are effectively managed within a best practice risk management framework.

These developments will place considerable pressure on all businesses globally to transition towards net zero emissions, as well as to ensure their operations reflect other important ESG goals, if they wish to access indispensable sources of finance and insurance.

Given the existential nature of these transformed social and policy settings, many of the restructuring opportunities in coming years will need to be undertaken through a range of informal, hybrid and formal insolvency processes, such as schemes of arrangement, pre-pack administrations and restructuring plans. Further, with the pace of globalisation and the increased use of complicated corporate structures to conduct business on a regional and global basis, sustainability-linked corporate restructurings will often involve simultaneous cross-border processes in different jurisdictions.

These complex processes will require the support of a strong and experienced network of cross-border insolvency and restructuring professionals. After all, with every crisis comes an opportunity to learn, grow, change and make an enduring contribution to something stronger and better.

#### About the authors

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**Kai Luck's** practice as Executive Counsel at Norton Rose Fulbright concentrates on cross-border insolvency and restructuring. He has worked as an insolvency specialist for over 12 years in several global law firms. Before this time, Luck obtained his doctorate in corporate insolvency law at The University of Queensland and has worked across academia, policy and practice.

# A new era of mutual recognition of insolvency proceedings between Hong Kong and Mainland China

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Under the constitutional principle of 'one country, two systems' after the reunification in July 1997, the Special Administrative Region of Hong Kong retained its common law legal system. This system is quite different from the socialist legal system in Mainland China. Given that neither Mainland China nor Hong Kong have adopted the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-border Insolvency, this has created a legal void for mutual recognition of insolvency proceedings between the two jurisdictions.

This article discusses:

- the extent to which the Hong Kong Court will recognise Mainland insolvency proceedings;
- the historical development of recognition of Hong Kong insolvency proceedings in Mainland China; and
- the latest developments with mutual recognition of insolvency proceedings under the 'Record of Meeting on Mutual Recognition of and Assistance to Bankruptcy (Insolvency) Proceedings between the Courts of the Mainland and of the Hong Kong Special Administrative Region', signed on 14 May 2021.

The Greater Bay Area (GBA) initiative is an ambitious scheme to link the nine cities in Guangdong's Pearl River Delta, Hong Kong and Macau into an integrated economy and world-class business hub. Leveraging each city's individual strengths, the project will oversee improved transport infrastructure, the creation of an international innovation and technology centre, and the development of a globally competitive modern industrial system, while promoting the free flow of people, goods, capital and information within the region.<sup>1</sup>

As major trading partners, trade between Hong Kong and Mainland China is strong. Hong Kong has always been one of Mainland China's largest sources of foreign direct investment; similarly, Hong Kong has been a major recipient of direct investment from Mainland China. For example, Mainland China's share of Hong Kong's global trade was at 50.8 per cent (US\$544.8bn) in 2019 and Hong Kong was Mainland China's second largest export market accounting for 11.2 per cent (US\$278.3bn) of its total exports in 2019.<sup>2</sup>

Mainland companies also maintain a strong physical presence in Hong Kong. As of June 2020, Mainland companies had established 1,986 regional headquarters/ regional offices/ or local offices in Hong Kong.<sup>3</sup>

However, unlike other famous Bay Areas, such as the Tokyo Bay Area and the San Francisco Bay Area, each of which has a unitary legal and political system, the GBA has a unique socio-economic and legal profile including three different legal systems, currencies and customs.

To further complicate matters in an insolvency context, neither Hong Kong nor Mainland China have adopted the United Nations Commission on International Trade Law Model Law on Cross-border Insolvency (the 'UNCITRAL Model Law'), and there were historically no formal protocols or arrangements to facilitate the smooth and consistent handling of liquidations of companies with business and assets traversing the territorial borders within the GBA.

There is no statutory provision in Hong Kong mandating the recognition of the appointment of a company's insolvency office holder (eg, trustee in bankruptcy, liquidator, provisional liquidator or administrator) appointed in insolvency proceedings outside Hong Kong, or providing judicial assistance to them. Rather, the High Court of Hong Kong ('Hong Kong Court') has developed a set of common law principles to assist in this area of cross-border insolvency.

A series of judgments from the Hong Kong Court (discussed below) in recent years confirms that it can and will recognise collective insolvency proceedings commenced in a company's place of incorporation outside Hong Kong.

The Hong Kong Court has even developed a standard practice on applications for recognition and assistance, including a 'standard-form recognition order'.<sup>4</sup> This empowers the insolvency office holder to, among other things:

- take possession and control of the company's property in Hong Kong;
- investigate its affairs in Hong Kong;
- bring proceedings in Hong Kong; and
- provides for a stay of the commencement or continuation of proceedings against the company or its assets in Hong Kong except with the leave of the Hong Kong Court.

The Hong Kong Court has adopted the legal concept of 'modified universalism' in relation to corporate insolvency (which broadly underpins the UNCITRAL Model Law) to 'recognise and assist' foreign insolvency office holders. This essentially means that the Hong Kong Court will, so far as is consistent with justice and public policy, cooperate with the courts in the country of the principal liquidation to ensure that all the company's assets are distributed to its creditors through a single system of distribution. It is important to note that the Hong Kong Court does *not* currently require mutual reciprocity with relevant foreign 'lead' jurisdictions.

Likewise, the Mainland Court will explore the possibility of utilising the built-in provisions of its Enterprise Bankruptcy Law (EBL), which came into force in Mainland China on 1 June 2007.

Recognising the practical problems that arise from what is essentially a legal 'void' or lack of legal mechanism for mutual recognition of insolvency proceedings and assistance to enable insolvency office holders to exercise their powers, on 14 May 2021, the Supreme People's Court (SPC) and the Secretary of Justice of Hong Kong signed a formal record which signifies a consensus on the mutual recognition of, and assistance with, insolvency proceedings between the two jurisdictions (see below).

There can be no doubt that a practical and positive attitude towards cooperation between the courts in Mainland China, Hong Kong and Macao will significantly promote the effective handling of any cross-border insolvency of companies with business and assets within the GBA.

## Recognition of Mainland insolvency proceedings by the Hong Kong Court

On 18 December 2019, the Hong Kong Court heard the first ever application by Mainland Administrators for recognition of their appointment and judicial assistance in Hong Kong under common law – *Re CEFC Shanghai International Group Limited (Mainland liquidation)*.<sup>5</sup>

CEFC Shanghai International Group Limited (CEFC), a Mainland-incorporated investment holding company, was placed into liquidation by the Shanghai No.3 Intermediate People's Court (the 'Shanghai Court'). The Shanghai Court appointed three law firms in Mainland China as administrators. The CEFC administrators performed a similar role to court-appointed liquidators in Hong Kong.

CEFC's assets in Hong Kong included a significant claim (HK\$7.2bn) against its Hong Kong subsidiary (the 'CEFC HK subsidiary'). The CEFC administrators discovered that a creditor of CEFC had obtained a default judgment in Hong Kong against CEFC, and successfully obtained a garnishee order *nisi* against the CEFC HK subsidiary. Given the pending 'show cause' hearing for a garnishee order to be made absolute, the CEFC administrators urgently applied to the Hong Kong Court for recognition and assistance in order to stay the garnishee proceedings to maintain fairness between all CEFC's creditors. The Shanghai Court also issued a letter of request to support the application by the CEFC administrators.

The Hong Kong Court re-affirmed that, before it would recognise foreign court-appointed administrators or liquidators and provide necessary judicial assistance, the following criteria must be satisfied: (1) The foreign insolvency proceedings are collective insolvency proceedings; and (2) the foreign insolvency proceedings have been opened in the company's country of incorporation. The criteria remain the same whether the recognition request comes from a common law jurisdiction (eg, the Cayman Islands) or a civil law jurisdiction (eg, Mainland China).

With respect to the 'collective insolvency proceedings', the Hong Kong Court stated that 'the Company's Mainland liquidation is undoubtedly a collective insolvency proceeding. This is demonstrated by the fact that the liquidation proceeding encompasses all of the debtor's assets (Article 30 of the [EBL]).'

The Hong Kong Court also stated that recognising foreign insolvency proceedings and providing assistance did not mean that the Court would grant a foreign liquidator/administrator all the powers that are available to liquidators in Hong Kong under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (CWUMPO).

The common law power of assistance is subject to three limitations:

- the power of assistance is not available to enable the foreign office holder to do something which they could not do under the insolvency law of their ‘home’ jurisdiction;
- the power of assistance is available only when it is necessary for the performance of the foreign office holders’ functions; and
- an order granting assistance must be consistent with the substantive law and public policy of the assisting court (ie, the Hong Kong Court).

The Hong Kong Court also made the following observations on key similarities between insolvency regimes in Mainland China and Hong Kong:

- Article 25 of the EBL sets out the powers and duties of administrators that correspond to the powers and duties of liquidators in Hong Kong;
- Article 19 of the EBL imposes a stay of proceedings, which is similar to the Hong Kong liquidation stay; and
- Article 113 of the EBL requires *pari passu* distribution of the debtor’s assets, which is consistent with the Hong Kong insolvency regime.

The Hong Kong Court concluded that the powers sought by the CEFC Administrators were consistent with the Mainland’s insolvency law and the standard-form recognition order. The Hong Kong Court agreed to recognise the CEFC Administrators and granted them the conventional powers set out in the standard-form recognition order (conventional powers).

There is no requirement under common law principles that recognition and assistance require demonstration of reciprocity. However, the Hong Kong Court emphasised that any future development of recognising administrators appointed by the Mainland Court will depend on the extent to which the Mainland Courts promote a unitary approach to cross-border insolvency (to avoid having separate liquidations in multiple jurisdictions).

Within three months after the judgment in *Re CEFC Shanghai International Group Limited*, there was another application for recognition of an insolvency appointment from a Mainland administrator to the Hong Kong Court – *Re Shenzhen Everich Supply Chain Co Ltd (in liquidation in the Mainland)*.<sup>6</sup>

Shenzhen Everich Supply Chain Co, Ltd (Shenzhen Everich) is a Mainland-incorporated company, which had been placed into liquidation by the Bankruptcy Court in Shenzhen (the ‘Shenzhen Bankruptcy Court’). The administrator of Shenzhen Everich was required to take control and manage the affairs of two Hong Kong subsidiaries as part of the liquidation of Shenzhen Everich. These subsidiaries held substantial assets in Hong Kong (cash in bank accounts and substantial external trade receivables).

In addition to the Conventional Powers, the Everich administrator asked the Hong Kong Court for the express power ‘to take control of and exercise all rights that the Company may have in relation to any of its subsidiaries, joint ventures, associated companies or other entities in which the Company has an interest (whether directly or indirectly)’. The Everich administrator intended to use this express power primarily to gain control of the company’s subsidiaries in Hong Kong which held very significant external trade receivables.

The Hong Kong Court applied the principles in *Re CEFC Shanghai International Group Limited*, ordering that the Everich administrator should be recognised. It also granted the Everich administrator the conventional powers and the express power to take control of the subsidiaries in Hong Kong.

The Hong Kong Court took the opportunity to reiterate that future applications and letters of request issued by the Mainland Court should be drafted in a way which reflects the form of order approved in *Re CEFC Shanghai International Group Limited*.

### Position in Hong Kong

It now seems settled that the Hong Kong Court accepts that insolvency proceedings in Mainland China are ‘collective insolvency proceedings’. As such, for companies incorporated in Mainland China, insolvency proceedings in Mainland China satisfy the two essential criteria to enable insolvency office holders to obtain recognition and assistance from the Hong Kong Court, that is: (1) the foreign insolvency proceedings are collective insolvency proceedings; and (2) the foreign insolvency proceedings were opened in the company’s country of incorporation.

With respect to the express power granted to the Everich administrator, it is arguable that such power was not strictly necessary since the conventional powers would allow the Everich administrator to ‘take into possession and control all assets in Hong Kong of the company under liquidation’ (which would include any subsidiaries of Shenzhen Everich in Hong Kong).

In any event, the willingness of the Hong Kong Court to be flexible when considering requests from Mainland insolvency office holders for express powers, other than the conventional powers, is a positive development. The Hong Kong Court will usually always expect a foreign insolvency office holder to support a request with credible evidence on the relevant legal regime to substantiate the requests.

## Historic recognition of Hong Kong insolvency proceedings in Mainland China

In *Re CEFC Shanghai International Group Limited*, the Hong Kong Court noted that Article 5 of the EBL appears to be the closest statutory provision that will potentially empower the Mainland Court to recognise foreign insolvency proceedings.<sup>7</sup>

Article 5 of the EBL<sup>8</sup> states:

‘Once the procedure for bankruptcy is initiated according to this Law, it shall come into effect in respect of the debtor’s property outside of the territory of the People’s Republic of China.

Where a *legally effective judgment or ruling made on a bankruptcy case by a court of another country* involves a debtor’s property within the territory of the People’s Republic of China and the said court applies with or requests the people’s court to recognise and enforce it, the people’s court shall, *according to the relevant international treaties that China has concluded or acceded to or on the basis of the principle of reciprocity*, conduct examination thereof and, when believing that the said judgment or ruling does not violate the basic principles of the laws of the People’s Republic of China, does not jeopardise the sovereignty and security of the State or public interests, does not undermine the legitimate rights and interests of the creditors within the territory of the People’s Republic of China, *decide to recognise and enforce the judgment or ruling.*’ (emphasis added)

Importantly, the ‘*principle of reciprocity*’ is a relevant factor for the Mainland Court to recognise a ‘*judgment or ruling made on a bankruptcy case by a court of another country*’.

In September 2011, a Hong Kong liquidator applied to the Mainland Court to recognise a winding-up order issued by the Hong Kong Court. Both the Beijing Intermediate People’s Court and the Beijing Higher People’s Court had conditionally approved the application. However, due to complex legal issues and lack of precedents for such recognition, the Higher People’s Court requested the SPC to confirm *inter alia* what Mainland law would be applicable to recognise the winding-up order issued by the Hong Kong Court.<sup>9</sup>

In its official reply, the SPC indicated that there was no legal basis for the Mainland courts to recognise the particular winding-up order issued by the Hong Kong Court and, more generally, that a winding up order did *not* constitute a foreign judgment for the purpose of Article 5 of the EBL.<sup>10</sup>

Subsequently, in September 2020, three judges of the Shenzhen Bankruptcy Court (which is part of the Shenzhen Intermediate People’s Court) wrote an article<sup>11</sup> indicating that the Mainland courts may have changed course and that future recognition of Hong Kong liquidators can be anticipated. Referring

to earlier judgments of the Hong Kong Court, they concluded the article by stating:

‘The Hong Kong Courts in the Nianfu case, and previously in the Guangxin case and the Huaxin case, have shown an open attitude towards recognition and assistance to Mainland insolvency proceedings. This provides a basis for the Mainland courts to hear applications for recognition and assistance from Hong Kong liquidators in the future on the principle of reciprocity. The exploration and accumulation of mutual recognition and assistance by the courts of the two places will inevitably promote future promulgation of cross-border judicial cooperation arrangements for insolvency matters across the border.’

It is relevant to note also that the Shenzhen Bankruptcy Court was established fairly recently (in 2019) with a mandate from the SPC to rule on ‘cross-border’ cases and ‘other cases that fall within its jurisdiction’.<sup>12</sup> The Shenzhen Bankruptcy Court states that it will provide ‘powerful judicial services and guarantees for Greater Bay Area development’.<sup>13</sup>

The comments from the judges of the Shenzhen Bankruptcy Court provide both insight and optimism for how the Bankruptcy Court may handle future cross-border insolvency cases from Hong Kong.

## Potential ‘test case’ for reciprocity in Mainland China

On 23 October 2020, the Hong Kong Court ruled on the first ever application by a petitioner for the appointment of provisional liquidators (over a Hong Kong-incorporated company) with the express purpose of seeking recognition of their appointment in Mainland China. The provisional liquidators asked for this power to enable them to seek to recover substantial receivables owed to the company by its debtors in Mainland China – *Re Ando Credit Limited*.<sup>14</sup>

The Hong Kong Court referred to the Proposed Framework for Co-operation with the Mainland in Corporate Insolvency Matters issued by the Department of Justice on 22 June 2020,<sup>15</sup> which states:

‘It is anticipated that in the near future a protocol will be entered into between Hong Kong and the [SPC] which will provide for such mutual recognition. Any application made by the provisional liquidators of [Ando Credit Limited] is likely to move in tandem with the finalisation and implementation of that protocol.’

The Proposed Framework specifically referred to the SPC’s decision in 2011 that Article 5 of the EBL ‘does not appear to apply to the recognition of a winding up order given by a Hong Kong court’.

The Hong Kong Court also referred to the article (an English translation of the article is appended to the written decision) and granted the application to appoint provisional liquidators.

That the Hong Kong Court agreed to appoint the provisional liquidators with the express purpose of seeking recognition in Mainland China may suggest that the Hong Kong Court is optimistic that the Hong Kong provisional liquidators will ultimately be recognised by the Mainland Court.

The decision in *Re Ando Credit Limit* also suggests that there may have been some positive developments 'behind the scenes' with the negotiation of the protocol for mutual recognition between Hong Kong and Mainland China.

### Formal mutual recognition of insolvency proceedings between Mainland China and Hong Kong

On 14 May 2021, the SPC and the Hong Kong SAR Government signed the Record of Meeting on Mutual Recognition of and Assistance to Bankruptcy (Insolvency) Proceedings between the Courts of the Mainland and of the Hong Kong Special Administrative Region (the 'Record'), representing a consensus between the two jurisdictions on the mutual recognition and assistance of insolvency proceedings.

The SPC and the Hong Kong SAR Government have each issued an opinion and practical guide to give further guidance on the matter.

The main features of 'The Supreme People's Court's Opinion on Taking Forward a Pilot Measure in relation to the Recognition of and Assistance to Insolvency Proceedings in the Hong Kong Special Administrative Region' (the 'SPC Opinion') are as follows:

- Shanghai Municipality, Xiamen Municipality and Shenzhen Municipality are designated as 'pilot' areas given their close trade ties to Hong Kong, and the Intermediate People's Courts of these areas may recognise and assist Hong Kong insolvency proceedings;
- Hong Kong insolvency proceedings include compulsory winding-up proceedings and creditors' voluntary winding-up proceedings commenced in accordance with CWUMPO and scheme of arrangement promoted by a liquidator or provisional liquidator and sanctioned by the Hong Kong Court in accordance with Section 673 of the Companies Ordinance (Cap. 622);
- the recognition applies to both provisional liquidators and liquidators in the Hong Kong Insolvency Proceedings;
- the SPC Opinion will only apply to Hong Kong insolvency proceedings where the centre of main

interests (COMI) of the insolvent company is in Hong Kong continuously for at least six months. COMI will generally be determined by the place of incorporation of the insolvent company. However, the People's Court will also take account of other factors, such as the place of principal office, the principal place of business and the place of principal assets of the insolvent company;

- the insolvent company must have a place of business or a representative office in one of the pilot areas;
- after the People's Court recognises the Hong Kong insolvency proceedings, payment of debts made by the insolvent company to individual creditors shall be invalid;
- after the People's Court recognises the Hong Kong insolvency proceedings, any civil action or arbitration involving the insolvent company that has started but has not yet been concluded shall be suspended. However, such action or arbitration can proceed after the Hong Kong Administrator takes over the insolvent company's property; and
- after the People's Court recognises the Hong Kong insolvency proceedings, it may, upon application from the Hong Kong administrator, decide to allow them to perform the following duties in Mainland China:
  - taking over the property, seals, account books, documents and other data of the insolvent company;
  - investigating the financial position of the insolvent company and preparing a report on such position;
  - deciding on the matters of the insolvent company's internal management;
  - deciding on day-to-day expenses and other necessary expenditures;
  - before the holding of the first creditors' meeting, deciding whether to continue or suspend the business of the insolvent company;
  - managing and disposing of the insolvent company's property;
  - participating in legal actions, arbitrations or any other legal proceedings on behalf of the insolvent company;
  - accepting declaration of claims by creditors in Mainland China and examining them; and
  - performing other duties that the People's Court considers that they may be so allowed.
- the performance of the above duties by a Hong Kong administrator which involves waiver of property rights, creation of security on property, loan, transfer of property out of Mainland China and other acts for disposing of the property that has a major impact on the creditors' interest require separate approval by the People's Court.

Subsequently, on 20 July 2021, Justice Harris handed down his decision in *Re Samson Paper Company Limited*



(in *Creditors' Voluntary Liquidation*),<sup>16</sup> approving the first application for a letter of request to be issued by the Hong Kong Court for judicial assistance to facilitate the liquidators to be recognised by the Shenzhen Bankruptcy Court under the Record.

Justice Harris confirmed that the Hong Kong Court has an inherent jurisdiction under common law to issue a letter of request in order to permit Hong Kong liquidators to seek recognition and assistance in another jurisdiction for judicial assistance.

In determining whether it should issue a letter of request, the Hong Kong Court would consider whether Hong Kong is the most appropriate or convenient forum for determining the issue in question. In the present case, the Hong Kong Court agreed that it would be appropriate to issue a letter of request, for the following reasons:

- the liquidators had shown that the company had substantial assets in Mainland China, principally located in Shenzhen;
- the liquidators had a duty to collect company's assets;
- the liquidators have an express statutory power to commence legal proceedings (in Hong Kong and elsewhere) to recover assets; and
- the assistance from the Shenzhen Bankruptcy Court related to conventional asset collection action.

In his decision, Justice Harris also noted from the SPC Opinion that two documents from the Hong Kong Court are necessary for the Shenzhen Bankruptcy Court to consider whether to recognise Hong Kong liquidators, namely: (1) a letter of request for judicial assistance; and (2) a judgment determining that a letter of request should be issued.

Accordingly, Justice Harris specifically stated in the decision that:

'it is desirable that the Liquidators' appointment should be recognised and assisted in Shenzhen ... the criteria for issuing a letter of request are satisfied in the present case ... this is a proper case for a letter of request to be issued by the Hong Kong Court to the Shenzhen Court requesting that the Shenzhen Court make an order recognising the Liquidators and providing assistance to them.'

On 6 September 2021, the Shenzhen Intermediate People's Court announced that it had received the request of the liquidators to be recognised and assisted in Mainland China on 30 August 2021.<sup>17</sup> This is the first request that the Mainland judiciary has received pursuant to the Record. So far as we are aware, there has not yet been any formal ruling on the request from the Shenzhen Bankruptcy Court.

## UNCITRAL Model Law and the Record

As stated above, neither Hong Kong nor Mainland China have adopted the UNCITRAL Model Law, although the Hong Kong Court has adopted the legal concept of 'modified universalism' in relation to corporate insolvency to 'recognise and assist' foreign insolvency office holders. Therefore, the record represents a special recognition protocol between the two jurisdictions under the 'one country, two systems' principle, and is unlikely to be replicated between Mainland China and other jurisdictions.

Having said that, in formulating the Record, the Department of Justice in Hong Kong has made references to and has been influenced by the mechanisms for dealing with cross-border insolvency in the UNCITRAL Model Law.

It was initially suggested that in the Proposed Framework that, like the UNCITRAL Model Law, insolvency proceedings commenced in Hong Kong may be recognised by the Mainland Court either as 'main' or 'non-main' proceedings, with the determining factor being the COMI of the company in question:

'25(1). Where a debtor company's 'Centre of Main Interests' (COMI) is in Hong Kong, insolvency proceedings commenced in Hong Kong may be recognised by a Mainland court as main proceedings upon which a variety of assistance may, in principle, be granted by the Mainland court to 'insolvency office-holders' appointed in such proceedings.

28. The definition of COMI is suggested to be formulated along the lines as provided under Article 16 of the UNCITRAL Model Law... interpreted in light of the comments set out in [paragraphs 145 to 147 of] the Guide to Enactment and Interpretation of the Model Law. The COMI of a company incorporated in Hong Kong would be presumed to be in Hong Kong.

33. ...if the Mainland court is satisfied that the debtor's COMI is not in Hong Kong, it may, at its discretion, grant such assistance as necessary to protect the assets of the debtor in the Mainland or the interests of the creditors. It is further contemplated that suitable reference would be made to Article 21 of the Model Law...'

The above suggestion ultimately did not find its way fully into the current mutual recognition regime, as it is clearly stated in the SPC Opinion that the People's Court would only recognise or assist Hong Kong insolvency proceedings if the COMI of the company in question is situated in Hong Kong<sup>18</sup> – that is, that only 'main' proceedings would be recognised. It remains to be seen whether the Mainland Court will broaden the scope of recognition to include 'non-main' proceedings as Hong Kong and Mainland China take steps in the future to 'persistently improve the mechanism' and 'progressively expand the scope of the pilot areas' as contemplated under Article 5 of the Record.

## Conclusion

The milestone case of *Re CEFC Shanghai International Group Limited* was the first formal recognition by the Hong Kong Court of a Mainland insolvency proceeding. It represents a significant leap forward as regards judicial cooperation between Hong Kong and Mainland China.

The subsequent case of *Re Shenzhen Everich Supply Chain Co Ltd* also shows that the Hong Kong Court continues to be flexible and adaptable to accommodate the practical needs of Mainland administrators to perform their duties for the benefit of creditors.

On 14 May 2021, the SPC and the Secretary of Justice of Hong Kong entered into a ‘cooperation mechanism’ in the form of the Record, which provides a procedure for mutual recognition of insolvency process and liquidators between Hong Kong and (for now) Shenzhen, Shanghai and Xiamen.

Subsequently, on 20 July 2021, the Hong Kong Court in *Re Samson Paper Company Limited (in creditor’s voluntary liquidation)* allowed the first application for a letter of request to be issued to the Mainland judiciary for formal recognition.

On 6 September 2021, the Shenzhen Intermediate People’s Court announced that it has received the request of the Liquidators of Samson Paper Company Limited to be recognised and assisted in Mainland China on 30 August 2021. Assuming that the Shenzhen Bankruptcy Court acts upon the letter of request, it will be the first occasion on which a court in Mainland China has formally recognised and assisted a liquidator appointed by the Hong Kong High Court – a milestone development in cross-border corporate insolvency cooperation between Hong Kong and Mainland China.

The recognition of Hong Kong insolvency office holders in Mainland China would undoubtedly reinforce Hong Kong’s position as a major financial and debt restructuring centre. Judicial co-operation between the Hong Kong courts and the Mainland courts would facilitate Hong Kong in maintaining its status as one of the world’s leading financial centres and a true ‘gateway’ to Mainland China for many years to come.

## Notes

- 1 ‘Greater Bay Area Overview’ (Constitutional and Mainland Affairs Bureau), see [www.bayarea.gov.hk/en/about/overview.html](http://www.bayarea.gov.hk/en/about/overview.html), accessed 8 October 2021.
- 2 ‘Greater Bay Area – Hong Kong’ (Constitutional and Mainland Affairs Bureau), see [www.bayarea.gov.hk/en/about/hongkong.html](http://www.bayarea.gov.hk/en/about/hongkong.html), accessed 8 October 2021.
- 3 *Ibid.*
- 4 The standard form recognition order is set out in *Re Joint and Several Liquidators of Pacific Andes Enterprises (BVI) Ltd* [2017] HKCU 245 and further revised in *Re Joint Provisional Liquidators of Hsin Chong Group Holdings Ltd* [2019] HKCFI 805.
- 5 *Re CEFC Shanghai International Group Limited* [2020] HKCFI 167.
- 6 *Re Shenzhen Everich Supply Chain Co Ltd* [2020] HKCFI 965.
- 7 *Supra* 5.
- 8 Enterprise Bankruptcy Law of the People’s Republic of China, see [http://english.www.gov.cn/services/doingbusiness/202102/24/content\\_WS6035f009c6d0719374af97ad.html](http://english.www.gov.cn/services/doingbusiness/202102/24/content_WS6035f009c6d0719374af97ad.html), last accessed 17 October 2021.
- 9 ‘Reply of the Supreme People’s Court to the request for instructions for the application from Norstar Automobile Industrial Holdings Ltd to recognise a court order of the Hong Kong Special Administrative Region’ (isheng.net) <http://ms.isheng.net/index.php?doc-view-27746>, accessed 8 October 2021.
- 10 *Ibid.*
- 11 ‘Practical exploration of cross-border bankruptcy between the Mainland and Hong Kong’ (The People’s Judicature, 11 September 2020), see <https://wemp.app/posts/c4ee81da-dfc9-45e3-b440-fcf9d88d47c1>, last accessed 17 October 2021.
- 12 ‘Shenzhen’s new bankruptcy court could track assets transferred to Hong Kong’ (South China Morning Post, 17 January 2019).
- 13 *Ibid.*
- 14 *Re Ando Credit Ltd* [2020] HKCFI 2775.
- 15 ‘Legislative Council Panel on Administration of Justice and Legal Services – Proposed Framework for Co-operation with the Mainland in Corporate Insolvency Matters’ (Department of Justice, June 2020).
- 16 [2021] HKCFI 2151
- 17 See <https://finance.sina.com.cn/tech/2021-09-07/doc-iktzscyx2726232.shtml>, accessed 8 October 2021.
- 18 Article 18 of the SPC Opinion.

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# Transposing the new EU Restructuring Directive into Belgian law, focusing on debt-to-equity conversions

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In the ordinary course of business, shareholders bear the entrepreneurial risk. Indeed, they risk losing everything they have invested in their companies if these companies become insolvent. Should their companies be turned around through a judicial reorganisation by way of both collective and amicable agreement, the entrepreneurial risk has been diverted to the creditors and replaced by their efforts to make concessions in respect of their claims. In this situation, the shareholders retain all their equity and gain back a healthy, valuable company should the procedure turn out to be successful. The new European Union directive encourages the prevention of the aforementioned risk diversion to creditors by allowing the inclusion of debt-to-equity conversions in restructuring plans and by sidelining dissenting shareholders. Nevertheless, awaiting the transposition of the EU directive, current Belgian company law provisions make it almost impossible to include such debt-to-equity conversions in restructuring plans.

The shareholder primacy theory states that a business should always endeavour to maximise its value for the shareholders. Indeed, the key motivation for starting a business is the creation of wealth for the owner.<sup>1</sup> However, value creation is inextricably linked to risks, especially the entrepreneurial risk that shareholders bear. Should the business become insolvent, shareholders risk losing everything they have invested in their company.

One way to limit the possible amount of financial loss that entrepreneurs could face is to set up a limited liability company. Since 2019, entrepreneurs can incorporate Belgian private limited liability companies without any starting capital, and the legislator encourages them to structure their business entities using this company form. This article therefore focuses on private limited companies in relation to the European Union Directive on Restructuring and Insolvency introduced in 2019 (the 'EU Restructuring Directive' or the 'Directive').

A company attracts not only equity but also resources from lenders, and will obviously have obligations towards its counterparties (eg, trade creditors). In return for the resources (borrowed), the company is bound to perform its obligations to the creditors, and

this performance is secured by all its assets. This is where equity and debt capital are distinguished: if the liabilities exceed the assets and this causes the company to go into liquidation, creditors will be paid first. If nothing is left for distribution, the shareholders' entire contribution will simply be wiped out and they will not receive anything from the liquidation proceeds.

Shareholders of insolvent companies bear the highest risk of not receiving any liquidation dividend, regardless of whether the company is declared bankrupt or undergoing informal reorganisation. However, when designing formal reorganisation proceedings, one often sees a reorganisation procedure as a rehabilitation tool that serves the interest of the debtor (ie, the shareholders) whereby the company could avoid liquidation. This leads to creditors having too little control over the process on one hand, and the debtor having the possibility of curtailing creditors too much when they exercise their (collective) rights of recourse on the other hand.<sup>2</sup>

Under Belgian law, the same criticism can also be valid: when companies file for judicial reorganisation by way of both collective and amicable agreement (in Dutch: *gerechtelijke reorganisatie door een collectief akkoord en minnelijk akkoord*), the entrepreneurial risk, which

is due to be borne by the shareholders, has been diverted to the creditors and replaced by their efforts to make concessions in respect of their claims. Even creditors who vote against the restructuring plan must undergo write-offs. The shareholders, on the other hand, retain all their equity and gain back a healthy, valuable company after the reorganisation procedure, possibly without any effort from their part and while piggybacking on the creditors. This seems to contradict the general principle that the shareholders – not the creditors – bear the entrepreneurial risk. This can be nuanced if shareholders have made additional investments already before the company files for the opening of a formal reorganisation procedure.

The EU Commission and Council have recognised this problem of risk-shifting to the creditors in reorganisation proceedings. It is true that debtors could propose to creditors a replacement of debt with a shareholder's interest. However, such issuance of shares to creditors leads to dilution of the shareholders, resulting in a change in shareholders' rights and entitling them to vote on the restructuring plan. They often vote against it, which ultimately results the absence of an approved restructuring plan, pushing the debtor into liquidation.

### The EU directive

Consequently, the new EU Restructuring Directive<sup>3</sup> was adopted, which also amended Directive 2017/1132.<sup>4</sup> This directive provides options to sideline shareholders when a company adopts restructuring plans, ensuring that there are minimum standards for preventive restructuring procedures available across Europe to enable debtors in financial distress to solve their problems at an early stage and avoid formal insolvency proceedings. Moreover, the Directive encourages the prevention of the aforementioned risk-shifting to creditors by allowing the inclusion of debt-to-equity conversions in a company's restructuring plan.<sup>5</sup>

A debt-to-equity conversion is an equity increase by way of contribution in kind (namely incorporating creditors' claims into the company's books, which in turn eliminates the outstanding debt). The debt and interest associated with it then becomes annihilated while new shares are issued to the creditor. The new shareholder then gets a share in the upside when the restructured company recovers, is eventually sold or floated. However, existing shareholders of the company could be reluctant to allow such debt-to-equity conversion because of its possible dilutive effect on their equity stake, depending on the size of the creditor's stake. Moreover, the conversion could consequently impact future shareholders dividends.

Given that debt-to-equity conversions have long been possible in the ordinary course of business (and the EU legislature recognises this) the Directive has allowed these types of conversions to be incorporated into restructuring plans of insolvent companies.

For over two decades,<sup>6</sup> Belgian law has allowed the conversion of debt claims into equity to be included in restructuring plans. But, despite this, debtors lack the legal tools to actually impose the conversion, so they could hardly use this mechanism.<sup>7,8</sup> One could argue that the current Belgian company law provisions – mainly those on contributions in kind – make it very difficult for creditors to apply debt-to-equity conversions. If the Belgian legislature envisages increasing the use of debt-to-equity conversions in reorganisation proceedings, it should find a way to eliminate these bottlenecks. In the next sections, we explain the current problems that creditors encounter in these situations.

### Bottlenecks in Belgian company law

In theory, it is the shareholders' general meeting that is authorised to decide on equity increases. The reasoning is that equity is used as a factor for allocating the rights and obligations of shareholders, and it serves to protect (minority) shareholders.<sup>9</sup> The legislature thus gave full discretion to the shareholders to decide on any changes to their rights. In a private limited company, the general meeting could delegate the power to decide on equity increases to the governing body, if this permission is stipulated in the company's articles of association. In addition, any equity increase that results in the issuance of new shares requires the articles of association to be amended with the amendment authenticated by deed, for example, by notarial deed or by bailiff's service of a judge's decision.

The fact that shareholders have full say is the main reason why debt-to-equity conversions are rarely carried out. Shareholders that oppose to the dilution of their equity stake would simply vote against such conversions at the general meeting, leaving creditors empty-handed. As regards restructuring plans, the debtor still needs a statutory majority of its shareholders to approve the debt-to-equity conversions even if the majority of creditors has adopted the plan.

The Belgian legislature is therefore expected to put the relevant provisions of Belgian company law out of action. Debt-to-equity conversions would still be allowed in restructuring plans and insolvency law would expressly exclude the possibility to the shareholders to obstruct the execution of restructuring plans.

The new EU Restructuring Directive offers three options that can sideline shareholders when a company adopts restructuring plans:

### *1. Shareholders could be 'affected parties' with voting rights*

National law systems can choose to give shareholders the right to vote on the approval of restructuring plans. If shareholders exercise this right and oppose the plan because, for example, it includes a debt-to-equity conversion, the plan could still become effective and bind the shareholders, even dissenting ones, following a so-called 'cross-class cram-down', whereby all creditors of any class will be bound by a restructuring plan. The Directive states:

'While a restructuring plan should always be adopted if the required majority in each affected class supports the plan, it should still be possible for a restructuring plan which is not supported by the required majority in each affected class to be confirmed by a judicial or administrative authority, upon the proposal of a debtor or with the debtor's agreement.'<sup>10</sup>

This gives rise to another question that the Belgian legislature must consider: which corporate body has the right to propose the restructuring plan to the judicial or administrative authority? Should this be the governing body or the shareholders' general meeting? One could imagine that the general meeting would not be eager to submit a plan that it had opposed.

### *2. Shareholders could be 'affected parties' without voting rights*

National law systems could have the scope of the definition of 'affected parties' cover shareholders so that the restructuring plan will bind them too, but nonetheless exclude their voting rights. In this scenario, shareholders will have to bear the consequences of a debt-to-equity conversion if the other affected parties approve the plan.

### *3. Shareholders could be non-affected parties and thus be excluded from the plan*

As a third option, national law systems could exclude shareholders from the scope of the definition of 'affected parties'. This implies that the shareholders do not have any voting rights and that the restructuring plan will not bind them. However, the Directive expressly states that EU Member States should ensure that equity holders (ie, shareholders) are not allowed to unreasonably prevent or create obstacles to the adoption and confirmation of a restructuring plan.<sup>11</sup>

This leads to the question 'how far should Member States go to ensure that shareholders cannot unreasonably block the adoption of restructuring plans?' Any adoption of a restructuring plan should not be conditional on the consent from equity holders

who, upon the valuation of the enterprise, would not receive any payment or other consideration if the normal ranking of liquidation priorities were applied. Member States can attain this by not giving equity holders the right to vote on a restructuring plan. Should the equity holders nonetheless have that right, then a judicial or administrative authority should be able to confirm the plan even though one or more classes of equity holders oppose it. This could take place through a cross-class cram-down mechanism. In addition, the Directive prevents shareholders from refusing debt-to-equity conversions.<sup>12</sup>

A second point about bottlenecks in Belgian company law is that private limited liability companies continue to be characterised by their private nature and structure. Belgian company law makes it difficult for external parties to subscribe to a company's newly issued shares. Any issuance of new shares in a private limited company requires a decision by the extraordinary shareholders' meeting of the company, deciding by a special majority of at least three-quarters of the shares. The same majority is needed if third parties wish to subscribe to the new shares.<sup>13</sup> This majority approval is not needed if the new shareholders belong to certain categories, or if the articles of association or the provisions of the shareholders' agreement deviate from the Belgian company law provisions. Such majority approval requirement is aimed at protecting family-owned businesses.

When classes of shares have been created and the issuance of new shares causes such classes to change, the decision to issue new shares must additionally have a special majority vote of at least three-quarters of the shares in each share class.

Other statutory provisions or provisions in shareholders' agreements could also impose additional restrictions – notably more stringent majorities – in the issuance of new shares or the possibility for external parties to subscribe to new shares, which would bind the company and, by extension, the creditors wishing to convert their debt claims into equity.

Another important issue relating to shareholder agreements concerns the survival and continued application of such agreements if the shareholding of the company changes substantially due to debt-to-equity conversions. Should (initial) shareholders have the right to demand that new shareholders accede to the shareholders' agreement without having any say on the contents of such agreement? Or should the adoption of a restructuring plan, which includes debt-to-equity conversions, automatically lead to the termination of existing shareholders' agreements or create the right for new shareholders, as part of the restructuring plan, to amend the existing

contractual provisions? The same questions arise with respect to the articles of association of the company, which could reproduce all or part of the provisions of the shareholders' agreement or contain specific provisions, and for the amendment of which a three-quarter-majority decision by an extraordinary shareholders' meeting is required.

Third, the Belgian legislature has devised a special procedure for limited liability companies that wish to increase its equity by way of contribution in kind. This procedure entails that specific requirements apply concerning the valuation of the assets that are contributed in exchange for shares, and that both the governing body and the statutory auditor of the company (or a chartered accountant if there is no statutory auditor) must draft valuation reports and submit them to the shareholders to substantiate the proposal to approve the contributions in kind.

Since the Ruling of 16 July 2019 by the Belgian Accounting Standards Committee (Commissie voor Boekhoudkundige Normen), a company's governing body no longer has full discretion to determine the valuation of the debt claims. The debt claims must be valued at nominal value (including expired interest) for which the equity should be increased by the same value.<sup>14</sup>

This brings us to another bottleneck, but one in terms of practice as opposed to theory: how will a company's governing body decide on how many shares a creditor should receive when its debt claim is converted into equity, and, *in fine*, how many shares should be diluted for existing shareholders? For insolvent companies, calculating the market value per share (and the valuation of the company as a whole) can be a difficult exercise. Moreover, what role should the court-appointed insolvency practitioner play as regards the fulfilment of formal requirements? On the one hand, their power is limited in most cases to negotiating the restructuring plan. On the other hand, the 'debtor in possession' principle still applies, meaning that the company's governing body still has all governing powers and remains liable towards the shareholders for the execution of its mandate.

The issue of tax consequences has already been solved by the Belgian Accounting Standards Committee as well. In the same 16 July 2019 Ruling, it states that converting debt claims into equity does not qualify as granting exceptional and gratuitous advantages (in Dutch: *abnormale en goedgeunstige voordelen*) that lead to no additional taxes for the (Belgian) company under the reorganisation procedure. Equally, on behalf of the company that converts its debt claims, debt-to-equity conversions do not qualify as debt discharge

(*kwijtschelding van schuld*).<sup>15</sup> Therefore, the intended conversion should not qualify as any kind of taxable income of the two companies.

Fifth, existing third-party agreements could also cause difficulties for debt-to-equity conversions, notably if such agreements contain change-of-control clauses. The change in the shareholding of a company that is caused by debt-to-equity conversions could lead to the termination or renegotiation of contracts, which is what an insolvent company would most likely want to avoid.

To conclude this section on bottlenecks, let us briefly extend the subject matter to companies whose liability is not limited. We highly doubt that they would include debt-to-equity conversions in their restructuring plans, since creditors that eventually become shareholders through a debt conversion would consequently incur unlimited liability with the insolvent company.

## Conclusion

In the ordinary course of business, shareholders bear the entrepreneurial risk. In reorganisation proceedings, by way of both collective and amicable agreement, the entrepreneurial risk shifts from the shareholders of a company to its creditors. Allowing debt-to-equity conversions in plans could correct the imbalance. The EU Restructuring Directive allows Member States to ensure that shareholders can no longer obstruct the adoption of restructuring plans. Although Member States should be able to put certain schemes in place to sideline the shareholders when they vote whether to adopt a restructuring plan, national legislatures should bear in mind the bottlenecks in national company law.

### Notes

- 1 BR Barringer and RD Ireland, *Entrepreneurship: Successfully launching new ventures*, (Pearson Prentice Hall, 2008).
- 2 NWA Tollenaar, *Het pre-insolventieakkoord. Grondslagen en raamwerk*, (Wolters Kluwer, 2016), III.
- 3 Directive (EU) 2019/1023 on preventive restructuring frameworks.
- 4 Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law.
- 5 Recitals 2 and 96 of the Directive.
- 6 This possibility was introduced by the Act of 17 July 1997 on judicial restructurings.
- 7 D De Marez and C Stragier, *Boek XX. Een commentaar bij het nieuwe insolventierecht*, 2018, 215 No 38 (*die Keure*), 6.
- 8 The Enterprise Court of Antwerp has already confirmed a debt-to-equity conversion in its judgment of 28 March 2014 (Enterprise Court of Antwerp, 28 March 2014, *Limb. Rechtsl.* 2014, (248) 251).
- 9 D Bruloot, *Vennootschapskapitaal en schuldeisers. Een onderzoek naar de effectiviteit van de (Europese) kapitaalregelen en alternatieve technieken van schuldeisersbescherming*, 2014, 17, No 31. (*Intersentia*)
- 10 Recital 53 of the Directive.
- 11 Article 12 of the Directive.

- 12 A Zenner, 'La directive du 20 juin 2019 sur la restructuration préventive, la remise de dettes et les déchéances et l'efficacité des procédures en matière de restructuration, d'insolvabilité et de remise de dettes', 2021, liv. 138, (*DAOR*), 49, para 65.
- 13 De Geyter, 'A'rt. 5:123 WVV', in H Braekmans, K Geens and E Wymeersch (eds.), *Vennootschappen en verenigingen. Artikelsgewijze commentaar met overzicht van rechtspraak en rechtsleer*, (Wolters Kluwer, 2021), 69.
- 14 Ruling No 2019.0471 of 16 July 2019, paragraph 38.
- 15 Ruling No 2019.0471 of 16 July 2019, paragraph 32.

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# General overview of and recent developments in Japanese rescue-type insolvency proceedings

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In Japan, the most significant historical difference between civil rehabilitation proceedings and corporate reorganisation proceedings were whether it is debtor-in-possession (DIP) or trustee-type. However, due to the certain number of trustee-type civil rehabilitations, as well as the increasing number of quasi-DIP type corporate reorganisations, this difference has become less pronounced over the past few years. Therefore, debtors seeking to restructure their business in Japan have more flexibility than before when considering which rescue-type proceedings to choose from.

The primary laws governing Japan's insolvency regulations are:

- the Bankruptcy Act;
- the Civil Rehabilitation Act;
- the Corporate Reorganization Act; and
- Chapter IX of Section 2 (Special Liquidation) of the Companies Act.

Of these legislations, the civil rehabilitation proceedings (*minji saisei*) pursuant to the Civil Rehabilitation Act (Act No 225 of December 22, 1999), and the corporate reorganisation proceedings (*kaisha kosei*) pursuant to the Corporate Reorganization Act (Act No 154 of December 13, 2002), aim to rehabilitate and rescue insolvent debtors and preserve their businesses as ongoing concerns.

These laws are applicable to foreign companies as long as the respective foreign companies have: (1) a business office or assets in Japan for civil rehabilitation proceedings; or (2) a business office in Japan for corporate reorganisation proceedings.

### *The Civil Rehabilitation Act*

Influenced by Chapter 11 proceedings under United States law, Japan's civil rehabilitation proceedings adopt the debtor-in-possession (DIP) model in principle, with the courts keeping a watchful eye through court-appointed supervisors. The Civil Rehabilitation Act also

allows a trustee-type process when the administration or disposal of a debtor's estate through DIP is inappropriate or there is a particular need to rehabilitate the debtor. This trustee-type process has been implemented in a certain number of cases during recent years.

### *Corporate Reorganization Act*

The precursor to the current Corporate Reorganization Act was enacted in 1952. Pursuant thereto, the debtor's business was always administered by a court-appointed trustee. That practice changed when major amendments adopted in 2002 enabled the court to appoint the management of the debtor as its trustee. This so-called 'quasi-DIP' practice has rendered the corporate reorganisation process closer to the US Chapter 11 proceedings and Japan's civil rehabilitation proceedings.

This article provides a general overview of the differences between the Japanese civil rehabilitation and corporate reorganisation proceedings. It then focuses on certain trustee-type civil rehabilitation and quasi-DIP corporate reorganisation proceedings, along with other trends. While recent developments seem to blur the differences between these two proceedings, each still has its pros and cons: we hope to highlight certain elements to be taken into consideration when opting for the most suitable proceeding.

### Civil rehabilitation proceedings and corporate reorganisation proceedings

Both the civil rehabilitation proceeding and corporate reorganisation proceedings aim to rehabilitate the debtor’s business operations in accordance with a rehabilitation/reorganisation plan and preserve it as an ongoing concern.

One of the major differences between the two is that creditors’ rights are automatically stayed in a corporate reorganisation, while the secured creditors’ rights are still enforceable in a civil rehabilitation proceeding unless the court grants a specific injunction.

Another distinguishing feature to note is that the civil rehabilitation proceeding is a DIP-type process (ie, the debtor has the power to control the business) whereas a corporate reorganisation proceeding is managed by a court-appointed trustee rather than the debtor’s former management. Table 1 summarises the key elements of these proceedings.

#### Petition

A debtor or any of its creditors may file a petition for commencement of civil rehabilitation proceedings. A petition for commencement of corporate reorganisation can be filed by a debtor, a creditor (or creditors) holding claims equal to ten per cent or more of the debtor’s paid-up capital or a shareholder (or shareholders) holding ten per cent or more of the debtor’s voting shares.

#### Commencement order

The court will enter an order for commencement of the proceedings if the petition satisfies the substantive test provided in the Civil Rehabilitation Act/Corporate Reorganization Act. To issue a commencement order (*kaishi kettei*), the court may investigate all relevant facts of the petition *ex officio*.

Table 1: comparing civil rehabilitation and corporate reorganisation proceedings

	Civil rehabilitation	Corporate reorganisation
<b>Applicable entity/ individual</b>	Individuals and all legal entities.	Stock corporations only.
<b>Petitioner(s)</b>	Debtor or creditor(s).	Debtor or creditor(s) holding claims of ten per cent or more of the debtor’s paid-up capital, or shareholder(s) holding ten per cent or more of debtor’s voting rights.
<b>Business operations control</b>	In principle, DIP-type procedures – the debtor has the power to control the business under the scrutiny of a court-appointed supervisor.	In principle, trustee-type procedures – the court-appointed trustee has the power to administer and dispose of the estate.
<b>Effect of stay, etc</b>	In general, automatic stay applies upon commencement of the proceeding. However, the rights of secured creditors are not automatically stayed.	Automatic stay applies upon commencement of the proceeding. The rights of even secured creditors are automatically stayed.
<b>Class of creditors</b>	One class of general unsecured claims.	Different classes for different types of creditors. In practice, usually there are only two classes – secured and unsecured creditors.
<b>Plan approval</b>	<ul style="list-style-type: none"> <li>An affirmative vote by a majority of the creditors present or represented at the creditors’ meeting, or voting on a ballot; and</li> <li>an affirmative vote by holders of 50 per cent or more of the amount of claims held by such creditors.</li> </ul>	<ul style="list-style-type: none"> <li>Unsecured creditors class: when creditors whose voting rights account for more than half of the total voting rights of holders of unsecured or preferred claims support the plan.</li> <li>Secured creditors class: if a plan seeks to extend the due date for repayment of secured claims, the consent of creditors holding voting rights that account for not less than two-thirds of the total voting rights held by secured creditors is required. In addition, a reorganisation plan that intends to discharge all or part of the secured claims can be approved only after the consent of creditors holding voting rights that account for not less than three-quarters of the total voting rights held by secured creditors is obtained.</li> </ul>

### *Business operation control*

In civil rehabilitation proceedings, the debtor's management will generally continue to operate and control the business and assets as a 'debtor in possession', with the courts keeping a watchful eye through court-appointed supervisors. The court has the option to appoint a trustee (*kanzainin*), but in most cases only nominates a supervisor (*kantoku-iin*) to oversee the proceedings. If no trustee is appointed, subject to the supervisor's oversight, the debtor's management retains the power to carry out the debtor's business operations. A supervisor may be appointed by the court prior to the issuance of a commencement order and may remain in that role thereafter. The supervisor has the power to investigate the debtor's business and assets, report the outcome of such investigations to the court, attend creditors' meetings, allow administrative claims, oversee the performance of the rehabilitation plan and so on.

In corporate reorganisation proceedings, the court appoints a trustee (*kanzainin*) upon the commencement of the proceedings. It often nominates an interim trustee (*hozen kanrinin*) as soon as the petition is filed but before any commencement order is issued. A trustee, including an interim trustee, has the power to manage the debtor's business, administer and dispose of its assets and is entitled to exercise the power of avoidance. The trustee must, however, obtain the court's approval prior to engaging in certain activities, such as selling the debtor's assets outside of the ordinary course of business.

Having said this, where the court intends to appoint a former management member of the debtor as the trustee upon commencement of corporate reorganisation (ie, the quasi-DIP model), the court always appoints a supervisor rather than an interim trustee at the outset of the process. Where the quasi-DIP model is elected upon commencement, the court always appoints additional trustees (or at least supervisors) who are insolvency specialists in addition to the trustee who was a member of the debtor's former management, so that it can keep an eye on the debtor through trusted professionals.

### *Directors and officers of debtors*

In civil rehabilitation proceedings, unless a trustee is appointed under certain circumstances, the debtor's directors and officers may remain in control. On the other hand, in corporate reorganisation proceedings, a trustee is appointed by the court to take control of the debtor. Other than when one (or more) of them is appointed as trustee under the quasi-DIP model,

the debtor's directors and officers do not remain in their positions.

In civil rehabilitation proceedings, the debtor's management owes a duty of care to the creditors and may be – and practically, always is – subject to supervision by either the court or the court-appointed supervisor. For example, material transactions, such as the disposal of the debtor's assets not in the ordinary course of business, must be approved by the court or the supervisor as so ordered by the court. Meanwhile, in corporate reorganisation proceedings, the debtor's directors and officers no longer have the power to manage the business and dispose of assets; their power is limited to corporate administrative activities, such as convening shareholders' meetings, which have no real impact on the debtor's financial position. Unless taken in accordance with the relevant rescue plan and/or where statutory requirements are met, corporate actions – including the disposal of the debtor's business and the distribution of dividends – are prohibited during corporate reorganisations.

### *Effect of the stay*

Once rescue-type proceedings commence, the enforcement of claims and the exercise of rights subject to those proceedings are automatically stayed.

However, in civil rehabilitation proceedings, unless a specific injunction is granted, the rights of secured creditors are not automatically stayed and do remain enforceable. In corporate reorganisation proceedings, the rights of both secured and unsecured creditors are stayed. In practice, however, debtors in civil rehabilitation cases usually settle with their secured creditors on the value of the collateral and promise to pay it out. Debtors lacking sufficient cash often sell the collateral to third parties to fund the payment to creditors.

### *Rescue plan*

The debtor must propose a rehabilitation/reorganisation plan and submit it to the court within the period prescribed thereby. Creditors who have filed their proofs of claim may also propose separate rescue plans. Based on ordinary practice, the court sets a timeline so that a rescue plan is confirmed within five months in civil rehabilitation proceedings, and one year in corporate reorganisation proceedings, from the date the petition for the relevant proceeding was filed. Most cases are handled within these timeframes.

All creditors potentially affected by a proposed rescue plan are entitled to receive notice of, and vote on, such plans. In corporate reorganisation proceedings, votes should be cast separately by each class of creditors and

shareholders. In practice, however, usually only two classes, secured and unsecured creditors, are formed. In civil rehabilitation proceedings, there is always only one class of creditors eligible to vote – the general unsecured claims.

In corporate reorganisation proceedings, secured creditors, preferred unsecured creditors and general unsecured creditors are bound by a rescue plan approved by the statutory majority of creditors of each class. In civil rehabilitation proceedings, only general unsecured creditors are bound by a duly approved rescue plan. Hence, a rescue plan may be crammed down in corporate reorganisation proceedings, whereas the debtor cannot cram down a rescue plan in civil rehabilitation proceedings, which are governed by only one class of general unsecured claims.

In civil rehabilitation proceedings, a proposed rehabilitation plan may be voted on either by ballot or at a creditors' meeting, or both. Approval of the proposed plan requires: (1) an affirmative vote by a majority of the creditors present or represented at the creditors' meeting, or voted on ballot; and (2) an affirmative vote by holders of 50 per cent or more of the amount of claims held by such creditors.

In corporate reorganisation proceedings, a reorganisation plan is approved when creditors whose voting rights account for more than half of the total voting rights held by holders of unsecured or preferred claims support the plan. With regard to secured creditors, if a plan seeks to extend the due date for repayment of secured claims, the consent of creditors holding voting rights that account for not less than two-thirds of the total voting rights held by secured creditors is required. In addition, a reorganisation plan that intends to discharge all or part of the secured claims can be approved only after the consent of creditors holding voting rights that account for not less than three-quarters of the total voting rights held by secured creditors is obtained.

When the proposed rescue plan is approved, unless certain circumstances prescribed under the Civil Rehabilitation Act/Corporate Reorganization Act are present, the court will issue an order of confirmation of the approved rehabilitation plan. The confirmed plan becomes effective when the confirmation order is final and binding.

## **Trustee-type civil rehabilitation and quasi-DIP corporate reorganisation proceedings, and recent trends in connection with civil rehabilitation and corporate reorganisation proceedings**

### *Trustee-type civil rehabilitation and quasi-DIP corporate reorganisation proceedings*

As discussed above, trustee-type civil rehabilitation proceedings are deemed as the exception under the law. However, the Osaka District Court, which handles the second largest number of bankruptcy cases in Japan, has actively – and fairly often – used trustee-type civil rehabilitation proceedings. In recent years, the number of trustee-type civil rehabilitation proceedings in the Tokyo District Court, which handles the largest number of bankruptcy cases in Japan, has slightly increased as well. The Tokyo District Court had used the trustee-type civil rehabilitation only once in the past ten years prior to 2010, but since started to positively consider using such proceedings where truly necessary. Since then, the number of trustee-type civil rehabilitation proceedings in the Tokyo District Court has reached approximately 25 cases.

With respect to the quasi-DIP corporate reorganisation proceedings, following the amendments to the Corporate Reorganization Act in 2002, there are no provisions explicitly preventing the court from adopting quasi-DIP corporate reorganisation proceedings. However, since the prevailing view was that the Corporate Reorganization Act intended the court to appoint as trustees only turnaround manager, such as candidates proposed by the sponsor, rather than the prior management, the quasi-DIP model had not been implemented until the end of 2008. Only in January 2009, when the Tokyo District Court announced its intention to expand the practice of trustee appointments, was the quasi-DIP model implemented for the first time by appointing a trustee who had belonged to the previous management. The Osaka District Court also followed this practice. The number of cases using the quasi-DIP model has increased after the first case, reaching approximately 20. Please note that the number of corporate reorganisation proceedings in Japan is quite limited, with about 45 cases coming before the Tokyo District Court since 2009; hence, the quasi-DIP model now accounts for more than 40 per cent of all cases in the Tokyo District Court. The number of corporate reorganisation proceedings in Japan were historically limited: they were viewed as inflexible and time consuming, since an average corporate reorganisation proceedings takes around a year whereas civil rehabilitation proceedings take up to six months.

The quasi-DIP model requires that:

- the DIP does not have any management responsibilities;
- the major creditors do not oppose the quasi-DIP model;
- the sponsor gives its consent (in the event there is a sponsor candidate); and
- there are no elements which may lead to inappropriate conduct during the corporate reorganisation proceedings due to the DIP's involvement.

#### *Recent trends in civil rehabilitation and corporate reorganisation proceedings*

In rescue-type proceedings (ie, civil rehabilitation and corporate reorganisation proceedings), the sale of the debtor's assets as a going concern may take place within the rescue plan, or out of the rescue plan under court approval, where the court deems such sale necessary for the successful rescue of the debtor's business. In other words, a pre-packaged sale is possible.

Whichever the case may be, the debtor may reach an agreement with a prospective buyer before filing for the commencement of the relevant proceedings. However, such pre-filing agreement is treated as an executory contact and may be rejected following the commencement of the proceedings. Therefore, the common arrangement is that both parties agree prior to filing that the prospective buyer gets priority in the race to be the sponsor (ie, the successor to the debtor's business). No definite jurisprudence has yet been established as to when would an auction be required to determine the buyer and sale conditions, but market practice is fairly clear: the sponsor selection process must be fair. Fairness is determined by taking into consideration various factors, primarily the size of the debtor, the nature of its business, the degree of dependence on a specific individual and timing. In Japan, pre-packaged civil rehabilitation has become a popular process and the first so-called 'pre-packaged corporate reorganisation' was conducted earlier this year.

## Conclusion

Due to the certain number of trustee-type civil rehabilitations, as well as the increasing number of quasi-DIP type corporate reorganisations, the previously significant differences between civil rehabilitation and corporate reorganisation proceedings – whether DIP or trustee-type – has become less pronounced over recent years. While corporate reorganisation processes were historically viewed as inflexible and time consuming, the recent introduction of pre-packaged sales is a step towards the simplification and efficiency of these proceedings. For debtors seeking to restructure their business in Japan, it can have more flexibility than before when considering which rescue-type proceedings to choose from.

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# Has Gategroup raised the gate for the WHOA?

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Not many in the restructuring community will have missed that the WHOA, also known as the Dutch scheme, entered into force at the beginning of this year. This new Dutch debtor-in-possession process, which is in many respects similar to the English Restructuring Plan, has already been used to great effect in the Netherlands. However, it is yet to see its first use in a truly international context. This article covers the potential impact the judgment following the convening hearing of Gategroup might have on the use of the WHOA as a tool for implementation of cross-border restructurings.

With the enactment of the *Wet homologatie onderhands akkoord ter voorkoming van faillissement* (the ‘WHAO’) on 1 January 2021, Dutch practitioners saw a long-cherished wish fulfilled. After a lengthy legislative process, the Netherlands now has its own debtor-in-possession (DIP) process. Its introduction was hastened by the Covid-19 pandemic, but was still long overdue in the view of the Dutch restructuring community. The available Dutch processes of suspension of payments (*surseance van betaling*) and bankruptcy (*faillissement*) both had proven largely ineffective because they do not offer the possibility to impair secured and preferential claims, and result in loss of control to court-appointed insolvency practitioners. Accordingly, financial restructurings of large Dutch companies in recent years were predominantly effected through the English scheme of arrangement (the ‘English Scheme’) and to a lesser extent the United States’ Chapter 11 process.

Although the Dutch legislator’s primary aim with the WHOA was to provide an accessible and efficient framework that could be used by both larger groups and small and medium-sized enterprises (SMEs), the process also has been clearly structured as an instrument to effect cross-border restructurings of international groups of companies.<sup>1</sup> Having arrived in the last quarter of its first year in operation, it can already be concluded that the WHOA has proven to be a powerful and efficient instrument – at least in a domestic context – with court processes being completed in a relatively short

timeframe (four to five weeks from start to finish) and at relatively low cost (as compared to the UK Scheme and Chapter 11). We are however yet to see the WHOA’s first true use as an implementation tool for a cross-border restructuring. Compared to its main competitors on the old continent – next to the tried and tested English Scheme and the relatively new English restructuring plan (the ‘Restructuring Plan’) – the WHOA is still relatively untested, leading parties to opt for more established methods of implementation.

However, Gategroup ruling has cast some doubt as to the effectiveness of the Restructuring Plan – and potentially also the English Scheme – as an implementation tool for restructurings with an European Union nexus. It has (again) become relevant to consider to what extent the WHOA has the potential to become one of the preferred tools for international (debt) restructurings. As to how the WHOA matches up with the English processes as regards flexibility of the instrument, the answer to that question lies in its potential for recognition. This article will first provide a high-level overview of the WHOA’s main features, after which it will focus on (potential issues regarding) its recognition.

## The WHOA at a glance

Save for banks and insurers, all debtors are eligible to commence WHOA proceedings. The ‘entrance test’ is whether, at the time the court is first addressed, the debtor is or can reasonably be expected to become insolvent. Creditors, shareholders or works councils

can also initiate proceedings by requesting the court to appoint a so-called ‘restructuring expert’, who is independent from the debtor and exclusively authorised to offer a composition on the debtor’s behalf.

The WHOA is designed as a ‘light touch’ process, with court involvement in principle limited to a single court hearing on the ratification of an adopted composition. With a view to enhance deal certainty, the offeror can, however, request to render preliminary judgment on matters that are important within the context of effecting a composition (eg, class division, eligibility to vote).

Furthermore, while the WHOA does not provide for an automatic moratorium, the debtor may request the court to grant a general or specific moratorium against enforcement actions by creditors for a maximum period of eight months (extensions included). Once a moratorium has been granted, termination of contracts or suspension of performance thereunder is allowed neither for existing obligations nor for new obligations (if performance of the latter is sufficiently ensured). *Ipsa facto* clauses providing for the termination of contracts based purely upon the commencement or implementation of restructuring proceedings are invalid.

The WHOA also provides for safe harbours for legal acts required for the debtor to continue trading while working on the implementation of a composition (eg, providing credit support for emergency funding). If upfront court approval is obtained, such acts cannot be nullified in case the debtor subsequently goes into bankruptcy. No special priority applies to emergency funding provided in this context (eg, no priming liens).

The debtor may offer a composition to all or some of its creditors. Ordinary, preferred and secured creditors, as well as shareholders, can be bound to the composition. The WHOA also allows for the restructuring of guarantees provided by the debtor’s group companies (as long as these companies would otherwise also become insolvent). The only important exception is that employees’ rights cannot be compromised through the composition.

The offeror can furthermore propose amendments to contractual arrangements going forward. If such a proposal is refused by its counterparty, the debtor can request the court to terminate the contract with observance of a reasonable notice period (with the debtor being able to compromise the resulting damages claims through the composition).

Creditors and shareholders can – and under certain circumstances must – be divided into different classes. It is left up to the offeror to introduce tailor-made classes. Creditors or shareholders that will have a different ranking in bankruptcy, however, must be placed in

different classes. Secured creditors will only be placed in a secured class for the amount that they would have realised in case of a bankruptcy (ie, liquidation value).

Voting takes place per class. Approval of a composition by a class requires agreement of at least two-thirds by value of those voting. If at least one in-the-money class has voted in favour, the composition will be ratified by the court upon the debtor’s application, unless certain refusal grounds apply, the most notable being:

- The best interest of creditors test: a dissenting creditor may not receive less under the composition than it would have received in bankruptcy.
- The relative absolute priority rule: a dissenting creditor that forms part of a dissenting class of creditors may not receive less under the composition than it would receive according to its ranking, unless there are reasonable grounds for deviation and if the interests of the creditors in this class are not prejudiced.

A dissenting creditor that forms part of a dissenting class of creditors may not lose the right to receive cash payments of at least the amount that it would have received in bankruptcy. This protection does not apply to secured creditors that have granted financing on a commercial basis; these creditors can, however, refuse a debt-for-equity swap. Small and micro creditors that have claims stemming from either tort, delivery of goods or services will have to receive at least 20 per cent of their claim value, unless there are compelling reasons not to.

## Recognition

When ascertaining the WHOA’s potential for recognition, it is important to distinguish between the two types of proceedings available to a debtor: the public proceedings and the private proceedings.

The (irreversible) choice between the two must be made once court involvement is required – either when the court is asked to ratify a composition, or when certain protective measures or preliminary decisions are sought. The choice is strategically important as it will be decisive for the manner in which jurisdiction is assumed and recognition can be obtained.

### Public proceedings

The intention is to have the public proceedings added to the list of insolvency proceedings (Annex A) of the European Union Insolvency Regulation (EIR)<sup>2</sup>, the main advantage being automatic recognition within the EU (save for Denmark). The listing process has already been initiated by the Dutch government and seems to be a formality, as the public proceedings meet the relevant material requirements under the EIR: it is a

public proceeding that is based in the Dutch Bankruptcy Act.<sup>3</sup> However, until public WHOA proceedings have been added to Annex A, the EIR will not apply and recognition will depend on the private international law of the relevant jurisdiction.<sup>4</sup> Recognition in non-EU jurisdictions that have incorporated United Nations Commission on International Trade Law (UNCITRAL) model law should be a relatively straightforward affair.

The start of public proceedings is registered in the Central Insolvency Register and court hearings are public (in principle). Based on the EIR, Dutch courts have jurisdiction regarding debtors whose centre of main interests (COMI) is located in the Netherlands or who have an establishment there.<sup>5</sup>

A distinct disadvantage of public proceedings is that, due to the EIR, rights *in rem* with respect to assets of the debtor located in another Member State are respected in full: neither a cooling-off period nor the composition itself will therefore have any effect with respect to such rights.<sup>6</sup>

### Private proceedings

Private proceedings are not published in any register and the court hearings are not public – both reasons why they are not subject to the EIR. The Dutch court will assume jurisdiction if the debtor or a stakeholder named in the petition has residence in the Netherlands, or if the matter is otherwise sufficiently connected to Dutch jurisdiction. The Dutch legislator has provided a (non-exhaustive) list of grounds, each of which provides a sufficient link with the Dutch legal jurisdiction:

- the debtor has its COMI or an establishment in the Netherlands;
- the debtor has (substantial) assets in the Netherlands;
- a (substantial) part of the to-be-restructured debts obligations are subject to Dutch law or a choice of jurisdiction has been made before a Dutch court;
- a (substantial) part of the debtor's group consists of companies established in the Netherlands; or
- the debtor is liable for debts of another debtor in respect of which the Dutch court has jurisdiction.

As opposed to public proceedings, private proceedings therefore offer the option of initiating WHOA proceedings with respect to a foreign debtor with its COMI outside the Netherlands (including EU Member States). Recognition of private proceedings will principally depend on the private international law of the relevant jurisdiction in which recognition is sought.

## Comparison and conclusions

Although there are some important differences between the Restructuring Plan and the WHOA, both frameworks have a lot of similarities – unsurprisingly, as the WHOA was heavily inspired by the UK Scheme and the Restructuring Plan is an evolution thereof. Both are highly flexible instruments, offering cross-class cram-down mechanisms, moratoria on enforcement and bans on *ipso facto* clauses. The threshold for assuming jurisdiction in private WHOA proceedings also seems comparable to that of the English processes, relying on the concept of sufficient connection, although time will tell whether Dutch courts will be as flexible in this regard as their English counterparts. Given the similarities between the processes, the choice between either the WHOA or the Restructuring Plan will likely largely depend on their capacity for recognition.

Discussions in the restructuring space regarding the qualification of the Restructuring Plan have (for now) come to an end as a result of the judgment in the convening hearing on Gategroup's restructuring, in which it was effectively held that the Restructuring Plan constitutes an insolvency proceeding.<sup>7</sup> As a result, the Restructuring Plan falls outside of the scope of the Lugano Convention (to which the United Kingdom has requested to accede) and recognition in most of the EU Member States has become a complicated matter.

As regards recognition of the Restructuring Plan within the Dutch jurisdiction, this as such has now become impossible as Dutch law does not recognise insolvency proceedings outside of the EIR.<sup>8</sup> The Netherlands has no equivalent to the US Chapter 15 or the UK Cross Border Insolvency Regulations, and has not adopted the UNCITRAL Model Law.

In respect of the English Scheme, pre-Brexit Dutch practitioners generally assumed that it would likely be recognised by Dutch courts on the basis of the Brussels Regulation Recast and otherwise on the basis of general Dutch private international law.<sup>9</sup> A key factor in arriving at that conclusion was that it was generally held by English courts that the English Scheme wasn't an insolvency proceeding.<sup>10</sup> In *MAB Leasing*, the question was raised whether an English Scheme amounts to an insolvency-related event under the Cape Town Convention.<sup>11</sup> The matter ultimately did not have to be determined by the court, but it considered there was a very strong reason to think that this was not the case. However, it seems that, on the basis of the Gategroup judgment, it could be argued that the English Scheme constitutes an insolvency proceeding if the debtor is technically insolvent.<sup>12</sup> Together with the fact that that recognition of an English Scheme on the basis of Dutch



private international law has not yet been confirmed in case law, this creates uncertainty regarding its capacity for recognition in the Netherlands (and comparable jurisdictions) and it will be interesting to see how the market reacts.

Where it concerns recognition of WHOA proceedings, the distinction between public and private proceedings is of course most relevant. It seems that debtors with their COMI in the Netherlands will be incentivised to initiate public proceedings. Not only will these be automatically recognised in the EU, recognition in the US (Chapter 15) and UK (UK Cross Border Insolvency Regulations) – the most relevant jurisdictions given the governing law of most debt instruments – should also not cause any issues. The Gibbs Rule will, however, remain a potential impediment to the successful use of the WHOA for debt restructurings where English law governed debt is involved.

When looking at recognition of private proceedings, it seems likely that these will face the same issues as the Restructuring Plan. The question has been raised in Dutch literature whether private proceedings can be automatically recognised in the EU pursuant to the Brussels Regulation Recast. The majority consensus seems to be that private proceedings fall outside of the scope of the Brussels Regulation Recast,<sup>13</sup> but there are those who argue that this is not necessarily the case.<sup>14</sup> In essence, the question is whether private proceedings fall under the so-called ‘insolvency exception’ of the Brussels Regulation Recast. Ultimately, this will be a matter for the EU High Court of Justice to decide: until then, it would seem safer not to rely on this form of recognition in cross-border restructurings. At least for now, a practical solution to recognition issues faced by the available Dutch and English frameworks might be to run parallel processes.

#### Notes

- 1 During the WHOA’s legislative process, the EU Directive (EU) 2019/1023, requiring Member States to implement a minimum framework for out-of-insolvency restructuring regimes, was issued. Although not its primary aim, the WHOA (largely) implements this directive.
- 2 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (Recast).
- 3 Art 1.1, EIR
- 4 In a recent ruling regarding the ratification of a suspension of payments proceeding, the court explicitly considered that the WHOA was not a relevant alternative for the debtor given that it had not yet been added to Annex A.
- 5 Jurisdiction in public proceedings can in principle also be assumed in respect of a debtor with its COMI outside of the EU, based on the principle of sufficient connection with the Dutch jurisdiction, but these proceedings will not benefit from automatic recognition under the EIR.
- 6 Art 8, EIR
- 7 *Re Gategroup Guarantee Limited* [2021] EWHC 304 (Ch), paragraph 137.

- 8 Dutch Supreme Court, 31 May 1996, ECLI:NL:HR:1996:ZC2091, *NJ* 1998/108 (*Coppoolse/De Vleeschmeesters*) and Dutch Supreme Court 19 December 2008, ECLI:NL:HR:BG3573, *NJ* 2009/456 (Yukos). In the latter judgment, the Supreme Court clarified among others that creditors who have attached assets in the Netherlands can continue to take recourse on such assets in spite of a foreign bankruptcy proceeding. In practice, Chapter 11 rulings are, however, recognised by creditors with a US nexus given the contempt of court provisions.
- 9 Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters. See eg: LP Kortmann and PM Veder, ‘The Uneasy Case for Schemes of Arrangement under English Law in relation to non-UK Companies in Financial Distress: Pushing the Envelope?’, in: P Omar (ed), *Festschrift in Honour of Professor Ian Fletcher QC, Special edition of the Nottingham Insolvency and Business Law eJournal*, 2015 (3) *NIBLeJ* 13, 259-260; and NED. Faber & others (eds.), *Overeenkomsten en insolventie*, Kluwer 2012, 259-260.
- 10 Eg, *Re Magyar Telecom BV* [2014] BCC 448; *Re Rodenstock GmbH* [2012] BCC 459; *Re Van Gansewinkel Groep BV* [2015] EWHC 2151 (Ch).
- 11 *Re MAB Leasing Ltd* [2021] EWHC 152 (Ch) and [2021] EWHC 379 (Ch).
- 12 *Re Gategroup Guarantee Limited* [2021] EWHC 304 (Ch), paragraph 118.
- 13 AM Mennens, ‘Het dwangakkoord buiten surseance en faillissement,’ Deventer: (Wolters Kluwer, 2020), 790; PM Veder, ‘Internationale aspecten van de WHOA: de openbare en de besloten akkoordprocedure buiten faillissement’, (FIP, 2019/219), para 3.1.
- 14 RD Vriesendorp, W van Kesteren, E Vilarin-Seivane and S Hinse, ‘Automatic recognition of the Dutch undisclosed WHOA procedure in the European Union’ (NIPR 2021) Afl.1, para 4.2.4.

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**3**  
Trial hearings observed



**150**  
Individuals trained



**2**  
Mission reports



**166**  
Intervention letters



**9**  
Reports published



**32**  
Countries



**5**  
Continents



**23**  
Grant-funded projects



**17**  
Legal consultants



**£100k**  
Grant-funded projects

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