NORTON ROSE FULBRIGHT

International Restructuring Newswire

A quarterly newsletter from the bankruptcy, financial restructuring and insolvency team at Norton Rose Fulbright

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To our clients and friends:

The global COVID-19 pandemic continues unabated and the resulting economic dislocation can be expected to continue for some time. While government intervention and measured responses from financial institutions have tempered the immediate impact of the crisis, the road ahead for the world economy and our global businesses remain of deep concern. Undoubtedly more business failures are on the horizon. In this issue we examine new developments in a number of the tools available for financial restructurings. These changes, in the United Kingdom, Germany, and the Netherlands, are designed to incorporate some of the benefits of restructuring available under chapter 11 in the United States.

In the UK, the Corporate Insolvency and Governance Act 2020 (CIGA) entered into force this summer, is the most wide-ranging change to the UK corporate insolvency framework for a generation. We are beginning now to see instances of UK and non-UK debtors actively considering and seeking to avail themselves of the new procedures and protections available in evaluating and implementing their restructuring options. An article about CIGA walks us through this new act and its implications.

Next, we offer an article on the EU Preventive Restructuring Frameworks Directive which permits a restructuring at an earlier stage than currently allowed under German law. This past September, the German Federal Ministry of Justice presented a ministerial draft act which goes far beyond the mere implementation of the EU Directive and promises to herald a dramatically new era in restructuring in Germany.

And in the Netherlands, there is also being introduced pre-insolvency restructuring legislation. The proposed law, referred to as WHOA, introduces schemes of arrangement and has been the center of attention of Dutch restructuring professionals for quite some time now. We present an update on the current status of the proposed law.

Finally, two additional articles focus on key areas that impact restructurings, tax and litigation. Tax considerations often determine the structures used to implement corporate restructurings. We discuss those different structures and the tax impact. On the litigation front, we report on a recent decision of the Canadian Supreme Court on the legitimacy of the use of litigation funding agreements as an interim financing in an insolvency proceeding.

Enjoy the issue and stay safe.

Howard Seife
Global Head
Bankruptcy, Financial Restructuring and Insolvency

Lighting up the CIGA!

Mark Craggs

The Corporate Insolvency and Governance Act 2020 **(CIGA)** entered into force in the United Kingdom this summer, amidst the economic and social disruption caused by the COVID-19 crisis. The reforms enacted by CIGA represent the most wide-ranging amendments to the UK corporate insolvency framework for a generation.

We are beginning now to see instances of UK and non-UK debtors actively considering and seeking to avail themselves of the new procedures and protections available following CIGA in evaluating and implementing their restructuring options. Norton Rose Fulbright has recently represented a significant creditor in the restructuring of Virgin Atlantic, which is the first example of the use of the new scheme of arrangement introduced by CIGA. This article provides a timely overview of the main CIGA reforms and reaches some conclusions about the utility of the reforms for UK and non-UK debtors.

There are two main features of CIGA:

1. first, short-term measures enacted in direct response to the economic fall-out from COVID-19, which were intended to provide temporary relief to viable companies and their directors and assurance against the premature cessation of business (notably, restrictions on statutory demands and wind-up petitions and financial liability of directors for wrongful trading in certain circumstances); and
2. secondly, permanent measures which are designed to facilitate the rescue of viable companies in financial difficulties (effected by CIGA introducing new provisions into, and amending, existing legislation).

The short-term measures had been due to expire on September 30, 2020, under CIGA as originally enacted. The restrictions related to statutory demands and winding-up petitions were extended shortly before that deadline to December 31, 2020, so that creditors cannot rely on statutory demands to bring winding-up petitions before the end of the year, and are prohibited from filing winding-up petitions where the company's inability to pay is due to COVID-19. There has been no equivalent extension of the wrongful trading dispensation, which – since it went to the award the court is able to make on a successful claim by an insolvency office-holder, rather than liability as such – provided little comfort to directors in any event.

CIGA restructuring measures

The focus of this article is the permanent measures falling in the second category above, as follows:

(i) the introduction of a new Part A1 of the Insolvency Act 1986 which permits some companies, in certain circumstances, to obtain a moratorium for an initial period of twenty business days (and extendable, subject to certain conditions), giving them various protections from creditors and a payment holiday from certain debts falling due prior to, and during, the moratorium;
(ii) the introduction of new provisions into the Insolvency Act 1986 which invalidate clauses of certain contracts for the supply of good or services if those clauses provide that the contract or the supply would terminate or *"any other thing would take place"* because the company becomes subject to a *"relevant insolvency procedure"* (being a specified form of UK insolvency or restructuring process); and
(iii) the introduction of a new Part 26A of the Companies Act 2006 which allows companies in financial difficulties to propose an arrangement or compromise with their shareholders and/or creditors (a **Super-scheme**). The Super-scheme, if sanctioned (approved) by the court, may result in certain creditors being forced to accept, against their will, revised terms for the debts owing to them (a so-called "cram-down") because they form part of a dissenting minority or because that particular class of creditor has been subjected to a cross-class cram-down.

These measures have each featured in consultations on insolvency law reform in the UK in recent years. Their introduction by CIGA has been expedited by the COVID-19 crisis and the legislation passed through Parliament very quickly. The moratorium and essential supplies provisions are facilitative provisions, to be used in conjunction with other restructuring steps. The Super-scheme is different, in that it provides a non-prescriptive and flexible framework for an all-encompassing restructuring of specified claims against a company (in-keeping with existing scheme of arrangement provisions in the Companies Act).

Each of the measures will be addressed in turn.

(i) Moratorium

The new moratorium is a free-standing process intended to serve as a gateway for debtor companies to further restructuring steps. Since its introduction by CIGA, the moratorium has featured widely in discussions with companies and management around available measures and relief in response to financial difficulties caused by COVID-19, but it has not yet been widely used in practice.

It is comparatively easy to access – in a straightforward case for an English company, the company can enter the moratorium by its directors filing prescribed documents at court. In this sense, it is similar to an administration moratorium. The scope of the moratorium, too, is similar to that which applies in administration. The main difference is that, unlike administration, the new moratorium is primarily a "debtor-in-possession"

procedure, in that the directors of the company retain ordinary-course management powers, albeit it does entail the appointment of a monitor (who, in practice, will normally be a qualified insolvency practitioner). It follows that the directors' duties and responsibilities to creditors and other stakeholders continue throughout the moratorium.

The moratorium is intended to be used by debtor companies in financial distress where there remains a realistic prospect of survival. It permits eligible companies (excluding, for example, financial services-related companies) in certain circumstances to obtain a moratorium for an initial period of twenty business days (and extendable for up to a year, subject to conditions), giving them various protections from creditors and a payment holiday from certain debts falling due prior to the moratorium and during the moratorium (excluding, amongst other things, debts under financial services contracts and rents under leases, which remain payable). The intention is to provide an optional statutory breathing space from creditor actions in order to allow the debtor to formulate a turnaround strategy.

Although the moratorium involves the appointment of a monitor, day-to-day management decisions will continue to be exercised by the existing directors of the debtor. It is hoped that the debtor-in-possession nature of the procedure will mean that fewer directors are discouraged from having recourse to the protection available under the moratorium than has been the case historically with administration – which continues sometimes to carry a connotation of management failure. The monitor is responsible for the protection of creditors' interests and to ensure that the debtor continues to comply with moratorium eligibility requirements and conditions. In order to qualify for the moratorium, the papers filed at court in order to commence the process must contain a statement given by the proposed monitor that contain a statement from the proposed monitor that, in their view, it is likely that a moratorium for the company would result in the rescue of the company as a going concern. The monitor is able to attend board meetings and request information from the directors required for the performance of their functions. Further, the monitor is responsible for sanctioning any non-ordinary course of business transactions, as an additional safeguard for creditors.

The moratorium is available to UK companies in most cases by an out-of-court entry-route, and to non-UK companies with a sufficient connection to the UK through making an application to court (subject to conditions).

Although, on its face, the moratorium appears to be attractive as a means of "holding the ring" pending the formulation and implementation of definitive restructuring steps, the process in its current form has a number of limitations which are likely to limit its use in practice, including the following. First of all, it has to be questioned whether the initial four- or eight-week period will be sufficient to formulate a restructuring proposal. This suggests that "open-ended" or "free-fall" moratorium filings will be uncommon; rather, it will be preferable, if using a moratorium at all, to ensure a certain degree of creditor support for a filing and underlying restructuring plans. Secondly, in that regard, the exclusion from the payment holiday of debts under financial services contracts means that a moratorium will not be sustainable with the support of financial creditors, since, otherwise, those debts must continue to be paid as usual and the commencement of the moratorium would likely trigger an event of default under standard insolvency proceedings-type events of default. Finally, the eligibility criteria for a moratorium exclude companies that are a party to a capital market arrangement. This is defined broadly, and basically includes any company which is part of a group that has issued bonds or notes; clearly, this will limit considerably the numbers of eligible companies.

(ii) Restricting termination of supply contracts

The new restrictions ensuring continuity of supply of goods and services are intended to help foster an environment that is more conducive to achieving a corporate rescue properly so-called than has historically been the case in the UK. The new Insolvency Act provisions introduced by CIGA prohibit the termination of any contract for the supply of goods and services to a company or the occurrence of terminate or *"any other thing"* under the contract by reason of the company entering into a relevant insolvency procedure (including the new moratorium, administration, a company voluntary arrangement and the new Super-scheme but not an ordinary (or Part 26) scheme of arrangement). Unsurprisingly, "any other thing" is not defined, but it is likely to include increases in interest rate consequent on entry into relevant insolvency procedures or the changing of the terms of the supply.

In the past, it has all too often been the case that insolvent debtors have been held to ransom by threats of termination by suppliers of the improvement of terms of supply and payment of pre-insolvency arrears as conditions of continued supply of goods and services. Under the new provisions, suppliers must continue to supply the debtor in an insolvency or restructuring process and are not guaranteed payment of outstanding arrears.

If the debtor ceases to pay for goods or services during the insolvency procedure, this will normally give rise to a termination right exercisable by the supplier. Otherwise, where the provisions apply and the debtor requires continued supply, a supplier will only be entitled to terminate where the court gives termination on the basis that the obligation to continue to supply is causing hardship to the supplier. "Hardship" is not defined in the new provisions; it is expected that its meaning will be explored and clarified in cases over the coming months and years.

The prohibition applies to supply contracts for goods and services, although there are wide-ranging exceptions to the prohibition, including in the case of persons involved in financial services (whether they are the company or the supplier) and contracts involving financial services. The effect of these exclusions is that lenders are not precluded from exercising rights to draw-stop facilities or accelerate loans.

Inevitably, many queries we have received from suppliers whose contracts may fall within the prohibition have related to introducing termination events vis-à-vis counterparties into contracts which are triggered at an earlier stage than commencement of specified insolvency proceedings. Another widely-mooted "work-around" is the use of shorter-term contracts, perhaps under the auspices of a wider framework agreement. Paradoxically, the use of such measures may lead to the scuppering of the survival chances of businesses encountering modest levels of distress, if there is a perception on the part of suppliers that a continued business relationship will lead to them becoming "locked in" and unable subsequently to exercise termination rights if the plight of the debtor worsens.

The new Insolvency Act provisions do not specify whether the protections on supplies apply to all contracts to which the debtor is a party or only English law-governed contracts. Presumably, the former is intended but this is likely to give rise to complex conflicts of law questions in practice.

(iii) Super-schemes

The new Super-scheme provisions in Part 26A of the Companies Act are largely based on schemes of arrangement under Part 26 of the Act, as commonly used by UK and foreign debtors to effect financial restructurings over the past decade or so. However, unlike with an ordinary scheme (which have no "entry criteria"), in order to be eligible the debtor proposing a Super-scheme must be facing current or anticipated financial difficulties. In addition, the voting requirements for a Super-scheme are more straightforward; it requires the approval of only 75 per cent by value of each class of shareholders and/or creditors (subject to the below), whereas an ordinary scheme requires 75 per cent by value and a majority in number in each class of shareholders and/or creditors.

The most noteworthy feature of Super-schemes is the ability to effect a "cross-class cram-down" using the process. Whereas, under an ordinary scheme, consent is required from the relevant majorities in each affected class, under a Super-scheme, creditors within a class that votes against the Super-scheme can nevertheless be forced to accept the plan if: (a) at least one class of creditors with a genuine economic interest voted in favour of the plan; (b) the creditors in the dissenting class would not be any worse off under the Super-scheme than they would have been in the relevant alternative scenario; and (c) the court considers the Super-scheme to be fair. The "relevant alternative" is the outcome the court considers would be most likely to occur in relation to the company if the Super-scheme were not sanctioned. The concepts of "genuine economic interest" and the "relevant alternative" are likely to be the most contentious aspects of Super-schemes. They will likely draw English judges into determining commercial issues and matters of valuation (as matters to be addressed through expert evidence) which they have traditionally steered clear of – particularly when compared with judges in the US Bankruptcy Court. This will be all the more so when the debtor seeking to implement a Super-scheme is a non-UK debtor, since, in that event, the relevant alternative is less likely to be a UK insolvency process; rather, such cases will invariably involve grappling with estimated outcomes for different creditor groups and shareholders in foreign insolvency and/or corporate recovery processes.

Some commentators have focused on the potential under a Super-scheme for a "cross-class cram-up"; in other words, a situation in which classes of junior or unsecured creditors might seek to impose a plan on a class or classes of dissenting secured creditors, assuming the above tests are satisfied. It would be highly surprising in the current restructuring environment – where high levels of support are customarily assured in advance through the use of "lock-up" agreements – if secured creditors who are not supportive of a Super-scheme proposal were to refrain from exercising their rights of enforcement for long enough for their wider rights to be compromised in this way (and, separately, for the court to exercise its discretion to sanction a Super-scheme in such a case).

Even though Super-schemes are intended for use by companies experiencing financial difficulties, they are unlikely now – prior to the end of the Brexit implementation period – to be designated in Annex A to the EU Regulation on Insolvency Proceedings as a relevant type of insolvency proceedings for the purposes of the Regulation. Accordingly, they will not benefit from automatic recognition under that Regulation. It remains to be seen whether Super-schemes for non-UK debtors will be recognised across the European Union post-Brexit. In practice, this has rarely been an issue for ordinary schemes and other member states have readily recognised and given effect to schemes. We expect that the same will be true in respect of Super-schemes, but the position is far from clear. Significantly, in this respect, the English court must be satisfied in determining whether or not it has jurisdiction to sanction schemes and Super-schemes alike that they will achieve a substantial effect in key non-UK jurisdictions.

As noted, Virgin Atlantic, the airline, has recently successfully implemented a Super-scheme (the English court sanctioning the Super-scheme on September 2, with recognition in the US under Chapter 15 of the US Bankruptcy Code following shortly afterwards, on September 3). Both judgments handed down in the course of the passage of the Virgin Atlantic Super-scheme through the approval process – following the "class-convening" and sanction hearings – are instructive to the approach the court will take going forward on matters of procedure and issues like class constitution. However, it is fair to say that the Virgin Atlantic scheme did not truly test the parameters of the kinds of restructurings possible using a Super-scheme. Of the four classes of creditors, three had agreed prospectively, through lock-up agreements (or, in this case, "support agreements"), to vote in favour of the Super-scheme, leaving only one class, a select group of trade creditors, whose vote could not be wholly assured at the time of the class meetings. In the event, 99% of the trade creditors attending and voting at the relevant class meeting voted in favour of the Super-scheme. Accordingly, while a resounding success in terms of the level of creditor buy-in, the Virgin Atlantic Super-scheme leaves untested issues such as cross-class cram-down and related considerations. A further point is that, since all operating lessors voted in favour of the Super-scheme, the court was not required to consider whether a Super-scheme qualifies as "insolvency proceedings" for the purposes of the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015 (the effect of so qualifying being that it would not be possible to modify the obligations of the airline under leases without the consent of the relevant lessors).

Conclusions

CIGA marks an ambitious shift towards more debtor-led restructurings and the pursuit of corporate rescue, and seeks to address some of the perceived shortcomings of existing insolvency proceedings in the UK – including the loss of control by management and the ability (historically) of suppliers freely to rely on contractual rights of termination once insolvency proceedings commence.

In particular, CIGA has adopted some features similar to those that contribute to the strong track-record of Chapter 11 of the US Bankruptcy Code for effecting corporate restructurings – notably, the provisions restricting termination of supply contracts, which have close parallels to the prohibition under Chapter 11 on enforcement of ipso facto clauses. However, it must be remembered that there remain crucial differences between insolvency systems on either side of the Atlantic, including the degree of court involvement (which remains much more extensive in the US) and the ease of access of super-priority new money to fund a restructuring process. The latter point is something that has featured in recent UK corporate insolvency reform consultations but was not pursued in the last Government consultation response prior to COVID-19 or indeed in CIGA itself.

Further, closer examination of the moratorium and essential supplies provisions introduced by CIGA – and the wide-ranging exceptions thereto – reveals a focus on restricting rights of trade creditors and suppliers, which suggest that they will have most practical use in the restructuring of small to medium-sized enterprises. Although the flexibility and breadth of the new Super-scheme is attractive and opens up new possibilities for UK-centred restructurings, there is a concern that the cost and typical gestation period for a scheme of arrangement – typically 8 to 12 weeks – might remain out of reach of large numbers of corporates in need of immediate rehabilitation.

It remains to be seen whether the attempt by the UK, in enacting CIGA, to align itself with more debtor-friendly systems will in fact achieve the desired aim of increased instances of corporate rescue and value-preservation. So far, official formal insolvency figures during the COVID-19 era have been relatively benign, but that has more to do with the CIGA short-term restrictions on winding-up petitions and Government support initiatives for corporates than the permanent CIGA reforms considered in this article. It will be interesting to gauge the impact of the restructuring-focused measures of CIGA in the coming months – including the appetite of non-UK debtors to seek protection in the UK. This is especially the case with the end of the Brexit implementation period looming at the end of 2020 and continuing EU member states legislating to implement and shore up their own restructuring processes in transposing the EU Restructuring Directive into national law by July 2021.

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The Netherlands – *Wet Homologatie Onderhands Akkoord*

Koen Durlinger

In the First Quarter 2020 issue of our *International Restructuring Newswire*, we described and discussed the legislative proposal introducing a pre-insolvency restructuring mechanism in the Netherlands. The proposed law called *Wet Homologatie Onderhands Akkoord* or "WHOA" has been in the centre of attention of Dutch restructuring professionals for quite some time now. The WHOA is also referred to as the Dutch Scheme or the CERP (Court Confirmation of Extrajudicial Restructuring Plans).

Status

The WHOA was submitted to the Dutch House of Representatives on July 5, 2019. The Netherlands were on track to be the first mover in implementing legislation attuned to the EU Restructuring Directive (EU 2019/1023). After quite some delay – partially due to the COVID-19 pandemic and extensive debate in parliament – the proposal was adopted by the House of Representatives on May 26, 2020, albeit with a few amendments to the initial proposal. In turn, the Dutch Senate on October 6, 2020 adopted the proposed law.

Restructuring professionals in the Dutch market are eagerly awaiting the enactment of the WHOA. Over the past year, law firms have speculated on the date of enactment, which was first expected on January 1, 2020 and later on July 1, 2020. Both these expectations were not met. The WHOA will enter into force at a date to be decided by Royal Decree (which is to be issued on a date yet to be determined at the time of writing this article). Based on the current planning of the Dutch Ministry of Justice and Safety, it is expected that the WHOA will be enacted on January 1, 2021.

It is safe to say that in anticipation of the WHOA, there are quite a number of restructurings in which a WHOA-procedure is considered either as a fall-back if consensual restructuring attempts fail or as a planned procedure to be set in motion once WHOA takes force.

Amendments to the proposed law

The amendments made by the House of Representative are – in short – as follows:

1. Under secured creditors need to be put in two classes:

In the event a secured creditor's collateral has insufficient value to fully pay the secured debt, the secured creditor will need to be placed in one class with its claim for the amount covered by the security and in another class for the remainder of its claim.

2. Minimum threshold of 20 per cent for unsecured creditors up to a certain size:

Unless there are compelling reasons, when a plan involves the cram down of small unsecured trade creditors or creditors having a tort claim, the plan must provide that these creditors receive at least 20 per cent of their claim in cash. By means of this amendment, the interests of smaller creditors are sought to be protected. Small creditors are those who are considered small and micro companies according to Dutch corporate law or companies with less than fifty employees.

3. Cash-out option for secured creditors is removed from the proposed law:

Under the law as originally proposed, if a class of creditors is crammed down by means of a cross-class cram down, the creditors that are being crammed down must have been given the option to cash-out at the liquidation value of their claim. If such option is not given, the plan could be rejected by the court. By means of the amendments, this rule has been limited in the sense that secured lenders do not need to be given the cash-out option in order for a plan to be eligible for confirmation if these secured creditors are crammed down. The cash out option however is retained for unsecured creditors.

Overview of the proposed law

The following is an overview and summary of the proposed WHOA as now amended by the Dutch House of Representatives and being considered by the Senate.

Some key characteristics

The procedure provided in the WHOA has a number of key characteristics, for example:

- It is a debtor-in-possession procedure.
- The procedure is conducted outside of formal bankruptcy proceedings.

- Limited court involvement; there is no court-assessment at the very start of the procedure.
- Cram-down and cross class cram-down are possible.

Who can take the initiative to prepare and propose a plan?

A plan can be prepared by the debtor itself or, alternatively, each creditor, shareholder or statutory works council or workplace representative set up in the debtor's business may initiate a plan by requesting the court for a restructuring expert to be appointed.

The WHOA is designed to be used not only by large companies, but also by small and mid-size enterprises (**SMEs**) (which represent ninety-nine per cent of the businesses in the EU if the standards of the Directive 2013/34/EU of the European Parliament and of the Council are applied). The WHOA provides specific requirements when SME debtors are involved. SME debtors will have to approve: (i) the proposal of a plan by a restructuring expert; as well as (ii) the adopted plan to be submitted to the court for confirmation where the plan is sought to be crammed upon a dissenting class of creditors.

A dual-track – public and confidential procedures

The WHOA provides for a dual-track, meaning that at the very start of preparing the plan, the debtor or restructuring expert will have to choose to follow either the public procedure or the confidential procedure.

In a public procedure, the preparation of a plan is published in the Dutch central insolvency register, the Dutch Government Gazette and the Dutch trade register and any hearing will be public. The public procedure will be submitted to be included in Annex A of the EU regulation 2015/848 of the European Parliament and of the Council of May 20, 2015 on insolvency proceedings (the **Insolvency Regulation (recast)**) and confirmed restructuring plans following a public procedure are consequently more easily recognised and enforced in the Member States of the EU. The Dutch courts will, however, in a public procedure only be able to assume jurisdiction if the COMI (centre of main interests) of the debtor is in the Netherlands.

The preparation of a plan in a confidential procedure is not announced and hearings will be held in chambers. This procedure will not fall within the scope of the Insolvency Regulation (recast), which is the reason that the Dutch courts may also assume jurisdiction to confirm a plan in the context of a confidential procedure where the debtor does not have its COMI in the Netherlands – provided such non-Dutch debtor has a sufficiently close connection to the Netherlands (the threshold for which is relatively low).

Which type of procedure is preferable will depend *inter alia* on the specifics of the matter and the location of the debtor's creditors.

Two new players in the field

The WHOA introduces two new players in the field of Dutch insolvency proceedings, the restructuring expert and the observer.

A restructuring expert is (only) burdened with the preparation of a restructuring plan, not the day-to-day business of the debtor, as the debtor remains in possession while a restructuring plan is being prepared. Once the court has appointed a restructuring expert, the debtor can no longer propose a plan to its creditors and shareholders.

An observer is appointed in the case of a potential cross class cram-down or in case the court orders a general stay. The task of the observer is to monitor the process revolving around the preparation of the plan, taking into account the interests of the creditors of the debtor.

There are no statutory requirements for a professional or firm to be appointed as restructuring expert or observer. In the market, some say that bankruptcy trustees will be best suited for appointment as restructuring experts, whilst others consider the CRO-type of professionals to be most appropriate. It may even be that, offering services as restructuring experts may become a new niche. It seems safe to say that the specifics of different restructuring plans or different industries might cause the decision on who or what type of professional to appoint to vary on a case by case basis. In any event, time will tell.

The process: from financial difficulties to a confirmed plan

The process starts with the preparation of a restructuring plan. The proponent of the plan enjoys great flexibility, as long as it contains sufficient information in order for those entitled to vote to be able to make an educated decision on voting in favour or against its adoption. Apart from prohibiting the amendment of rights arising from employment contracts, the WHOA does not set limitations on the arrangements that can be included in the restructuring plan. For example, the restructuring plan can provide for a restructuring of debt, a debt-for-equity swap and/or the issuance of new shares. Furthermore, the restructuring plan may provide for the amendment of obligations of group entities of the debtor, effectively allowing for group restructurings. Also, the restructuring plan may entail the amendment and – if such amendment cannot be agreed upon – the termination of burdensome reciprocal contracts, such as leases. In addition, the rights of secured creditors may under circumstances be amended by means of the restructuring plan.

In the restructuring plan, creditors and shareholders whose rights are so different that they are not considered to be in a same position need to be divided into separate classes. The positions are considered against the backdrop of both: (i) their position in the case of liquidation of the debtor; and (ii) their rights under the restructuring plan (if confirmed). As a rule of thumb, shareholders should be placed in a separate class, as must for example holders of secured claims (to the extent their collateral secures their claim).

When finalised, the restructuring plan will be proposed to those allowed to vote, which are those (classes of) creditors and shareholders whose rights are sought to be impaired or amended. The rights of (classes of) creditors that are not allowed to vote cannot be impaired or amended by means of the restructuring plan.

A class is deemed to have voted in favour of the restructuring plan if creditors voting in favour in that class together represent two-thirds of the total amount of the claims of the creditors that have cast a vote in that class. There will be no headcount. If at least one class of creditors has voted in favour of the restructuring plan, the plan can be submitted to the court for confirmation. If no restructuring expert or observer is appointed and no interim decisions are requested by the debtor, the confirmation hearing will be the first occasion in which the court will become involved in the process. Up until that moment, the procedure will have been conducted outside of any court-supervision.

The court will decide whether or not to confirm the restructuring plan. In that context, the court is required to consider the so-called general grounds for refusal at its own initiative.

General grounds for refusal include:

- It cannot reasonably be assumed that the debtor will be unable to continue paying its debts as they fall due absent the restructuring plan.
- The plan does not contain the required information for creditors.
- The class formation does not meet the statutory requirements.
- The performance of the plan is not adequately safeguarded.
- The plan is deceptive.

Furthermore, the court will – at the request of a nay-voting creditor that is (or should have been) placed in a class that has voted against the restructuring plan – consider the so-called additional grounds for refusal.

Additional grounds for refusal include:

- Failure to comply with the best interests of creditors test.
- An unjustified breach of the absolute priority rule.
- Creditors (other than commercial secured lenders) that voted against the restructuring plan and are in a class that is about to be crammed-down are not given the opportunity to opt for a “cash-out” by reference to the value such creditor would have had obtained in case of a bankruptcy of the debtor.

Upon confirmation by the court, the restructuring plan is binding on the debtor and all that were entitled to vote on the adoption of the plan.

All in all, the whole process from the proposal of a restructuring plan until the court confirmation can be finalised within four to five weeks, as the timeframes provided for in the WHOA are relatively short.

Supportive measures

In order to the smooth preparation of the restructuring plan and the continued business of the debtor in the meantime, the debtor or restructuring expert, may request the court to order a variety of supportive measures.

These supportive measures may include:

- A general or tailored stay, applying to the creditors jointly or to certain creditors respectively, for a period up to eight months.
- The suspension of a bankruptcy application in respect of the debtor
- Lifting of attachments made.
- Protecting security granted for emergency funding against claw-back risks.
- Setting aside *ipso facto* and change of control clauses.
- Allowing the debtor to use encumbered assets in the ordinary course of its business against proper security.
- Bespoke provisions, such as declaring a pre-emptive right not applicable in case of issuing new shares.

Furthermore, the debtor or restructuring expert may – before the plan has been proposed to the creditors – ask the court to give a ruling on certain issues that are relevant in respect of the confirmation, in order to avoid obstacles in having a plan confirmed down the line. A ruling can entail a binding decision on issues such as the information required to be placed in the plan, class formation, the admission of a creditor to a certain class, or whether any of the grounds for refusal (general or additional) would apply. Also, the court can decide that the management of an SME-debtor objects to the proposal of a plan for no good reason, and approve the proposal on behalf of the SME debtor.

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Preventive Restructuring Framework – A new era for restructurings in Germany

Sylwia Bea and Regina Rath

With the EU Preventive Restructuring Frameworks Directive, the EU has developed a structure complementing the existing traditional restructuring procedures currently available under German law, namely consensual out-of-court solutions and in-court insolvency proceedings. The latest examples of German corporate insolvencies during the COVID-19 pandemic show that fast and flexible solutions can be obtained under current German insolvency law regimes. However, these existing in-court procedures require that an insolvency event has occurred, i.e. that the company be insolvent. The EU Directive instead offers an alternative in-court solution, allowing for a restructuring at an earlier stage and adding the cross-class cram down thereby avoiding the need for consent among all classes of stakeholders. The draft act for the implementation of the EU Directive has, thus, been awaited with impatience in Germany, since it could be an important additional tool to mitigate the impact of the COVID-19 pandemic. On September 19, 2020, the German Federal Ministry of Justice presented a ministerial draft act which goes far beyond the mere implementation of the EU Directive. The new act, entitled 'Law for the further development of restructuring and insolvency law' *(Gesetz zur Fortentwicklung des Sanierungs- und Insolvenzrechts* (SanInsFoG) lives up to its name and promises to be the start for a new restructuring era in Germany.

Status quo in Germany

In 2016 the European Commission introduced a proposal for a Directive defining certain minimum rules that must be achieved to allow the rescue of viable companies in financial difficulties. The subsequent Directive on preventive restructuring frameworks, on discharge of debt and disqualifications and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt (Preventive Restructuring Frameworks Directive) came into force on July 16, 2019.

A two-year transition period (July 17, 2021) for the implementation into national law has been set for all EU-Member States. The German legislature intended to submit a draft bill this spring, but with the outbreak of the COVID-19 pandemic the focus shifted to an emergency law (the ***COVInsAG***) in order to temporarily amend the strict German insolvency law rules. In particular, for companies that became insolvent due to the COVID-19 pandemic, the COVInsAG provides for a suspension of the mandatory filing obligation, which otherwise requires that the company's management files for insolvency within at most 21 days upon occurrence of an insolvency event (illiquidity or over-indebtedness). The emergency law further provides for a limitation of liability for managing directors as well as a limitation of claw back and tort liability risks for lenders. The COVInsAG initially was set to expire on September 30, 2020. In light of the ongoing effects of the COVID-19 pandemic and the associated uncertainties for companies in terms of their business forecasts, the German government approved an amendment partly extending the suspension of the obligation to file for insolvency until December 31, 2020. Under the amendment, the filing obligation shall remain suspended until December 31, 2020 for companies that are over-indebted, whereas for companies that are in a situation of illiquidity, the filing obligation shall come back into force as of October 1, 2020. Restructuring experts expect a significant increase in insolvency proceedings after this date.

On September 19, 2020, the Federal Ministry of Justice presented the long-awaited and, due to the COVID-19 legislation delayed ministerial draft of the new law implementing the EU Directive. The core of the draft is the new Corporate Stabilization and Restructuring Act (*'Unternehmensstabilisierungs- und –restrukturierungsgesetz'* (**StaRUG**)) implementing the EU Directive's Title II 'Preventive Restructuring Frameworks.' The draft StaRUG provides for a modular system with various options, ranging from

- The voting on a restructuring plan in a judicial proceeding.
- The judicial confirmation of the restructuring plan.
- The judicial pre-examination of questions relevant for the confirmation of the contemplated restructuring plan.
- The judicial termination of pending mutual agreements (executory contracts).
- Court-imposed stabilization measures (stay of individual enforcement measures/ moratorium).

The StaRUG is, thus, intended to offer companies in financial difficulties various options for a pre-insolvency restructuring, which do not require all creditor consent. These measures shall be available to companies that are in a situation of imminent illiquidity (*drohende Zahlungsunfähigkeit*) and, thus, not yet under the obligation to file for insolvency. The envisaged date for entry into force of the new law is January 1, 2021.

Under current German law, a company in distress is limited to either finding a consensual out-of-court solution with all relevant stakeholders or to enter into in-court insolvency proceedings. This is because, currently, there is no legal framework in Germany for pre-insolvent status court solutions akin to chapter 11 or the new scheme proceeding in the UK that offer the possibility of confirming or sanctioning a plan over dissenting classes of creditors – the so called 'cross-class cram-down.' Rather, under the current legal regime, a plan requires the unanimous consent of all classes of creditors. The StaRUG shall close this gap.

It is worth noticing, though, that despite the current absence of such formal pre-insolvent status court restructuring frameworks, the German Insolvency Code (*InsO*) offers – besides regular post insolvent status proceedings resulting in a liquidation – different types of proceedings that allow parties to reach flexible and fast results in in-court insolvency proceedings. In particular, companies can be restructured under an insolvency plan offering the possibility for a cross-class cram-down with majority vote. In more detail:

1. Self-administration (Eigenverwaltung)

Self-administration allows the company's management to remain in charge of the business activities under supervision of a court-appointed custodian (*Sachwalter*). Self-administration requires a respective application by the company's management when filing for insolvency and the insolvency court usually approves self-administration unless circumstances are known that indicate that self-administration is detrimental to the creditors. In contrast to regular insolvency proceedings, the control will not be transferred to a court-appointed insolvency administrator.

Upon receipt of the petition, the insolvency court will order the debtor company to enter into so-called preliminary self-administration proceedings which can last up to three months. During this time the management continues the company's business operations as usual and prepares an in-court restructuring solution. In most cases, such solution will consist of an insolvency plan, but it may also be an asset sale transaction.

In case of an insolvency plan, the debtor company will submit such plan after the conclusion of the preliminary proceedings and the plan will be subject to creditors' vote following the opening of the main proceedings.

In contrast to regular insolvency proceedings resulting in the liquidation of the company, there is a large variety and flexibility of options available under an insolvency plan. While the primary guiding principle and objective of all types of German insolvency proceedings is the same, namely the best possible satisfaction of all insolvency creditors, insolvency plans can also pursue additional economic and legal objectives: The "fresh start" and continuation of the company after discharge of debts or corporate restructurings, including debt to equity swaps.

2. Protective shield proceedings (Schutzschirm-verfahren)

Protective shield proceedings are a special type of preliminary self-administration, offering certain additional options to plan the self-administration in advance. The company in distress is given a special protection period of up to three months from filing for insolvency. During this period, the company can develop a restructuring plan and will be protected from individual enforcement measures by creditors. The proceedings are available for companies that suffer from threatened or near illiquidity and/ or over-indebtedness. If illiquidity already exists, protective shield proceedings are no longer available.

Main insolvency proceedings in self-administration will be opened upon conclusion of the protective shield proceedings and the plan will be submitted to the insolvency creditors for their vote. In practice, a restructuring using protective shield proceedings is usually implemented very quickly – in a matter of a few months.

Since the outbreak of the COVID-19 pandemic, more than half of the corporate insolvency filings were petitions for self-administration (including protective shield) proceedings. The number of protective shield proceedings has doubled compared to the previous year. In particular larger German corporates have successfully applied for protective shield proceedings, with the department store chain GALERIA Karstadt Kaufhof as one of the most prominent examples. These developments evidence the significance and acceptance of this restructuring tool in the German market.

In addition to the proceedings described above, the German insolvency law provides that an insolvency plan may also be submitted in regular insolvency proceedings. However, this scenario is rather rare in practice and is very difficult for the company to achieve since control shifts to the insolvency administrator that is automatically appointed in regular German insolvency proceedings.

Outlook: The SanInsFoG - Beginning of a new restructuring era in Germany

The ministerial draft of the SanInsFoG does not limit itself to a mere implementation of the EU Directive by creating a new law (the **StaRUG**), it also contains important amendments to existing laws, in particular to the German Insolvency Code (**InsO**).

1. Draft Amendments to InsO and COVInsAG

The amendments to the InsO are intended to improve and modernize the existing German insolvency regimes, in particular the self-administration

proceedings. The requirements for self-administration shall be specified in more detail, ensuring that self-administration proceedings are well-prepared, which is a prerequisite for their success. Basis for these amendments was an evaluation of the major insolvency law reform of 2012.

In addition, the definition of the insolvency events 'imminent illiquidity' (*drohende Zahlungsunfähigkeit*) and 'over-indebtedness' (Überschuldung), both generally triggering the duty to file for insolvency without undue delay and within 21 days at the latest, shall be redefined. The prognosis period to be covered for the assessment of over-indebtedness shall be 12 months, whereas for imminent illiquidity the period shall be 24 months. For companies that have become over-indebted as a consequence of the COVID-19 pandemic, the prognosis period shall be reduced to four months, provided the company was not yet insolvent on December 31, 2019, had a positive year end result in the fiscal year preceding January 1, 2020 and suffered a decline in turnover in the calendar year 2020 of more than 40 per cent compared to the previous year (Sec. 4 of the draft amendment to the COVInsAG). These amendments shall make it easier to assess over-indebtedness and to distinguish over-indebtedness from mere imminent illiquidity.

2. Draft of the new StaRUG

The draft of the new StaRUG implements the key elements of the preventive restructuring frameworks set out in the EU Directive.

According to the EU Directive the preventive restructuring framework shall be available for companies with a "likelihood of insolvency". Under the draft StaRUG the criteria to make use of the measures shall be 'imminent illiquidity' (*drohende Zahlungsunfähigkeit,* Sec. 18 InsO).

The EU Directive provides for debtor-in possession proceedings which is also the guiding principle under the draft StaRUG.

Under the EU Directive, Member States shall ensure that a moratorium is available. In accordance with the draft StaRUG, the company may apply for so-called stabilization measures, which provide for a moratorium of a maximum of three months which can be extended under certain requirements.

As far as the restructuring plan and its implementation is concerned, the draft StaRUG contains rules which have various similarities to the rules applicable to insolvency plans. Namely, the restructuring plan shall consist of a descriptive part (*darstellender Teil*) and a constructive part (*gestaltender Teil*) and the creditors will be divided into creditor groups for voting purpose. However, in contrast to insolvency plans, the majority per creditor group is 75 per cent of the claim value. Further, the restructuring plan does not need to cover all creditors, it may also be limited to certain claims to be restructured. Employees' claims, including under company pension schemes as well as tort claims and fines shall be excluded from a restructuring. The German Federal Ministry of Justice will publish a checklist of the key features of restructuring plans for small and medium companies on its internet.

The company may also make use of additional support measures, such as the assistance of a restructuring moderator (*Sanierungsmoderator*) and/ or a restructuring officer (*Restrukturierungsbeauftragter*).

In terms of voting on the restructuring plan, the draft StaRUG allows that the plan may be confirmed under certain conditions even if not every class votes in favour of the plan, ('cross-class cram-down'). The draft StaRUG opts for the so-called 'absolute priority rule' with certain limitations. Generally speaking, the dissenting group can be crammed down if its members are not in a situation that is worse as compared to the situation without the plan and if its members adequately participate in the value of the plan. It shall not be an obstacle to an adequate participation of such creditor class if the debtor company or its shareholders retain an economic value, as long as their participation is required for the continuation of the company in order to generate an added value as set forth under the plan or if their creditor rights are only marginally affected, namely the rights are not reduced, but only deferred for a period not exceeding 12 months.

Once the restructuring plan has been approved by the required majority vote, the debtor company may file an application to the restructuring court for confirmation of the restructuring plan. The court shall refuse such confirmation, e.g. if there was in fact no imminent illiquidity of the company, if the claims of the participating creditors as well as of the creditors that did not participate in the restructuring can obviously not be satisfied or if, in a scenario where the plan provides for additional financing, the restructuring concept is obviously incoherent, is based on wrong circumstances or has no chances of success. The court decision is subject to an appeal.

Conclusion

The ministerial draft sets the scene for a new era in German restructurings. The draft does not limit itself to a mere implementation of the EU Directive, but intends to create a flexible toolbox for pre-insolvency restructurings which complements the existing procedures under German insolvency law.

This new restructuring toolbox will offer attractive alternatives, in particular for companies with a solid business model but a heavy debt load. Such companies can achieve a financial restructuring even if there is no unanimity amongst the creditors or classes of creditors, provided that the majority of creditor classes support the restructuring. Critical voices fear, however, that many debtor companies with predominantly considerable operational and/ or strategic problems will also try to benefit from this regime. This is particularly the case due to the possibility to judicially terminate existing agreements as set forth in the current draft. It remains to be seen in how far the draft will be amended as a result of the current consultation process.

Despite certain areas of criticism, the ministerial draft is the right signal at the right time. If the new law is actually enacted by January 1, 2021 as currently contemplated, it will clearly help to further mitigate the impact of the expected significant increase in companies that face a duty to file for insolvency upon expiry of the – extended – suspension under the COVInsAG. Given the existing experience with insolvency plan proceedings and the increased acceptance of German in-court restructurings by way of self-administration/ protective shield proceedings, Germany is very well placed in putting in practice a framework which appears to be both, well elaborated and well received by the market participants.

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Authority to bar a creditor from voting and litigation funding as interim financing: The Supreme Court of Canada's ruling in *Bluberi*

Sylvain Rigaud and Arad Mojtahedi

We previously reported on a lower court decision in the case of in *9354-9186 Québec inc. v. Callidus Capital Corp.*, the "Bluberi" decision, approving litigation funding arrangements in the context of a Canadian restructuring proceeding.

The reversal of that decision by the Quebec Court of Appeal created significant questions about the viability of litigation funding in an insolvency case in Canada.

The matter was further appealed to the Supreme Court of Canada. On May 8, 2020, the Supreme Court of Canada released its written decision and reasoning reversing the Quebec Court of Appeal and reinstating the lower court decision.

The unanimous Supreme Court decision enshrines the recognition of an insolvency court's wide discretion to, *inter alia*, approve a litigation funding agreement as interim financing, and to prevent a creditor from voting on a plan for an improper purpose.

Background

Bluberi Gaming Technologies Inc., now 9354-9186 Québec Inc., (**Bluberi**) manufactured, distributed, installed, and serviced electronic casino gaming machines. It also provided management systems for gambling operations.

In 2012, Callidus Capital Corporation (**Callidus**) provided Bluberi with a C$24 million secured loan. Despite missed projections, Callidus continued to extend credit to Bluberi and, by 2015, Bluberi owed approximately C$86 million to Callidus, close to half of which comprised interest and fees.

In 2015, Bluberi filed for protection under Canada's *Companies' Creditors Arrangement Act* (**CCAA**) and alleged in its filings that Callidus had deliberately employed predatory lending tactics and consumed the equity value of Bluberi with a view of taking over the business. Bluberi's filing for protection succeeded despite Callidus' objection.

In 2016, Bluberi proposed a sale solicitation process, which resulted in four offers, with Callidus submitting the winning offer. Pursuant to the sale agreement, Callidus would obtain all of Bluberi's assets in exchange for extinguishing almost the entirety of its secured claim against Bluberi, except for an undischarged C$3 million secured claim. Bluberi, on the other hand, was permitted to retain claims for damages against Callidus arising from its alleged involvement in Bluberi's financial difficulties (the **Retained Claims**). The Retained Claims against Callidus were Bluberi's sole remaining asset and as such the sole security for Callidus' remaining C$3 million claim.

In 2017, Bluberi filed a court application seeking approval of a C$2 million interim financing credit facility to fund the litigation of the Retained Claim and sought the approval of a C$20 million interim lender super-priority charge in favour of the Funder (Bentham IMF, now Omni Bridgeway). The terms of the litigation funding agreement included a success fee based on a percentage of the litigation proceeds. The expended amounts were otherwise not reimbursable and carried no interest.

A week later, and a day short of the hearing of Bluberi's application to approve the litigation funding arrangement, Callidus proposed a plan of arrangement, providing for a C$2.63 million payment to Bluberi creditors, except for itself, in exchange for a release from the Retained Claims. The supervising judge adjourned the hearing of both applications. In the meantime, Bluberi filed its own plan of arrangement, which foresaw that proceeds of the Retained Claims, after payment of expenses, would be distributed to the creditors.

After Bluberi's failure to deposit the necessary funds to cover the expenses related to the presentation of its plan, Callidus' plan was the sole plan put to the creditors. Bluberi's second-largest creditor after Callidus voted against Callidus' plan, thereby preventing the Callidus plan from achieving two-thirds majority approval.

Following the rejection of the Callidus plan, Bluberi's application to approve its litigation funding arrangement was heard. In response, to that application, Callidus filed a new plan of arrangement, increasing its contribution to other creditors' recoveries by C$250,000. Callidus further valued its security at nil and requested the supervising judge allow it to exercise its voting rights as unsecured creditor for its C$3 million proof of claim. If allowed to vote on its own revised plan, Callidus would likely achieve the two-thirds majority vote required for approval of its plan of arrangement.

The Superior Court of Québec[1]

As we previously reported, the Quebec Superior Court approved Bluberi's litigation funding arrangement, finding that in an insolvency context third party litigation funding arrangements should generally be approved and did not require the creditors' approval, subject to the following principles:

- The third party funding agreement must be necessary to provide the plaintiff access to justice that would not otherwise be available to it;
- The plaintiff's right to instruct counsel and control the litigation should not be diminished by the third party funding agreement;
- The third party funding agreement must not compromise or impair the lawyer and client relationship or the lawyer's duties of confidentiality;
- The compensation of the third party funder must be fair and reasonable; and
- The third party funder must undertake to keep confidential any confidential or privileged information.

Of apparent significance was the fact that the Funder charged no fees or interest on the amounts funded, had expended significant resources in assessing the merits of the claim itself and therefore had no collateral interest in unduly drawing out the proceedings for the purpose of earning greater interest amounts or fees. The evidence was that the litigation against Callidus was the only option that may result in recovery for the creditors, other than the revised Callidus plan.

In refusing to submit Callidus' plan to a new vote by the creditors, the court noted that Callidus' behaviour had been contrary to the "requirements of appropriateness, good faith, and due diligence [that] are baseline considerations that a court should always bear in mind when exercising CCAA authority." The court observed that Callidus:

- Initially contested the appropriateness of the CCAA proceedings to prevent Bluberi from pursuing its claim in damages against Callidus;
- Allowed the company to work on a valuation of the business, then appointing a chief restructuring officer, only to adopt a different position before the Court in an apparent attempt to exhaust financially the company and its principal; and
- Filed its plan of arrangement, which provided releases from the claims against it, at 3 p.m. the day before the scheduled hearing for the company's application for approval of its litigation funding arrangement. Callidus was in effect "buying releases from creditors who have no interests in the awarding of such release."

The Québec Court of Appeal[2]

In a unanimous decision, the Court of Appeal reversed the supervising judge's ruling and ordered that a creditors' meeting be held to allow creditors to vote on the Callidus' plan or, if Bluberi files a plan consisting of the litigation funding arrangement, to vote on whether to approve the Callidus' plan or Bluberi's plan (including the litigation funding arrangement), with Callidus having the right to vote upon either plan.

If upheld, this decision would have had significant implications for litigation funding in an insolvency context in Canada. In particular, requiring that a litigation funding arrangement be incorporated into a restructuring plan rather than allowing the court to approve such arrangements on a standalone approval motion would be a material impediment to implementing and advancing the funding for claims. In many cases the funded claims may need to be brought and asserted well before a debtor company can reasonably put a restructuring plan to its creditors and there may be targeted creditors who have personal interests in voting against the plan and seeing the litigation not proceed despite its benefits to the estate.

The Supreme Court of Canada

The Supreme Court focused its attention on two issues: whether the supervising judge erred in (1) barring Callidus from voting on its own plan, and (2) approving the company's litigation funding arrangement outside of a plan.

Issues on appeal

The Court recognized the primacy of a creditor's right to vote but subjected it to the supervising judge's discretion to bar a creditor from voting to circumstances that demand such an outcome. For example, the supervising judge can bar a creditor from voting where the creditor is acting for an improper purpose.

The Court found that the supervising judge's authority to bar a creditor from voting rested on s. 11 of the CCAA and the factual determination as to whether the creditor's conduct in the case frustrated, undermined or ran counter to the objectives of the CCAA and basic fairness that permeates insolvency legislation and practice.

Given the wide discretion that the supervising judge enjoys, the Court deferred to the lower court's qualification as to whether the litigation funding arrangement should be approved as interim financing outside of a plan in the case at hand, taking into consideration the text of the CCAA and the remedial objectives of the CCAA more generally. The Court elected not to provide any definitive guidance for lower courts on the conditions for approval of litigation funding agreements, but recognized that the law on such agreements is still evolving and "insofar as third party litigation funding agreements are not *per se* illegal, there is no principled basis upon which to restrict supervising judges from approving such agreements as interim financing in appropriate cases." Therefore, it seems that the factors considered at the lower court in the Bluberi decision remain relevant.

1 **Arrangement relatif à 9354-9186 Québec inc. (Bluberi Gaming Technologies Inc.) -and- Ernst & Young Inc., 2018 QCCS 1040.**

2 **Arrangement relatif à 9354-9186 Québec inc. (Bluberi Gaming Technologies Inc.), 2019 QCCA 171.**

The Court noted that the litigation funding arrangement and the charge in favour of the Funder did not constitute a plan of arrangement and that formal creditor approval of the arrangement in a restructuring plan was therefore not mandated. Concurring with the lower court judge, the Supreme Court of Canada concluded that Callidus should be barred from voting on its proposed new plan.

Takeaways

As the global economy faces a growing number of reorganizations and liquidations, as well as an unequal and uncertain access to liquidity, the Supreme Court's decision in *Bluberi* lends support to the increasingly interventionist role of the CCAA supervising judge, as well as the legitimacy of the use of litigation funding agreements as interim financing. In parallel, the formal recognition of the doctrine of improper purpose in CCAA proceedings is likely to give rise to further scrutiny of stakeholders' conduct by the courts, particularly in connection with voting on restructuring plans..

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Tax – Do not overlook this critical component in an international restructuring solution

Michael Alliston, Bart Le Blanc, Tino Duttine

Uncertainty has gripped 2020 with financial pressures being felt by a wide range of businesses. Borrowers are seeking to restructure their debt to ensure they have the liquidity to ride out the economic downturn and lenders keen to assist their clients (or make new investments) are considering the options realistically available.

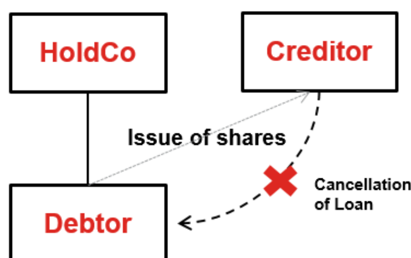
Tax is a critical component in the decision-making process, with jurisdiction-specific tax consequences to be taken into account on any cross-border debt restructuring.

For both borrowers and lenders, there are tax-related pitfalls and also opportunities that might arise in international debt restructurings, which must be at the forefront of any restructuring.

Three commonly considered debt restructuring scenarios are debt-to-equity swap; sales of distressed debt, and debt waivers (whether full, partial or conditional). The fact that the tax treatment varies according to the rules of each jurisdiction emphasises the need for careful consideration of the tax consequences in any proposed restructuring. This article flags some of the trends and idiosyncrasies that lenders and borrowers need to be aware of in order to avoid pitfalls and importantly take advantage of favourable rules.

Debt-to-equity swap

A debt-to-equity swap, substitution or restructuring is a capital reorganisation of a company in which a lender (usually a bank, possibly together with other banks, bondholders or creditors) converts indebtedness owed to it by a company into one or more classes of that company's share capital.



A debt-to-equity swap is a capital reorganisation of a company in which a creditor converts a debt owed to it into one or more classes of the debtor's share capital.

From a lender's perspective, a debt-to-equity swap should generally be a tax neutral transaction, with the tax book value of the shares received equal to the tax book value of the converted debt. Having said that, where the lender is a related party of the borrower the treatment may be different. A number of jurisdictions such as the Netherlands have legislation that prevents a lender from depreciating a debt and subsequently converting the debt into equity in a tax neutral way.

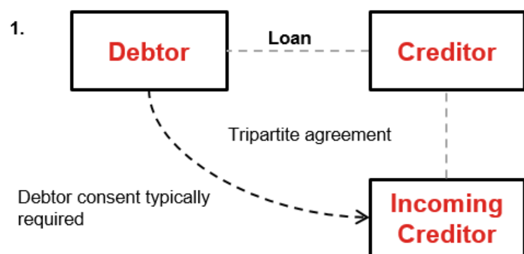
The borrower may suffer a reduction in its tax losses (which can be used to reduce future income) or be treated as receiving an amount of taxable income if the value of the equity is less than the value of debt released. In some jurisdictions though such as the UK and France a debt-for-equity swap may be treated as tax neutral. Achieving this tax neutral result may require particular formalities to be complied with. In the UK, for example, the relief is only available if the shares being issued are ordinary share capital – care must be taken to ensure that this is the case.

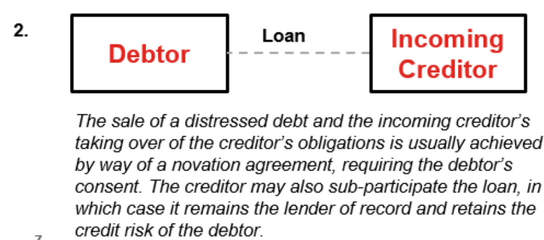
There are also jurisdictions where debt-for-equity swaps are actually adversely taxed. In Germany where a borrower is relieved from their debt, the cancellation will trigger a taxable gain to the extent the debt was impaired - it is for this reason debt-for-equity swaps are not commonly seen in Germany.

If there is a change of control of the borrower arising from the debt-for-equity swap, this may lead to further tax considerations, for example, restrictions of carry forward losses or degrouping charges. There will also be a change in the tax profile for the parties going forward – interest paid on a debt will likely be taxed differently to any dividends while the treatment of the parties on any future exit would again likely be different.

Sale of distressed debt

The sale of distressed debt is a mechanism for a lender to reduce their balance sheet exposure to debts which may currently be non-performing or have a significant risk of future default. In such circumstances, the debt would be expected to be sold at a discount to face value in view of the distressed financial circumstances of the borrower.





The sale of a distressed debt and the incoming creditor's taking over of the creditor's obligations is usually achieved by way of a novation agreement, requiring the debtor's consent. The creditor may also sub-participate the loan, in which case it remains the lender of record and retains the credit risk of the debtor.

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The common response to the question of whether the borrower should suffer any tax consequences as a result of the sale of distressed debt to a new lender is understandably 'no.'

But this is not, however, always the case. In France, the general rule that the borrower will not suffer any tax implications upon the sale holds true only if the borrower is notified of the change in lender. This underlines the importance of ensuring that tax matters are considered to ensure that the necessary formalities are carried out on any restructuring, even where one would reasonably not expect any impact on the borrower.

The situation may also be complicated where the parties are connected, for example, where a borrower wants to acquire a debt into a group to remove the controls placed on it by third party lenders. In Canada if a debt is sold to a connected party of the borrower for less than 80 per cent of the principal amount of the loan, then a taxable event may arise. Similar rules also exist in the UK (albeit with carve-outs including where the debt is released shortly after the sale) and the US.

The selling lender will expect to realise a tax deductible loss on any discount to the carrying value. Where the buyer and seller are connected parties or the transaction is otherwise than at an arm's length, tax loss restrictions may apply.

From the perspective of the buying lender, the base cost in the debt will usually be the price it paid (assuming again that the acquisition is on arm's length terms). In Luxembourg though where the sale is set up to be on beneficial terms for the incoming lender then they may be treated as having received a hidden distribution.

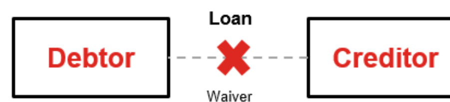
The buying lender will also need to consider transfer taxes which may apply particularly if the loan is equity-like in nature (for example, because it carries results-dependent interest) and the withholding tax position and whether any structuring is needed to mitigate any such tax.

Debt waivers or modifications

A debt waiver, debt modification or debt cancellation relieves, either temporarily or permanently, the borrower of its financial obligations under a debt instrument. It is a common element in restructuring scenarios including UK Schemes of Arrangement and US Chapter 11 plans (and is expected to a part of new WHOA legislation in the Netherlands).

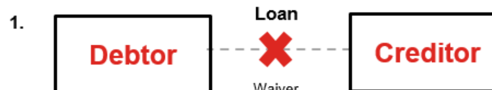
The diagram below sets out two distinct iterations of the solution, being the conditional waiver and the unconditional waiver.

Unconditional waiver

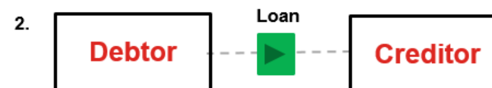


Creditor unconditionally waives the debt and releases the debtor from its obligations (this waiver can be partial).

Conditional waiver



Creditor waives the debt and releases the debtor from its obligations (this waiver can be partial) temporarily. The position can be reversed subject to the debtor fulfilling certain conditions (e.g. financial recovery).



3 *The debt is reinstated and the debtor's obligations are re-established.*

The starting point for a standard unconditional debt waiver is that borrowers can expect to be subject to tax on the value of the waived debt while lenders can expect to realise a corresponding tax benefit. A number of jurisdictions including the UK, Germany and US provide borrowers with relief in distressed situations. Furthermore, Canada and Australia have debt forgiveness rules which rather than imposing an immediate tax charge require the borrower to reduce its tax attributes by the amount of the waiver.

For connected parties, the situation may be tax neutral in some jurisdictions (for example, the UK, the Netherlands, South Africa) while in others (such as France, Germany and Luxembourg) there may still be tax liability.

Compared to unconditional waivers, conditional waivers (where the debt is reinstated at some future point) are not as commonly encountered. Indeed many jurisdictions would treat them as an amendment to the terms of the loan as opposed to a waiver. Accordingly many of the jurisdictions surveyed do not have specific taxing provisions dealing with conditional waivers. Germany though does see them used and while the waiver

triggers taxable income for the borrower when the debt is reinstated there is a corresponding loss with the lender's position similarly reversed out. The borrower's loss on reinstatement means that in Germany the mechanism can be used to refresh losses in a change of control situation.

When the terms of a loan are amended, it is necessary to consider whether this gives rise to a new loan such that new treaty formalities need to be undertaken from a withholding tax perspective.

Conclusion

Whilst there are many general principles that apply to the tax treatment of debt restructuring solutions across the jurisdictions, minor nuances and major deviations can be found, which should be at the forefront when considering the options available. Complex restructuring solutions generally have complex tax implications – it is without doubt a critical component.

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