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Comparative Corporate Insolvency Law

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Abstract

This chapter deals with fundamental issues of corporate insolvency law. Particular attention is paid to the agency problems related to “bankruptcy governance” and how these are addressed in various jurisdictions. Methodologically, the chapter is based on a functional approach that compares different legal regimes against the yardstick of economic efficiency. The structure of the chapter follows the issues as they arise in time in a corporate insolvency proceeding: objectives of insolvency laws, opening and governance of proceedings, ranking of claims and the position of secured creditors and shareholders, and rescue proceedings. The chapter also covers the contractual resolution of financial distress. It concludes with thoughts on the reasons for the identified jurisdictional divergences and an outlook on the worldwide efforts towards harmonization of (corporate) insolvency laws. In terms of jurisdictions, the chapter mainly draws on the corporate insolvency laws in the US, England, France and Germany. F

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CHAPTER 38

COMPARATIVE CORPORATE INSOLVENCY LAW

HORST EIDENMÜLLER

1 INTRODUCTION

CORPORATE law and governance on the one hand and insolvency/bankruptcy[1] law on the other have long been viewed as distinct disciplines: whereas the former deal with legal issues associated with the organization and operation of a solvent corporation, the latter is meant to address a new set of legal problems arising once a corporation finds itself in severe financial distress. Agency conflicts between shareholders and management and between majority and minority shareholders figure prominently in corporate law and governance.[2] Agency conflicts between the corporation and its creditors and within the creditor community are at the center of insolvency law.[3]

The divide between these two spheres of law and academic discipline becomes less clear, however, once one conceives of insolvency law as "corporate governance under financial distress." Indeed, "insolvency governance" can be characterized as a special form

[1] "Bankruptcy law" is the term more commonly used in the US, "insolvency law" is more common elsewhere in the world, especially in the UK.

[2] Reinier Kraakman et al., The Anatomy of Corporate Law: A Comparative and Functional Approach (2009), chapter 2; Gregor Bachmann et al., Regulating the Closed Corporation 8–13 (2014).

[3] Kraakman et al., *supra* note 2, at 115 et seq.; Horst Eidenmüller, Unternehmenssanierung zwischen Markt und Gesetz (1999).

(or case) of "corporate governance."[4] The conceptual/analytical apparatus to understand the regulatory problems and develop potential policy responses is the same; it is only the framework conditions which change, and possibly only to a small degree: laws on the (financial) restructuring of businesses pre-insolvency are gaining increasing importance, in the European Union and elsewhere.[5]

Hence, it appears sensible to include a chapter on corporate insolvency law in a handbook on corporate governance. Such a chapter should of course be comparative in nature, i.e., it should consider the regulatory approaches of different jurisdictions with respect to corporate insolvency law issues and compare their respective merits. Adopting a comparative perspective enlarges the "solution set" for legal problems and also helps evaluate domestic regulatory approaches against an international benchmark ("best practice"). This chapter focuses on the corporate insolvency laws of the US, England, France, and Germany. It does so because these jurisdictions are representative of diverse legal traditions and

[4] While "insolvency governance" probably is a new term, the interaction of corporate law and corporate bankruptcy was noted decades ago by scholars such as Whitford, LoPucki, and Skeel. See David Skeel, "Rediscovering Corporate Governance in Bankruptcy", 87 Temple L. Rev. 1021 (2015).

[5] In 2014, for example, the EU Commission published a Recommendation on a new approach to business failure and insolvency (2014/135/EU, OJ of the EU of 14 March 2014, L 74/65) that asks the Member States to bring their domestic pre-insolvency restructuring regimes into line with the principles set out in the recommendation (see Horst Eidenmüller & Kristin van Zwieten, "Restructuring the European Business Enterprise: the European Commission's Recommendation on a New Approach to Business Failure and Insolvency", 16 Eur. Bus. Org. L. Rev. 625 (2015)). The Commission has presented a legislative proposalin 2016; see Commission Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, COM (2016) 723 final(22 November 2016). On the proposal see Horst Eidenmüller, "Contracting for a European Insolvency Regime", 18 Eur. Bus. Org. L. Rev. 273 (2017). See also section 11 *infra*.

because they can rightfully be characterized as leading the international search for optimal insolvency and/or restructuring regimes with respect to corporate entities that find themselves in or near financial distress. Harmonization efforts worldwide are, or have been, heavily influenced by Chapter 11 of the US Bankruptcy Code, the English Scheme of Arrangement, the French *sauveguarde* proceedings, and German proposals to regulate insolvencies of members of a group of companies—to name just a few examples.[6]

Interest in comparative corporate insolvency law has grown considerably in the last years, driven by various factors. It is increasingly recognized that (corporate) insolvency laws have a significant impact on entrepreneurship and economic growth.[7] Hence, jurisdictions attempt to identify best practices that allow them to boost their domestic economies. At the same time, the number of transnational insolvencies is clearly on the rise. Given the growth in international commerce, today even the insolvency of small or medium-sized (closed) corporations usually will exhibit some transnational aspect such as foreign creditors, subsidiaries/branches/offices in other jurisdictions, or assets that are located abroad.

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[6] As for the last example, the recast European Insolvency Regulation (Regulation (EU) 2015/848 of 20 May 2015) contains a new Chapter V on insolvency proceedings of members of a group of companies (Arts. 56 et seq.). The conceptual approach underlying this chapter was first proposed by the German government in its legislative proposal for new domestic rules on insolvency proceedings of members of groups of companies. See Entwurf eines Gesetzes zur Erleichterung der Bewältigung von Konzerninsolvenzen, Bundestag-Drucksache 18/407 of 30 January 2014.

[7] See, for example, John Armour & Douglas Cumming, "Bankruptcy Law and Entrepreneurship", 10 Am. L. & Econ. Rev. 303 (2008); Kenneth M. Ayotte, "Bankruptcy and Entrepreneurship: The Value of a Fresh Start", 23 J. L. & Econ. 161 (2007).

However, scholarly work in the field of comparative corporate insolvency law up till now has been rather scarce.[8]

This chapter will start out with an introduction to the comparative approach as applied to corporate insolvency law (section 2). It will then provide a taxonomy of insolvency laws and identify objectives that these pursue (section 3). Substantive issues covered will be the opening (section 4) and governance (section 5) of insolvency proceedings, the ranking of claims, and, in particular, the position of secured creditors (section 6), contracting for assets of the debtor (section 7), rescue proceedings (section 8), and the contractual resolution of financial distress (section 9). The chapter concludes with some thoughts on the reasons for the identified jurisdictional divergences (section 10) and an outlook on the worldwide efforts toward harmonization of insolvency laws (section 11). It goes without saying that the level of detailed analysis that can be reached in a book chapter on these many important issues is limited. The emphasis will be on those issues that are more closely related to questions of corporate governance.

2 THE COMPARATIVE APPROACH

The comparative approach is characterized by a functional perspective. It starts with a particular regulatory problem, and it seeks to understand, describe, and evaluate how that problem is "solved" in a particular jurisdiction. This implies that the comparative approach needs to abstract from jurisdiction-specific categorizations and doctrinal classifications. To

[8] Gerard McCormack, Corporate Rescue Law: An Anglo-American Perspective (2008), focuses exclusively on the UK and the US. Philip R. Wood, Principles of International Insolvency (2007), is characterized by an enormous breadth of coverage and detail in the analysis but less by consideration of conceptual issues. Lawrence Westbrook et al., A Global View of Business Insolvency Systems (2010), are quite selective with respect to the issues studied. A book like Kraakman et al., *supra* note 2, for corporate insolvency law is missing.

illustrate: one important issue in comparative insolvency law is the "initiation problem":[9] What triggers insolvency proceedings? How do they get started? Jurisdictions worldwide approach this issue very differently. Some use liability rules—in corporate and/or insolvency law—that penalize managers for filing too late. Some reward managers for initiating insolvency proceedings in time by, for example, rights and/or privileges such as the "debtor in possession" (no insolvency administrator is appointed and management stays in charge of running the bankrupt firm) or an "exclusivity period" during which only the debtor may propose a restructuring plan (see in detail section 4 *infra*). Comparative analysis must be open to very different regulatory approaches and techniques in order not to lose sight of the wealth of rules and mechanisms that attempt to address a particular regulatory problem.

Another recurrent and important issue in comparative law is the problem of the appropriate measuring rod. Once different regulatory approaches and techniques have been identified, their operation in legal practice and their effects in reality must be studied in closer detail. The former task involves, in particular, an in-depth analysis of the relevant case law and contract practice; the latter social-scientific studies of causal consequences of legal rules. It is against this background that the important normative question must be put: Which regulatory approach/technique is or works best, given the regulatory background? This question can only be answered, if it can be answered at all,[10] on the basis of a clearly specified measuring rod. For a long time, "conventional" comparative private law scholarship has not been very convincing in this respect. To characterize a specific jurisdiction's rule or

[9] Douglas G. Baird, "The Initiation Problem in Bankruptcy", 11 Int'l. Rev. L. & Econ. 223 (1991).

[10] Apart from the regulatory background (complementarities in other areas of the law etc.), business realities (type of economy etc.) and the strength of different types of stakeholders of firms play an important role, to name just a few relevant factors. The point in the text is simply this: Without a precise normative measuring rod, no proper evaluative comparison of different approaches in different jurisdictions is feasible.

regime as "better" or "more appropriate"[11] rather begs the question: Why? The analytical landscape has changed considerably with the advent of the economic analysis of law in the 1970s. "Positive Law and Economics" offers tools to predict the effects of laws in reality, and "Normative Law and Economics" uses welfare economics to evaluate these effects, judging the underlying laws to be more or less efficient.[12] To be sure, both branches of the economic analysis of law are subject to severe criticisms.[13] The analytical apparatus of economics has been refined to respond to these criticisms, leading inter alia to new sub-disciplines such as "Behavioural Law and Economics."[14] For this reason and because (1) the economic analysis of legal rules often generates relatively precise answers (compared to more fuzzy measuring rods) and (2) efficiency has a relatively high appeal as a normative criterion especially in the field of commercial and corporate activities, this standard will be used in this chapter. However, shortcomings and/or limitations of the economic analysis will be mentioned where necessary.

3 TAXONOMY AND OBJECTIVES OF INSOLVENCY LAWS

As a starting point for comparative corporate insolvency law scholarship, it seems helpful to take stock of existing corporate insolvency law systems in select jurisdictions, identify the objectives these pursue, and compare them. A particular issue in this context is whether there is a need for a special insolvency regime for systemically important financial institutions.

[11] Konrad Zweigert & Hein Kötz, An Introduction to Comparative Law 15 (1998).

[12] Pioneering work in the field was done by Richard Posner. His book on Economic Analysis of Law was published in its first edition in 1972. It is now in its 9th edition (2014). "Law and Economics" has had and continues to have a significant influence on bankruptcy scholarship. See, for example, Mark J. Roe, Corporate Reorganization and Bankruptcy (2000); Douglas G. Baird, Elements of Bankruptcy (2006); Barry E. Adler, Foundations of Bankruptcy Law (2005).

[13] Horst Eidenmüller, Effizienz als Rechtsprinzip (2015).

[14] See, for example, Behavioral Law & Economics (Cass Sunstein ed., 2000).

This issue has assumed a significant importance in the regulatory aftermath of the most recent global financial and economic crisis.

3.1 Taxonomy of Insolvency Laws: Different Systems

Corporate insolvency law systems in various jurisdictions differ formally especially in that some jurisdictions have a multiplicity of proceedings that are regulated in different statutes or at least different chapters in one statute, whereas others are less "rich" in the choices they offer for corporate debtors that find themselves in or near financial distress.[15] A broad distinction can be drawn between proceedings that aim at a restructuring of corporate debtors and those that are directed toward liquidation. In its simplest form, this distinction is reflected in two well-known Chapters of the US Bankruptcy Code: Chapter 7 on liquidations and Chapter 11 on reorganizations. Germany modeled its own *Insolvenzordnung* (in force since 1999) against the background of these two Chapters: the statute contains liquidations in its initial parts and a Chapter-11-type debtor in possession restructuring proceeding in Parts 6 and 7.

With the increasing importance of corporate restructurings and the need for legal regimes to facilitate these, especially pre-insolvency, some jurisdictions now offer not just one restructuring regime but a multifaceted set of restructuring laws. This is true, for example, with respect to England: the Insolvency Act 1986 contains the Winding Up procedure in Part IV, a liquidation proceeding, but also the Administration (Schedule B1) and the Company Voluntary Arrangement [CVA] (Part I), which can be used as a restructuring framework. These are complemented by the Scheme of Arrangement (SoA) (sections 895–901 of the Companies Act 2006), another restructuring tool that can be employed both before and after insolvency (Solvent and Insolvent Schemes of Arrangement). The French

[15] For reorganization in the US and in European bankruptcy law, see Maria Brouwer, "Reorganization in US and European Bankruptcy Law", 22 Eur. J. L. Econ. 5 (2006).

insolvency landscape is even more diverse. Book 6 of the *Code de commerce* contains different types of court-supervised proceedings (*Redressement judiciaire*, *Liquidation judiciaire*), but also many different forms of restructuring proceedings with minimal or no court intervention: *Procédure de conciliation, Procédure de sauvegarde*,[16] *Procédure de sauvegarde financière accélérée*, and *Procédure de sauvegarde accélérée*.

A crucial distinguishing feature with respect to these various "modern" restructuring proceedings is whether they offer tools to discipline holdouts such as, for example, an automatic stay and/or the possibility of majority voting with respect to a restructuring plan.[17] Without these devices, the proceeding is purely voluntary in the sense that creditors cannot be forced to participate. This allows for strategic maneuvering and free riding. At the same time, introducing a stay or majority voting comes at a cost: it increases court involvement and (public) visibility and, as a consequence, direct and indirect bankruptcy costs.[18] The English Scheme, for example, does not impose a stay but allows majority voting, the French Procédure de sauvegarde and the Procédure de sauvegarde accélérée impose a (universal) stay but do not allow all dissenting creditors to be bound by a plan agreed by a majority of

[16] This procedure was used, for example, in the Eurotunnel restructuring (2006), https://www.nouvelobs.com/economie/20060801.OBS6977/procedure-de-sauvegarde-pour-eurotunnel.html, and in the Thomson case (2009), http://www.lefigaro.fr/societes/2009/12/01/04015-20091201ARTFIG00013-thomson-tente-un-plan-de-sauvegarde-express-.php.

[17] See Sarah Paterson, "Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century", 35 Oxford J. Leg. Stud. 1 (2015). Paterson distinguishes between "insolvency law" and "restructuring law." Whereas the former, in her view, is geared toward liquidation with the creditors facing a prisoners' dilemma justifying a stay, the latter is concerned with providing a deadlock resolution procedure that can discipline hold-outs but does not necessarily need a stay. Paterson does not, I believe, sufficiently appreciate that the strategic problem faced by creditors in a liquidation and in a restructuring is very much the same (prisoners' dilemma), and a stay is no less justified in a restructuring than it is in a liquidation.

[18] On bankruptcy costs see *infra* note 32 and accompanying text.

creditors, and the Procédure de conciliation exhibits neither of these "collectivizing" devices.[19]

Whether or not liquidations and (various forms of) restructurings are or should be regulated in different chapters of the same statute or in different statutes is more a formal than an important substantive question. Putting them in the same statute might generate certain cost advantages because an initial general chapter can be used to stipulate certain rules that apply to all types of proceedings. On the other hand, clarity and marketability of the proceeding for potential users might be said to argue in favor of a separate statute. Furthermore, including a chapter on restructurings in legislation entitled "Insolvenzordnung" (Insolvency Code)—as in Germany—might be said to be particularly bad in this respect, as "Insolvency Code" tends to be associated with liquidations.

A more important substantive issue is whether firms worldwide have access to efficient restructuring proceedings that can be initiated pre-insolvency. A lack of efficient local proceedings is not so much a problem for multinational corporations as they are usually able to forum shop for the best or most suitable restructuring regime. However, given the costs involved with forum shopping, this is not a viable alternative, especially for many SMEs. Hence, a case can be made for "minimum harmonization" with respect to jurisdictions' provisions of pre-insolvency restructuring regimes. Such harmonization efforts are currently being undertaken in the European Union, for example (see in detail section 11).

3.2 Bank Insolvency and Resolution

[19] In the case of the procédure de conciliation, there is no general stay affecting all creditors. However, where a creditor seeks to enforce his or her rights, the debtor can apply to the court for a moratorium (specific to that creditor) lasting a maximum of two years: Art. L.611-7 of the French Code de commerce, Art. 1343-5 Code civil.

Before the most recent global financial and economic crisis, very few jurisdictions worldwide had special bank insolvency and restructuring/resolution regimes in their statute books. It is true that banks were mostly subject to distinctive supervisory regimes. But once it came to insolvency, regular insolvency proceedings were applied, usually with certain exceptions—to account for the banks' unique corporate features—such as, for example, filing rights and pick of insolvency administrators.

This all changed with the global financial and economic crisis, starting in the UK with the bank run on Northern Rock (2007) and involving the bankruptcy of Lehman and a bailout of American International Group (AIG)—both within a couple of days of each other in September 2008. The policy shift followed rapidly. The evidence supporting the shift was not very strong though: if one compared the reaction of certain capital market indices to the Lehman Chapter 11 filing on the one hand and to the AIG bailout on the other, it appears that it was not the bankruptcy procedure itself that was the problem—the TED spread, for example, increased more after the AIG bailout.[20] Nevertheless and very soon, a worldwide near-consensus amongst policy makers and regulators emerged that the default, in particular, of a systemically important financial institution demands a special regime that kicks in earlier, is more flexible, and also much speedier than an ordinary bankruptcy proceeding.[21] Further, depositors should not have to fear that their claims would be reduced in a bankruptcy proceeding. After the 2007 collapse of Northern Rock, the UK was the first jurisdiction to

[20] See Kenneth M. Ayotte & David Skeel, "Bankruptcy or Bailouts?", 35 J. Corp. L. 469, 490 et seq. (2010); Horst Eidenmüller, Finanzkrise, Wirtschaftskrise und das deutsche Insolvenzrecht 51 et seq. (2009).

[21] See Horst Eidenmüller, Restrukturierung systemrelevanter Finanzinstitute, in Festschrift für Klaus J. Hopt zum 70. Geburtstag am 24. August 2010, 1713, 1716 et seq., 1718 et seq. (Stefan Grundmann et al. eds., 2010); Anat Admati & Martin Hellwig, The Bankers' New Clothes 35–38 (2013).

enact a "modern" bank resolution and recovery regime (Banking Act 2009).[22] Other jurisdictions followed suit: the US with Title II of the Dodd–Frank Wall Street Reform and Consumer Protection Act (2010)[23] and Germany with the Kreditinstitute-Reorganisationsgesetz (2010).[24]

Experimenting with different types of bank resolution and recovery regimes might be viewed as a potential regulatory option—let the market decide which rule systems work (best). However, at least in the banking field, a consensus amongst policy makers and regulators soon again emerged that this was no real option and that, wherever feasible, harmonization along the lines of best practice should be achieved. One can, of course, ask critical questions as to the existence of a best practice in a regulatory field so new and untested as bank resolution and recovery, and point to the dangers of harmonizing along the lines of principles that are potentially fundamentally flawed.[25] Nevertheless, the European Union (EU), for one, pushed forward and enacted the "Bank Recovery and Resolution

[22] On this, see Peter Brierley, "The UK Special Resolution Regime for Failing Banks in an International Context", Bank of England Financial Stability Paper No. 5, July 2009, available at https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-paper/2009/the-uk-special-resolution-regime-for-failing-banks-in-an-international-context.

[23] On the interaction of bank regulation and bankruptcy after Dodd–Frank see David Skeel, "The New Synthesis of Bank Regulation and Bankruptcy in the Dodd–Frank Era", ECGI Working Paper No. 308/2016, available at http://www.ecgi.org/wp/wp_id.php?id=771.

[24] For a comparison of the US, the English and the German system, see Matej Marinč & Razvan Vlahu, The Economics of Bank Bankruptcy Law 97 et seq. (2012). See also John Armour et al., Principles of Financial Regulation 340 et seq. (2016) with further references.

[25] Roberta Romano, "For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture", 31 Yale J. Reg. 1 (2014).

Directive (BRRD)" in 2014.[26] Member States only had until January 1, 2015 to adjust their domestic regimes to the rules stipulated in the Directive.

Simply put, it provides for a unitary system of bank resolution and recovery throughout the EU. The BRRD provides authorities with comprehensive and effective arrangements to deal with failing banks at national level, as well as cooperation arrangements to tackle cross-border banking failures. It sets out the rules for the resolution of banks and large investment firms in all EU Member States. Banks will be required to prepare recovery plans to overcome financial distress. Authorities are also granted a set of powers to intervene in the operations of banks to avoid them failing. If they do face failure, authorities are equipped with comprehensive powers and tools to restructure them, allocating losses to shareholders and creditors following a clearly defined hierarchy. They have the power to implement plans to resolve failed banks in a way that preserves their most critical functions and avoids taxpayers having to bail them out (bail-in versus bail-out). Precise arrangements are set out for how home and host authorities of banking groups should cooperate in all stages of cross-border resolution, from resolution planning to resolution itself, with a strong role for the European Banking Authority to coordinate and mediate in case of disagreements. National resolution funds are also being established. In the case of Member States within the Eurozone, these funds were replaced by the Single Resolution Fund as of 2016.

3.3 Economic versus Non-Economic Goals

[26] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU, and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ of the EU of 12 June 2014, L 173/190.

What are the proper goals of a corporate insolvency procedure? The normative importance of the answer to this question cannot be overestimated. It defines the architecture of an insolvency proceeding and is also important with respect to most specific regulatory issues in corporate insolvency law. As with many other areas of the law, an economic perspective on insolvency laws has become very influential—both in the scholarly literature and in law-making. Hence, it is indispensable to understand and study this perspective in order to be able to follow the conceptual debates about most insolvency law issues. However, jurisdictions differ markedly regarding the extent to which they design corporate insolvency law systems according to economic principles. This difference is also reflected in another distinction, namely whether a country's corporate insolvency regime is more creditor or more debtor oriented.

3.3.1 The Economic Perspective of Insolvency Laws

The economic perspective clearly distinguishes between an ex post and an ex ante view of insolvency laws. The former view is the one usually adopted by lawyers and legal scholars. With respect to corporate insolvency law, it focuses on the question of what to do with the assets of a corporation and the corporation itself in a situation in which it finds itself in financial distress, i.e., unable to pay all its debts as they fall due.[27] The economic maxim to address this question is simple: maximize the net company value. The larger the pie, the more is available for distribution to the company's creditors. This goal (function) implies at least three important sub-goals: (1) First, prevention of an asset race, i.e., a solution to the common

[27] In insolvency law and scholarship, usually two different tests for financial distress are used: cash-flow insolvency and balance-sheet insolvency. According to the former (used in the text above), a firm is insolvent if it cannot fully meet its financial obligations as they fall due. According to the latter, a firm is insolvent if its liabilities exceed its assets, measured by the applicable accounting rules. On the opening of insolvency proceedings see in detail section 4 *infra*.

pool problem.[28] Creditors of a financially distressed corporation find themselves in a multi-party prisoners' dilemma.[29] Each creditor has a dominant strategy to seize assets as fast as possible—with potentially disastrous consequences for the group. (2) Second, restructuring of the firm only if the restructuring value exceeds its liquidation value, i.e., if the firm is economically viable.[30] On the basis of this test, the great majority of insolvent corporations in legal practice should be liquidated because they suffer from financial *and* economic failure.[31] (3) Third, minimization of the direct and indirect costs of insolvency proceedings. Direct costs comprise the transactions costs triggered by the procedure such as, for example, administrators' or court fees. Indirect costs are economic losses caused by the procedure such as, for example, the reputational damage to the firm associated with the mere fact of an insolvency procedure. Indirect bankruptcy costs are usually much higher than direct bankruptcy costs and tend to consume approximately 10–20% of the remaining firm value.[32]

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[28] Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 7 et seq. (1986).

[29] Eidenmüller, *supra* note 3, at 19 et seq.

[30] To put it differently, if a firm is not only financially but also economically distressed, it should be liquidated. It should also be liquidated if it is economically distressed but not financially distressed. This scenario would lead to a liquidation outside bankruptcy/insolvency, however.

[31] In Germany, for example, businesses are reorganized in an *Insolvenzplanverfahren* according to sections 217 et seq. of the German Insolvenzordnung in no more than 1% of all business insolvencies; see the analysis of Schultze & Braun based on all business insolvencies from 1999–2011, available at http://www.schubra.de/de/presseservice/pressemitteilungen/sb/InsolvenzplanIndex1999bis2011.pdf. Data from other jurisdictions point in the same direction with respect to the ratio between reorganizations and liquidations. Clearly these data are no more than a proxy for the statement in the text: businesses may be liquidated even though they should have been reorganized or vice versa. But even if the former is more likely than the latter (which is unclear), the ratio is not going to change much in absolute terms.

[32] See Michelle J. White, The corporate bankruptcy decision, in Corporate Bankruptcy: Economic and Legal Perspectives 207, 226 et seq. (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996), with further references. A

Given the creditors' interest in as large a pie as possible in bankruptcy, minimizing direct and indirect bankruptcy costs is an economic imperative.

Economic analysis complements the ex post view of insolvency laws with an ex ante perspective. The message is as clear-cut and simple as the maxim from an ex post perspective. Ex ante is about setting the appropriate, i.e., welfare-maximizing, incentives for shareholders and managers of a corporation that might find itself in financial distress (with a non-trivial probability). This goal (function) implies at least two important sub-goals: (1) First, agency costs of debt must be reduced. As is well known, shareholders of a near-insolvent corporation have an incentive to undertake risky projects that might even have a negative net present value ("betting the bank's money").[33] Managers have similar incentives to the extent that they can be assumed to act according to the shareholders' preferences.[34] Hence, in closed corporations, where shareholders are usually able to directly control managers' actions, the "risk shifting incentive" of managers will be stronger than in public corporations where management enjoys more freedom in business decisions. (2) Second, restructuring efforts of a firm that faces serious business problems should be initiated sooner rather than later. Experience teaches us that the timely triggering of restructuring initiatives is

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rough proxy for indirect bankruptcy costs with respect to listed firms is the loss in market capitalization triggered by an insolvency filing.

[33] Bachmann et al., *supra* note 2, at 11 et seq.

[34] Paul Davies, "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency", 7 Eur. Bus. Org. L. Rev. 301, 306–07 (2006); Horst Eidenmüller, "Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers", 7 Eur. Bus. Org. L. Rev. 239, 243 (2006).

a crucial success factor for these initiatives.[35] Indeed, it is never too early to think about the competitiveness of one's business, and there is no clear-cut line between keeping a business on a competitive track—by appropriate measures—and restructuring it to avert a decline in financial and/or economic performance.

How do different jurisdictions' insolvency laws worldwide fare against these criteria for ex post and ex ante efficient insolvency regimes? There are no overall empirical analyses of the relevant cost/benefit effects available, and the methodological hurdles for such studies do seem insurmountable: recovery rates for creditors in bankruptcy tell only part of the story,[36] and how would one even start to identify and measure accurately all relevant cost/benefit factors that go into an overall calculus of the efficiency effects of a particular insolvency regime? What probably can be said, though, is that the ex ante effects are more important than the ex post effects: the former relate to all firms, whereas the latter are important only with a subset of firms, namely those that find themselves in financial distress.[37] To put it differently: maintaining the health of all firms is more important than

[35] For this reason, leverage has a positive influence on the likelihood and success rate of a restructuring: it triggers insolvency at an earlier point in time. See Michael C. Jensen, "Active Investors, LBOs, and the Privatization of Bankruptcy", 2 J. Appl. Corp. Fin. 35, 41 et seq. (1989).

[36] Recovery rates measure the return for creditors on the nominal value of their claim in a bankruptcy proceeding. They vary depending on various factors such as whether the company is liquidated or restructured, whether the claim is secured or unsecured, the claim ranking order in a specific jurisdiction, etc. For comparisons between France, Germany, and the UK see, for example, Régis Blazy, Joël Petey & Laurent Weill, "Can Bankruptcy Codes Create Value? Evidence from Creditors' Recoveries in France, Germany, and the United Kingdom", 2014, available at https://ssrn.com/abstract=2447296.

[37] Michelle J. White, The Costs of Corporate Bankruptcy: A U.S.–European Comparison, in Corporate Bankruptcy: Economic and Legal Perspectives, *supra* note 32, at 467–500. On the economics of English insolvency proceedings, see Julian Franks & Oren Sussman, The Economics of English Insolvency: Some

getting it right with respect to the subset of firms that find themselves in the emergency room. Hence, the fixation of lawyers and legal scholars with ex post efficiency is misplaced—at least from an economic standpoint.

3.3.2 Diversity of Bankruptcy Philosophies

As already stated in the introduction to this section, jurisdictions worldwide differ markedly with respect to the "bankruptcy philosophies" that they pursue.[38] On the one hand, there are jurisdictions that view insolvency law primarily or even exclusively as debt collection law, i.e., as an instrument to best satisfy creditors' interests when the debtor is in a situation of financial distress. These jurisdictions tend clearly to prioritize economic efficiency vis-à-vis any other potential goal to be pursued by insolvency laws. On the other hand, there are jurisdictions that entertain a policy according to which insolvency law should serve not only creditors' but also other stakeholders' interests, for example those of the debtor, workers, and the (local) community.[39] Under this policy, environmental concerns are a legitimate factor in a corporate insolvency as well as are, potentially, redistributive aims: insolvency is not just about enforcing pre-existing entitlements under conditions of scarcity; it is also about redefining entitlements and shifting rents.[40]

Recent Developments, in Company Charges: Spectrum and Beyond 253–66 (Joshua Getzler & Jennifer Payne eds., 2006).

[38] For different perspectives in the US see, for example, Jackson, *supra* note 28, Introduction and Chapters 1 and 2; Douglas G. Baird, "Bankruptcy's Uncontested Axioms", 108 Yale L. J. 573 (1998); Elizabeth Warren, "Bankruptcy Policy", 54 U. Chi. L. Rev. 775 (1987); for the UK, see Roy Goode, Principles of Corporate Insolvency Law (1997), Chapters 2 and 3; for the EU, see Federico Mucciarelli, "Not Just Efficiency: Insolvency Law in the EU and Its Political Dimension", 14 Eur. Bus. Org. L. Rev. 175 (2013).

[39] See Vanessa Finch, Corporate Insolvency Law 38 et seq. (2009).

[40] Finch, *supra* note 39, at 40 et seq.

The current German insolvency regime for corporate debtors clearly falls in the first group, i.e. it is debt collection law and nothing else. Section 1 of the Insolvenzordnung reads as follows:

> The insolvency proceedings shall serve the purpose of collective satisfaction of a debtor's creditors by liquidation of the debtor's assets and by distribution of the proceeds, or by reaching an arrangement in an insolvency plan, particularly in order to maintain the enterprise. Honest debtors shall be given the opportunity to achieve discharge of residual debt.

The discharge mentioned in the second sentence is irrelevant for corporate debtors: it applies only to natural persons (see sections 286 et seq. Insolvenzordnung). On the other end of the spectrum, we find the current French insolvency laws. With respect to a Redressment judiciaire, the Code de commerce sets out the following objectives: "The purpose of the judicial restructuring is to allow the continuation of the business's operations, the maintenance of employment and the settlement of its liabilities."[41] Hence, considerations of maintaining employment (in the short run) or "local business structures" may well trump economic logic. The "middle ground," so to speak, is firmly occupied by the US and the English insolvency regimes. Traditionally, US Chapter 11 has a very strong debtor orientation: despite some changes in more recent times,[42] the fresh start philosophy and giving the debtor a second chance is still characteristic of Chapter 11 proceedings. Of course, discharge can be advocated both on economic and on redistributive grounds, and the US version of discharge as a tool to promote entrepreneurship probably falls more in the first than in the second category (whether it is successful in that regard is another matter[43]). English insolvency law used to be and still is fairly creditor rights oriented. For example, the

[41] See Art. L.631-1 of the French Code de commerce.

[42] Most of these changes were introduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, available at https://www.gpo.gov/fdsys/pkg/BILLS-109s256enr/pdf/BILLS-109s256enr.pdf.

[43] Armour & Cumming, *supra* note 7, provide evidence that it is.

holder of a qualifying floating charge may appoint an administrator or an administrative receiver under the Insolvency Act 1986 without the need for an order of the court.[44] However, as early as 1982, the "Cork Report" (commissioned by a Labour government in 1977) had suggested that insolvency laws should pursue a multiplicity of aims and that the effects of insolvency are not limited to the private interests involved.[45] This view was reflected in later reforms, especially in those introduced by the Enterprise Act 2002. The Act made substantial amendments to the administration procedure for failing companies. The purpose was to enhance the policy of creating a "rescue culture," so that insolvent companies should so far as possible be saved, before their assets are stripped and distributed to creditors.[46]

Against the background of even this small sample of insolvency policy debates and lawmaking in select countries, it clearly emerges how markedly jurisdictions worldwide differ with respect to the "bankruptcy philosophies" that they pursue. The extent to which economic reasoning should appropriately inspire corporate insolvency law reform certainly is one of the features of this ongoing discussion. At the same time, the marked differences also indicate how difficult harmonization efforts with respect to corporate insolvency lawmaking are and will be (on this, see section 11 *infra*).

3.3.3 Creditor versus Debtor Orientation

The significant differences between various jurisdictions with respect to the degree to which their insolvency systems attempt to achieve economic efficiency is also reflected in another distinction, namely whether a country's corporate insolvency regime is more creditor or more debtor oriented. There are at least two reasons why one might want to undertake such a

[44] Paragraph 14 of Schedule B1 to the Insolvency Act 1986, introduced by the Enterprise Act 2002.

[45] Report of the Review Committee on Insolvency Law and Practice (1982) Cmnd 8558, 54–55.

[46] See Vanessa Finch, "Re-invigorating corporate rescue", J.B.L. 527, 530 et seq. (2003).

categorization or classification: first, it serves a heuristic purpose in the sense of informing scholars or policy makers of the principal direction of a jurisdiction's bankruptcy philosophy; second, it might be used as a basis for undertaking econometric analysis, for example with respect to the level and/or structure of debt financing in a particular jurisdiction. One could hypothesize, for example, that more creditor orientation will lead to more credit being extended and at terms more favorable to the debtors—a hypothesis that has indeed been confirmed by econometric studies.[47]

Various features of an insolvency regime can be singled out to signal more or less creditor or debtor orientation: the appointment of a trustee to safeguard creditors' interests versus the "debtor in possession" (DIP), the imposition of an automatic (and complete) stay with respect to creditors' enforcement actions (less creditor protection), or the so-called absolute priority rule, i.e., the rule that lower-ranking creditors or, more generally, claim-holders are allowed to receive any value only if higher-ranking claim-holders have been paid in full (more creditor protection). Other criteria that have been suggested are the existence of a set-off in insolvency, the protection of security interests, the existence of the trust as a legal device, the marketability of contracts, and the tracing of tainted money[48]—every single one of these criteria is meant to indicate a stronger creditor orientation. While most of these criteria make intuitive sense, others appear to be more idiosyncratic such as the existence of the trust, which is unknown in civil law jurisdictions without it being obvious that these jurisdictions therefore necessarily are less creditor oriented. Clearly for econometric studies such as those mentioned above, a less heterogeneous proxy needs to be constructed, and in

[47] See, for example, Rainer Haselmann, Katharina Pistor & Vikrant Vig, "How Law Affects Lending", 23 Rev. Fin. Stud. 549 (2010).

[48] Wood, *supra* note 8, at 56.

fact it was constructed ("creditor rights index"),[49] without doing away with the controversies about the appropriateness of the chosen index for its specific purpose.[50]

As with a categorization of jurisdictions as being more or less inclined to follow economic logic in the design of their insolvency laws, one can also categorize jurisdictions as being more or less creditor or debtor oriented (based on any of the metrics mentioned above). This would lead to Germany and England being representative of a fairly strong creditor-orientation policy, whereas France counts as strongly debtor oriented, with the US being positioned somewhere in the middle. The above-mentioned heuristic value of such a categorization or classification exists, but it is limited.[51] To begin with, it obviously makes a significant difference whether creditor orientation is about the interests and rights of secured creditors or whether one is talking about the interests and rights of unsecured creditors. Most metrics or schemes simply assume that, in principle, secured credit should receive priority in insolvency—an assumption that is far from uncontroversial (see section 6 *infra*). Moreover, a classification or categorization of an insolvency regime as creditor or debtor oriented neglects the importance of ownership, debt, and governance structures in a particular jurisdiction for the design of its insolvency laws.[52] For example, concentrated debt structures—such as exist in jurisdictions where the majority of debt is held by a few large commercial banks—facilitate workouts, i.e., out-of-court restructurings: the free-rider problem associated with holdouts is less acute in such jurisdictions, and negotiations amongst creditors proceed with greater ease and efficiency compared to jurisdictions in which most corporate debt is held by

[49] Rafael La Porta et al., "Law and Finance", 106 J. Pol. Econ. 1113, 1134 et seq. (1998).

[50] See, for example, Matthias Siems, "What Does Not work in Comparing Securities Laws: A Critique on La Porta et al.'s Methodology", 16 ICCLR 300 (2005).

[51] For a critique, see Kraakman et al., *supra* note 2, at 147–51.

[52] See Kraakman et al., *supra* note 2, at 147–51; Sefa Franken, "Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited", 5 Eur. Bus. Org. L. Rev. 645 (2004).

dispersed bondholders. Hence, in a jurisdiction with concentrated debt structures, there is less need for a debtor-friendly reorganization procedure. By contrast, fragmented and dispersed debt ownership calls for a statutory and debtor-friendly reorganization procedure that supports ex post efficiency in the restructuring of a financially distressed corporate debtor. To conclude, statements with respect to the creditor or debtor orientation of a particular jurisdiction need to be put in context, i.e., adjusted for the ownership, debt, and governance structures in the respective jurisdiction.

4 OPENING OF INSOLVENCY PROCEEDINGS

When should statutory insolvency proceedings with respect to a corporate debtor be opened? "The Initiation Problem in Bankruptcy"[53] is certainly one of the most important insolvency policy questions that every jurisdiction has to answer in one way or another. Based on economic reasoning, the answer to this question seems straightforward: insolvency proceedings should be opened in case of financial failure of a company. More formally, the test is $V = \max(Vgc, Vl) < L$, where V stands for the greater of the going concern value and the liquidation value of the company and L for its liabilities. In essence this means that insolvency proceedings should be initiated once whatever value is left in the firm is less than the firm's liabilities to its creditors. This does not mean that the firm should be shut down. The latter question, i.e., economic failure, is defined by the following condition: $Vgc < Vl$. A firm should be shut down if its going concern value is lower than its liquidation value.

In reality, it can be very difficult to determine whether $V = \max(Vgc, Vl) < L$ holds. Whereas it usually will be relatively straightforward to determine L, both the liquidation value of the firm (Vl) and especially its going concern value (Vgc) may be hard to estimate, let alone to quantify precisely. Hence, for practical purposes, a proxy for financial failure as defined above is needed. Most jurisdictions worldwide use some form of liquidity test: a firm

[53] Baird, *supra* note 9. See also Bachmann et al., *supra* note 2, at 149 et seq.

that is not able to pay all its debts as they fall due must file for insolvency. Usually, illiquidity in this sense will occur after a firm fails financially based on the V < L test. This is so because even firms whose asset value is lower than its debts may still be able to obtain credit, given information asymmetries, and hence still be liquid.

Initiating insolvency proceedings only once a firm fails financially (on either test) may be too late for two reasons. First, it ignores the effect of backward induction and the incentives thereby created for the firm's creditors.[54] If creditors anticipate that a firm will fail financially the day after tomorrow, they all have an incentive to enforce their claims tomorrow, and they all know this. If they all know that everybody will take enforcement action tomorrow, they all have an incentive to do this today, and that is what is going to happen. So backward induction "backdates" the common pool problem. Second, creditors' interests are already endangered before financial failure of a corporation. Once the equity position of a corporation deteriorates, shareholders and managers have an incentive to engage in risk shifting, i.e., in initiating risky projects that might even have a negative net present value (see section 3.3.1 *supra*). It is difficult to draw a precise lesson from these two complicating factors for the design of laws on the initiation of corporate insolvency proceedings. The only thing that can be said with certainty is that both backward induction by creditors and risk shifting by shareholders/managers may need to be addressed by insolvency-type rules that apply before a firm is technically financially insolvent.

Different jurisdictions approach the "Initiation Problem" very differently. In the US, for example, the regulatory strategy was, and still is, primarily based on rewarding shareholders/managers for filing early. Central features of (the practice of) Chapter 11, such as the "debtor in possession," the "exclusivity period" for the debtor to propose a

[54] Eidenmüller, *supra* note 34, at 242 et seq.

reorganization plan, the automatic stay, and violations of the absolute priority rule,[55] are best explained as carrots for the incumbent shareholders/managers to use the statutory reorganization procedure as a tool to get a distressed company back on track. The English and the French approaches differ significantly. Both jurisdictions rely on sticks rather than carrots to secure a timely filing. In England, section 214 of the Insolvency Act 1986 imposes unlimited personal liability ("make such contribution (if any) to the company's assets as the court thinks proper") for "wrongful trading" on a director of a company that went into insolvent liquidation, if he or she "knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation" and did not take "every step with a view to minimizing the potential loss to the company's creditors."[56] This statutory liability is flanked by a similar liability at common law.[57] In addition, "misbehaving" directors face potentially stiff sanctions under disqualification rules.[58] The French liability regime is similar to the English one. Art. L.651-2, sentence 1 of the Code de commerce ("action en comblement de l'insuffisance d'actif") reads as follows:

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[55] Eidenmüller, *supra* note 34, at 246 note 13 with further references.

[56] However, directors will not be held liable despite having failed to take every step to minimize losses to creditors if the company does not suffer a net deficiency as a result of the wrongful trading, *Grant & Anor v. Ralls & Ors (re Ralls Builders Ltd)* [2016] EWHC 243 (Ch), Snowden J. 16 February 2016.

[57] *West Mercia Safetywear Ltd v. Dodd* [1988] BCLC 250. For fiduciary duties of managers vis-à-vis the firm's creditors in the vicinity of insolvency in the US, see *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 1991); *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004); *Trenwick America Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006); *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169 (Del. Ch. 2006); *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A. 2d 92 (Del. 2007).

[58] Pursuant to section 6 of the Company Directors Disqualification Act 1986, directors of insolvent companies who are deemed "unfit" to act as directors can be disqualified for a minimum of two, and a maximum of 15, years.

> Where the judicial liquidation proceedings of a legal entity reveals an excess of liabilities over assets, the court may, in instances where management fault has contributed to the excess of liabilities over assets, decide that the debts of the legal entity will be borne, in whole or in part, by all or some of the de jure or de facto managers, or by some of them who have contributed to the management fault.[59]

In Germany, neither effective sticks nor sufficiently attractive carrots are currently in place to secure a timely filing. Managers face criminal and tort liability if they fail to file within three weeks *after* cash flow or balance sheet insolvency of a corporation (section 15a Insolvenzordnung, section 823 Bürgerliches Gesetzbuch). They are also liable vis-à-vis the corporation for payments made after that point in time (sections 64 GmbH-Gesetz, 92 para. 2 Aktiengesetz). Hence, it is only upon acute financial distress of a corporation that managers are required to take action.[60] In 2012, the German lawmaker tried to improve the situation by introducing a reformed DIP procedure which provides the debtor with a "protective regime" of three months during which creditors' enforcement action is stayed and the debtor is able to conceptualize and propose a reorganization plan (sections 270, 270a, 270b, 270c Insolvenzordnung). However, unlike in the US, the debtor may resort to this regime only after the firm is already balance sheet insolvent or there is a serious threat (likelihood > 50%) of a cash flow insolvency within the foreseeable future, i.e., the next months. This may be too late for the initiation of a successful restructuring operation.

The significant diversity of rules that seek to secure a timely initiation of insolvency proceedings in Europe and beyond gives rise to the question of whether some form of

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[59] The English translation is taken from https://www.legifrance.gouv.fr/Traductions/en-English/Legifrance-translations (last visited February 23, 2018).

[60] According to sections 64 GmbH-Gesetz, 92 para. 2 Aktiengesetz, managers also face a fault-based liability for payments to shareholders that directly caused the insolvency of the corporation. However, these provisions have only a very limited practical relevance as the insolvency administrator will usually find it extremely difficult to prove such an effect of a payment that was made.

harmonization might be beneficial. The case for such harmonization rests on forum shopping by firms in the vicinity of insolvency. Imagine an English company whose directors would face liability under section 214 of the Insolvency Act 1986 were they to put the company in an English insolvency proceeding. They decide to move the "Centre of Main Interests"[61] (COMI) of the company from England to Germany and file for insolvency in Germany. Moving a firm's COMI from one jurisdiction to another is costly, but it can be done (it is less costly within Europe than, say, from England to the US).[62] Under German insolvency laws, they are free from liability as long as they stay within the three-week period mentioned above.[63] Hence, they can escape liability in England by shifting the firm's COMI to

[61] Under the European Insolvency Regulation (EIR), this is the criterion for jurisdiction to open a "main insolvency proceeding" which has, in principle, worldwide effect (Article 3 EIR).

[62] The recast EIR does not change this. It only tries to limit opportunistic COMI moves on the eve of bankruptcy by limiting the scope of the presumption that the COMI is where the place of the registered office of the company is. Article 3(1) EIR now reads as follows: "In the case of a company or legal person, the place of the registered office shall be presumed to be the centre of its main interests in the absence of proof to the contrary. That presumption shall only apply if the registered office has not been moved to another Member State within the three-month period prior to the request for the opening of insolvency proceedings." Moreover, this provision does not affect the most "dangerous" of all COMI shifts, namely those that are factual only and not accompanied by a move of the registered office. These are detrimental to the company's creditors in particular because moving the registered office usually is done under the regime set up by the tenth company law directive on cross-border mergers (Directive 2005/56/EC of 26 October 2005) which contains safeguards for creditors and employees.

[63] On the issue of characterizing which laws are insolvency laws for the purposes of Article 4 EIR see CJEU, Case C-594/14 (*Kornhaas*), Judgment of 10 December 2015.

Germany. Against this background, a uniform European wrongful trading rule appears to be sensible, and it would also be within the competence of the EU to enact it.[64]

5 GOVERNANCE OF INSOLVENCY PROCEEDINGS

Once corporate insolvency proceedings are initiated, a governance mechanism must be put in place—"insolvency governance" substitutes "corporate governance." However, as mentioned in section 1, the divide between these two spheres of law and academic discipline is less pronounced once one conceives of insolvency law as "corporate governance under financial distress." To some extent, corporate law already caters for creditors. Just think about the European rules on legal capital, i.e., the regime established by the second company law directive on minimum capital (for certain corporations), capital maintenance, and actions to be taken upon a serious loss of capital.[65] Agency theory can be used to understand the regulatory problems and develop potential policy responses both with respect to financially healthy and financially distressed corporations. What is true, though, is that insolvency does not only exacerbate existing agency conflicts. The conflicts of interests also change, and new actors and interested parties come on to the stage: in addition to the debtor (shareholders/managers) and its creditors, insolvency courts—alongside general private law courts or specialized corporate courts— insolvency practitioners, and new institutions or agencies of the state/government—looking into, for example, tax, welfare, or environmental matters—become relevant actors, performing specific roles.

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[64] See Eidenmüller, *supra* note 34, at 251 et seq. This proposal was suggested originally by the High Level Group of Company Law Experts, A Modern Regulatory Framework for Company Law in Europe, 2002, 68–69, available at http://www.ecgi.org/publications/documents/report_en.pdf.

[65] Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 (recast), OJ of the EU of 14 November 2012, L 315/74.

Who sits "in the driver's seat" in various jurisdictions? Again, jurisdictions worldwide differ significantly in the governance mechanisms employed.[66] Mirroring an earlier categorization or classification of different jurisdictions being more or less creditor or debtor oriented, creditors enjoy a very strong position both in England and in Germany. This holds true for the various (insolvency) proceedings in England, especially for the CVA and the SoA, which do not involve an insolvency administrator/receiver, but also, albeit to a somewhat lesser degree, for the German Insolvenzordnung under which the appointment of at least a supervisor is mandatory if no insolvency administrator is installed. Such a supervisor functions as a controller for significant transactions but also as a mediator between the interests of all other stakeholders. Both in England and in Germany, the insolvency courts are of course in the picture, too. However, they don't actively "manage" the case but rather function as an arbiter that makes sure that fundamental procedural rules and rights are observed.

By contrast in the US, the debtor typically sits "in the driver's seat." This was certainly the case before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 curbed some of the debtor's rights and privileges in Chapter 11,[67] but it is still true today, albeit to a somewhat lesser degree. In France, it is the bankruptcy courts that hold a strong governance position. It was already mentioned that in a Redressement judiciaire, for

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[66] See, for example, Westbrook et al., *supra* note 8, at 74–83, 203–25; Douglas G. Baird & Robert K. Rasmussen, "Antibankruptcy", 119 Yale L. J. 648 (2010). On the importance of corporate ownership structures for issues of bankruptcy governance see John Armour, Brian Cheffins & David Skeel, "Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom", 55 Vand. L. Rev. 1699 (2002).

[67] For example, the 2005 Act imposes mandatory plan filing and confirmation deadlines on small business debtors, see McCormack, *supra* note 8, at 109.

example, the competent court can always decide on the closure or sale of distressed business—regardless of the business' economic viability (section 3.3.2 *supra*).

As a matter of first principles, there is much to be said in favor of a strong governance role of the firm's creditors in an insolvency proceeding. As the new residual claimants to the firm's assets, their money is at stake, so they have appropriate incentives to take economically rational decisions. However, not all creditors are alike, of course. Fully secured creditors may press for a premature liquidation even in cases where the company is not economically distressed, i.e., its going concern value exceeds its liquidation value. Conversely, creditors who are completely out of the money will push for a continuation of the business even where this would be unjustified economically. Hence, designing an appropriate "creditor governance mechanism" must ensure that creditors' control and decision rights are channeled toward value-maximizing decisions—by establishing appropriate procedural controls (by the competent courts), for example.

Putting creditors in the driver's seat does not imply that the debtor should be completely disempowered. The debtor's managers and, with respect to closed corporations, its shareholders will usually have a significant comparative informational advantage with respect to the debtor's economic and financial health. This can best be "exploited" for the timely initiation of insolvency proceedings if the debtor's managers and its shareholders are rewarded by retaining some control over the firm's management by a debtor in possession-like proceeding, and possibly also can expect to receive some equity value in the firm that is to be restructured. However, here again biases need to be controlled: as with out-of-the-money creditors, shareholders have a strong continuation bias even where a financially distressed firm should be liquidated because it suffers from economic failure.

Do courts have the information, expertise and incentives to play an active governance role that goes beyond arbitrating between competing stakeholders' interests and making sure

that fundamental (procedural) rights are observed? Most scholars would probably doubt the courts' competence to perform such a role on all three counts mentioned (information, expertise, and incentives) and hence be very critical of the very active, managerial role assumed by the French courts in a Redressement judiciaire, for example. However, there is some evidence that courts may do a better governance job than one could and would expect. In a study on Chapter 11 bankruptcies, it appeared that judges do not suffer from a continuation bias and that they are able and competent to filter correctly economically distressed from healthy firms and to do so quickly.[68] One probably needs to distinguish between judges in various jurisdictions, their training, expertise and also powers and "goal function" as established by the insolvency rules in place.

An illustrative example of the governance problems raised in insolvency proceedings is offered by going concern sales as a substitute for restructuring proceedings. Such going concern sales seem to offer the possibility of preserving a viable business as a going concern while avoiding the duration and costs involved with developing, negotiating, and confirming a restructuring plan. At the same time, markets for distressed firms often are thin—if they exist at all—and insiders have a strong interest to acquire whatever value is left in the firm at as low a price as possible (see in detail section 8.5.1 *infra*).

6 RANKING OF CLAIMS AND POSITION OF SECURED CREDITORS

One of the most important questions in the design of (corporate) insolvency procedures is the ranking of claims in general and the position of secured creditors in particular.[69] Jurisdictions worldwide differ significantly in their approach to this question, not least because it is perceived to involve highly "political" judgments, and the scholarly work, if it exists, does

[68] Edward R. Morrison, "Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies", 50 J. L. & Econ. 381 (2007).

[69] For a general analysis see Douglas G. Baird, "The Importance of Priority", 82 Cornell L. Rev. 1420 (1997).

not provide clear guidance. It is not surprising, then, that harmonization efforts in this area face significant challenges.

6.1 Approaches of Different Jurisdictions

If one makes a very stylized distinction between different types of claims, one can differentiate between administrative expenses (AE), secured creditors (SC), and unsecured creditors (UNSC). The latter include tax claims, wages and pensions, and shareholder loans. Based on these three categories, the ranking of different types of claims in England, the US, France, and Germany is remarkably different (see Table 38.1).[70]

The simplest ranking system appears to be the German one: secured creditors come first, followed by administrative expenses and all unsecured creditors. The English system varies this ordering in two important respects: first, floating charges have a lower ranking compared to fixed charges; second, certain unsecured creditors, including wage claims and unpaid pension contributions, receive a preferential treatment compared to general unsecured creditors. The differentiation between various types of unsecured creditors is also reflected in the US and the French system, with preferred unsecured creditors ranking highest in France—they top all other types of claims, even secured creditors.

Table 38.1

Ranking of Different Types of Claims

	England	US	France	Germany
1	SC (fixed charges)	SC (but see § 364 BC for post-commencement financing)	Pref. UNSC (certain taxes, wages/benefits)	SC
2	AE	AE	AE	AE

[70] The following representation is based on Wood, *supra* note 8, at 253 et seq. It takes account of later changes in the law.

3	Pref. UNSC (including certain wages, unpaid pension contributions)	Pref. UNSC (including certain wages, unpaid pension contributions, taxes)	SC	UNSC
4	Up to £600,000 for General UNSC	General UNSC	General UNSC	
5	SC (floating charges)			
6	General UNSC (including taxes)			

6.2 Secured Creditors

The treatment of secured creditors in insolvency proceedings has a significant effect on lending practice. One would assume that the higher the ranking of secured creditors in insolvency proceedings is, the cheaper credit will be for debtors, and the higher debt levels/lending volume will be in a particular jurisdiction. This is exactly what is confirmed by the available evidence: Using a sample of small firms that defaulted on their bank debt in France, Germany, and the UK, Davydenko and Franks found that large differences in creditors' rights across countries lead banks to adjust their lending and reorganization practices to mitigate costly aspects of bankruptcy law. In particular, they found that French banks respond to a code that is "unfriendly" to secured creditors by requiring more collateral than lenders elsewhere, and by relying on forms of collateral that minimize the statutory dilution of their claims in bankruptcy.[71]

These effects say something about the empirical importance of how secured creditors in particular are treated in insolvency proceedings. A very different matter is whether according secured creditors full priority in insolvency proceedings is a defendable policy choice. This is a normative question, and it is one of the most controversial ones in the scholarly and political debate about the design of (corporate) insolvency proceedings.

[71] Sergei A. Davydenko & Julian R. Franks, "Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the U.K.", 63 J. Fin. 565 (2008).

LoPucki once put the problem succinctly by stating that "Security is an agreement between A and B that C take nothing."[72] As between A (creditor) and B (debtor), security clearly has efficiency benefits: it lowers A's monitoring, enforcement, and risk costs, and it protects A against opportunistic business policies that would require B to use the pledged collateral. However, these efficiency benefits come at a cost to C if C cannot adjust to the transaction between A and B: the total asset pool available for the other creditors shrinks, and correspondingly their expected recovery prospects are reduced as well. C might not be able to adjust to the transaction between A and B either because C is an involuntary creditor such as a tort creditor, because C finds it not worth the effort given the size of his claim, or because he lacks the skill or bargaining power to push B to agree to a contractual regime that would effectively protect his interest.[73] Do the efficiency benefits of secured credit in the relationship between A and B outweigh the costs imposed on C? This is an empirical question, and some evidence suggests that in fact they do.[74] Hence, according secured

[72] Lynn M. LoPucki, "The Unsecured Creditor's Bargain", 80 Va. L. Rev. 1887, 1899 (1994).

[73] Using the terminology of Bebchuk and Fried, in the latter two alternatives C can be called a "non-adjusting" creditor. See Lucian A. Bebchuk & Jesse M. Fried, "The Uneasy Case for the Priority of Secured Claims in Bankruptcy", 105 Yale L. J. 857 (1996); Lucian A. Bebchuk & Jesse M. Fried, "The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics", 82 Cornell L. Rev. 1279 (1997).

[74] See John Armour, "The Law and Economics Debate About Secured Lending: Lessons for European Lawmaking?", 5 Eur. Comp. & Fin. L. Rev. 3 (2008); Yair Listokin, "Is Secured Debt Used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis", 57 Duke L. J. 1037 (2008) ("high-tort firms" have unusually low amounts of secured debt).

creditors (full) priority in insolvency proceedings appears to be a defendable policy choice in principle.[75]

Even if, in principle, secured creditors are given this priority position, the question arises of whether certain limits may be justified vis-à-vis all other creditors and the debtor. It is easy to see that the immediate realization of a secured claim upon the opening of an insolvency proceeding may have detrimental effects on the going concern value of a distressed firm. Consider, for example, a machine that is crucial for running a production process in a business. If the financing bank were allowed to take it away and sell it on the market to realize its claim, restructuring prospects for the firm would be greatly reduced or even eliminated. Hence, imposing a stay on enforcement actions also with respect to secured creditors, as many jurisdictions do,[76] makes sense. However, jurisdictions differ in the protection granted to secured creditors on whom such a stay is imposed. The US Supreme Court once held that § 362(d)(1) of the Bankruptcy Code does not afford protection in the form of interest for the deferred realization of the encumbered asset with respect to undersecured creditors.[77] The converse holds true under section 169 of the German Insolvenzordnung.

6.3 Administrative Expenses

The rationale for putting administrative expenses—such as court fees or fees for an insolvency administrator—before general unsecured creditors is straightforward: as a collective proceeding that aims to solve a multi-party prisoners' dilemma, an insolvency

[75] See Horst Eidenmüller, Secured Creditors in Insolvency Proceedings, in The Future of Secured Credit in Europe 273–83 (Horst Eidenmüller & Eva-Maria Kieninger eds., 2008), for a summary of the debate.

[76] See 11 U.S.C. § 362 in the US; Insolvency Act 1986 Schedule B1 para. 43 in England; Art. L.622-21 of the French Code de commerce, and sections 107 and 166 of the German Insolvenzordnung.

[77] *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd*., 484 US 365.

proceeding is run for the benefit of the unsecured creditors' collective. A more difficult question is whether contributions of the secured creditors to the administrative expenses are justified as well. A case can be made for such contributions if it can be shown that secured creditors, too, benefit from a collective proceeding or that certain costs can be attributed to them, for example costs of identifying collateral and realizing its value. Section 171 of the German Insolvenzordnung, for example, forces secured creditors to contribute as much as 4% of the collateral value as sorting costs, 5% as realization costs, and, if applicable, 19% VAT, i.e., a total of 28% of the collateral value. Based on the above-stated considerations, this appears to be justifiable. Against this background, secured creditors have an incentive to "oversecure" their claim, and German law allows them to do this within certain limits.[78]

6.4 Unsecured Creditors

No apparent efficiency rationale exists why certain unsecured creditors, for example tax, wage, and pension claims, should be given priority over the claims of other, general unsecured creditors. It is rather fairness or distributional concerns that are instrumental in this regard, as with the wage or pension claims of workers, or the clout that certain stakeholders have in the political process, as with claims of tax authorities, i.e., the state.

An interesting and important case for the design of corporate insolvency laws in particular is the ranking of shareholder loans vis-à-vis other unsecured creditors. Debt finance by shareholders is an important source of financing for closed corporations or in group structures in particular. It is driven primarily by tax considerations. Some jurisdictions subordinate shareholder loans relative to the claims of other unsecured creditors. This is the case, for example, according to section 39 para. 1 no. 5 of the German Insolvenzordnung. In

[78] See Christian Tetzlaff, Commentary on section 170 Insolvenzordnung, in Münchener Kommentar zur Insolvenzordnung Band 2 section 170 margin nos. 35 et seq. (Hans-Peter Kirchhof, Horst Eidenmüller, & Rolf Stürner eds., 2013).

the US, 11 U.S.C. § 510(c)(1) gives the bankruptcy court discretion to subordinate claims (equitable subordination).[79] By contrast, English law treats claims arising from shareholder loans *pari passu* with other unsecured claims, as does French law.[80]

It is relatively easy to come up with a justification for provisions that subject payments on shareholder loans to the avoidance provisions of an insolvency code (within certain time limits): shareholders are insiders, and they may enrich themselves to the detriment of other creditors by such payments in the vicinity of insolvency.[81] However, it is much more difficult to identify a convincing rationale for subordination rules if no such payments have taken place. Clearly, a subordination rule discourages debt financing by shareholders if the company is in financial distress, and the shareholders may be the only available financing source in such a setting. As a consequence, the prospects for a restructuring of the firm might be greatly reduced. On the other hand, one can argue that distressed firms might (ab)use funds made available by shareholder loans to "gamble for resurrection," further diluting existing claims of outside creditors. This is a serious concern. At the same time, it would appear that a liability rule for wrongful trading addresses this concern more directly and efficiently than a rule that subordinates all shareholder loans—whatever their purpose. The one remaining advantage of such a subordination rule might then lie in the lower-risk costs imposed on shareholders/managers compared to a liability regime: the loss from the shareholders' perspective is limited to the amount of the loan under a subordination regime, whereas they face a potentially unlimited personal liability under a liability regime.

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[79] On this discretionary power see, for example, Charles Tabb, The Law of Bankruptcy 527 et seq. (1997).

[80] See Horst Eidenmüller, Gesellschafterdarlehen in der Insolvenz, in Festschrift für Claus-Wilhelm Canaris zum 70. Geburtstag Band II 49, 53 et seq. (Andreas Heldrich et al. eds., 2007).

[81] Eidenmüller, *supra* note 80, at 61 et seq.

7 CONTRACTING FOR ASSETS OF THE DEBTOR

Given the statutory ranking of claims in an insolvency proceeding, creditors have an incentive to try and contract for a better position than that accorded to them by the statutory ranking. In principle, such contractual arrangements appear problematic as they are aimed at upsetting the statutory order. At the same time, creditors can legitimately contract for security and, hence, improve their ranking compared to having an unsecured position. So why not allow them to modify their statutory ranking in other ways?

A good illustration of the problem is the so-called "flip clause" that was the subject of litigation in the US and the UK in the aftermaths of the latest financial and economic crisis. The issue arose in the context of the Lehman bankruptcy. In essence, the flip clause stipulates that upon A's bankruptcy, a charge held by A over certain of B's assets would flip to certain of A's creditors. This results in these creditors gaining an advantage over A's other creditors: an asset that would have been available to *all* of A's creditors has now been carved out of the asset pool and is available only to *some* of them.

In the US, 11 U.S.C. § 365(e)(1) stipulates that executory contracts may not be terminated or modified as a result of a contractual provision which purports to permit such termination or modification conditioned on the insolvency of the debtor. According to § 541(c)(1)(B), an interest of the debtor in property becomes property of the estate notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law that is conditioned on the insolvency or financial condition of the debtor and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property. These provisions invalidate so-called ipso facto clauses,[82] and it

[82] Ipso facto clauses are clauses which purport to set out the consequences of bankruptcy on an agreement (e.g., automatic termination of a lease).

has been held that the flip clause amounted to just that.[83] Further, the clause was judged to violate the automatic stay.[84]

The English courts came to a different conclusion. The litigation in the UK centered around the common law "anti-deprivation principle," which aims to prevent arrangements—operating upon bankruptcy—which withdraw from the insolvent estate assets which would be otherwise available to the debtor's creditors.[85] The rationale of the principle originally was to prevent "false" ownership of assets and a deception of creditors.[86] Later on, the policy of preventing contracting out of bankruptcy became an issue as well, but there are other ways to contract out of bankruptcy not affected by the principle, such as creating a charge or contractually subordinating a claim.[87]

In *Belmont Park*, the UK Supreme Court held that a good faith transaction without the purpose of circumventing bankruptcy rules does not violate the anti-deprivation principle.[88] So the crucial test appears to be whether there is a "valid commercial reason" for the transaction or whether the only ("real") purpose is to circumvent bankruptcy rules.[89] Such a valid commercial reason was found to be present in *Belmont Park* and, accordingly, the transaction was upheld.

However, distinguishing cases based on the (non-)existence of valid commercial reasons for the transaction in question appears to obfuscate the real issue. If an insolvency

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[83] *In re Lehman Bros. Holdings Inc*., 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

[84] Id.

[85] See *Belmont Park Investments Pty Ltd and others v. BNY Corporate Trustee Services Ltd and another*, [2011] UKSC 38 at [1] and at [2]–[3] for references to further authorities.

[86] See Gabriel Moss, "Should British Eagle Be Extinct?", 24 Insolv. Int. 49 (2011).

[87] Id.

[88] *Belmont Park*, *supra* note 85, at [102] et seq.

[89] See *Belmont Park*, *supra* note 85, at [74]–[83] and [108]–[109].

system creates a mandatory statutory order with respect to the ranking of claims, *any* private arrangement that has the *effect* of upsetting or modifying the order must be judged to be impermissible. It simply does not matter whether it is a good faith transaction that was undertaken with other (legitimate) motives (also) in mind. The policy underlying the mandatory statutory ordering system overrides any "legitimate" commercial goal that the parties to the transaction wish to pursue. The only permissible contractual arrangement is for parties to agree to a priority position as defined by the statute, for example by creating a security right.[90]

8 RESCUE PROCEEDINGS

A central feature of modern corporate insolvency systems are rescue proceedings. These are proceedings that aim at restructuring the financially (and possibly also economically) distressed firm and putting it back on track financially (and possibly also economically). Various types of rescue proceedings exist in the US, England, France, and Germany.

8.1 Types of Proceedings

One way to classify or categorize these proceedings is to distinguish between "structured bargaining" procedures that involve negotiations over a restructuring plan and procedures

[90] The flip clause did not give rise to litigation in Germany. If it had, there is little doubt that according to section 81 para. 1 of the Insolvenzordnung, the clause would have been held to be invalid. According to this provision, rights in objects forming part of the insolvency estate cannot be acquired with legal effect after the opening of the insolvency proceedings even if such acquisition of rights is not based on the debtor's transfer or effected by way of execution. For a comparison of section 81 para. 1 of the Insolvenzordnung and the anti-deprivation principle see Reinhard Bork & Martin Voelker, "§ 91 InsO und die Anti-Deprivation Rule—ein Rechtsvergleich", 74 KTS 235 (2013).

that do not involve such negotiations.[91] Another differentiating feature is whether the procedure allows dissenting creditors to be bound by a restructuring plan or not. Chapter 11 of the Bankruptcy Code in the US, Company Voluntary Arrangements and Schemes of Arrangements under English law, the French Procédure de sauvegarde, and the Insolvenzplanverfahren according to sections 217 et seq. of the German Insolvenzordnung are structured bargaining procedures, and they also allow dissenting creditors to be bound. The French Redressement judiciaire allows dissenting creditors to be bound (but is not a structured bargaining procedure), the French Procédure de conciliation is a structured bargaining procedure (but does not allow dissenting creditors to be bound), and the English Administration is neither a structured bargaining procedure nor does it allow dissenting creditors to be bound (but it may be used as a restructuring tool).

Within the category of structured bargaining procedures, a further distinction can be drawn between systems that provide for a segmentation of creditors into classes with each class voting on the restructuring plan (followed by court approval)—this is the case, for example, with respect to Chapter 11, the Scheme of Arrangement, and the Insolvenzplanverfahren—and systems that do not provide for such a segmentation as, for example, the Company Voluntary Arrangement. Conducting bargaining and voting within classes enhances the legitimacy of the process as the likelihood of voting results that reflect the interests of similarly situated creditors increases. At the same time, the process becomes more cumbersome, and therefore costly. If time is of the essence, as it is with respect to the restructuring of financial institutions, for example, one would rather not want to use a

[91] On the former see, for example, Baird, *supra* note 12, chapter 11; Jennifer Payne, "Debt Restructuring in English Law: Lessons from the US and the Need for Reform", 120 Law Quarterly Review 282 (2014); McCormack, *supra* note 8, chapter 8; Westbrook et al., *supra* note 8, at 121–64.

structured bargaining process with creditors voting in classes (if one wanted to use an "ordinary" bankruptcy procedure at all).

8.2 The Position of Shareholders

Structured bargaining procedures with voting by classes often provide that the incumbent shareholders of the corporation form one or more of the various classes, i.e., they are "part of the plan," and their interests can be affected by it. This makes sense conceptually, as a corporation's shareholders, in a situation of financial distress, have the lowest ranking claim on the corporation's assets, i.e., they are "sub-subordinated."[92] This is how shareholders are treated, for example, in a Chapter 11 process (11 U.S.C. § 1123(a)(1)) and in an Insolvenzplanverfahren according to the German Insolvenzordnung (sections 217, 225a) since 2002.[93]

Integrating the shareholders into the structured bargaining and voting process allows debt to equity swaps to be part of a restructuring plan. Such swaps are an important element of restructuring practice. They reduce debt levels and interest payments, improving the balance sheet and liquidity position of a distressed firm. If they could not be implemented in a restructuring plan against the will of the incumbent shareholders as well, these shareholders could use their legal position to extract rents from the creditors—which is not justified. However, the prospect of being "expropriated" in an insolvency procedure by virtue of a debt to equity swap might lead the shareholders to delay the filing of an insolvency petition—which is not in the interest of the creditors. On the other hand, debt to equity swaps are a tool

[92] Horst Eidenmüller & Andreas Engert, "Reformperspektiven einer Umwandlung von Fremd- in Eigenkapital (Debt-Equity Swap) im Insolvenzplanverfahren", 30 Zeitschrift für Wirtschaftsrecht (ZIP) 541 (2009).

[93] See Horst Eidenmüller, Commentary on section 225a Insolvenzordnung, in Münchener Kommentar zur Insolvenzordnung Band 3 section 225a margin nos. 1 et seq. (Hans-Peter Kirchhof, Horst Eidenmüller, & Rolf Stürner eds., 2014).

that is usually employed more with respect to large public corporations, and in these managers enjoy more independence vis-à-vis the shareholders—also with respect to the filing decision—than in small closed corporations.

8.3 Cram Down Power of Courts

Structured bargaining procedures with class-wise voting differ with respect to the majority requirements that must be met if the plan is to be approved by the competent court. In the US, for example, a plan must, in principle, be accepted by each impaired class (11 U.S.C. § 1129(a)(8)). However, the competent court may "cram down" the plan on a non-accepting class if the members of this class do not fare worse than in a liquidation, and lower-ranking classes receive nothing under the plan ("absolute priority rule"). A similar provision can be found in the Insolvenzplanverfahren of the German Insolvenzordnung (section 245).

One of the critical questions relating to this cram-down power centers around a potential equity stake in the reorganized enterprise for the incumbent shareholders. Sometimes it appears commercially sensible to give them such a stake, for example in order to incentivize an early filing or to make them contribute productively to the restructuring process. US courts, therefore, have recognized a "new value" exception to the absolute priority rule. If the incumbent shareholders contribute "money or money's worth" to the restructured firm, they may retain an equity stake.[94] The German rule in section 245 of the Insolvenzordnung is stricter than its US counterpart and does not allow for a similar exception.

8.4 Financing Rescue Proceedings

[94] The promise of future labor was held not to be "money or money's worth," *Norwest Bank Worthington v. Ahlers*, 485 US 197 (1988).

Critically important for the success of a rescue proceeding is the issue of financing.[95] The firm entering an insolvency proceeding will usually be (extremely) cash short, making continuation and restructuring of the enterprise a difficult task that requires "fresh money." If no further security is available for a potential lender, no loan might be forthcoming and restructuring may be made impossible. Hence, many jurisdictions have provisions granting "superpriority" to financiers of restructuring proceedings under certain circumstances. This is the case, for example, with respect to a Chapter 11 proceeding. 11 U.S.C. § 364(d) permits the use of already encumbered assets as security for new loans provided that adequate protection is given to existing (secured) lenders. Superpriority loans are also possible in France[96] (but not vis-à-vis employee claims) but not in England[97] or in Germany.[98]

It is clear that superpriority provisions not only facilitate the financing of rescue proceedings. They also have a significant governance impact. The debtor in possession financier usually will condition lending on being granted important "governance rights"—for example, via loan covenants—on top of a superpriority before providing "fresh money." Baird and Rasmussen once put it succinctly as follows: "The board may be in the saddle, but

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[95] See McCormack, *supra* note 8, chapter 6; David Skeel, "The Past, Present and Future of Debtor-in-Possession Financing", 25 Cardozo L. Rev. 1905 (2004).

[96] Arts. L.611-11 and L.622-17 II of the French Code de commerce.

[97] Gerard McCormack, "Super-priority new financing and corporate rescue", J.B.L 701 (2007), notes that the Enterprise Act 2002 did not provide a legislative "superpriority" due to risk that it would grant a superpriority to all lenders irrespective of prospects of success of rescue proposals. He suggests that DIP financing will normally end up with a priority, however, if it is classed as an expense of the administration (section 19 Insolvency Act 1986 and para. 99 to Schedule B1 to the Insolvency Act 1986)—which are generally paid out of the pot of money available to the floating charge holders, as the fixed chargeholders are paid out of proceeds of realization of the assets to which they relate.

[98] Josef Parzinger, Fortführungsfinanzierung in der Insolvenz (2013), has convincingly argued that the legal position in Germany should be changed.

the whip is in the creditors' hands."[99] The clout exercised by dominant lenders is potentially problematic for various reasons: the managers negotiating the financing agreement on behalf of the firm may not have the best incentives to do so if they (are forced to) leave the firm and a new crisis management team comes in; firms might take too little risk in the restructuring process, and the dominant lenders might divert value from outside creditors with less clout but who are still in the money. The applicable insolvency regime needs to make sure that the benefits of superpriority are not outweighed by these costs.

8.5 Reform Proposals

Rescue proceedings for corporate debtors are a vibrant field for law reforms worldwide. Jurisdictions experiment with new proceedings (such as, for example, France with the Procédure de sauvegarde accélérée), or they try to improve on existing ones (such as, for example, the US with reforms of Chapter 11[100]).[101] Two "radical" proposals for corporate insolvency law reform deserve to be singled out: going concern sales as a substitute for restructuring proceedings, and "full" debt to equity swaps as a specific form of such proceedings.

8.5.1 Going Concern Sales

Restructuring proceedings are often lengthy and costly. This is especially so with respect to structured bargaining procedures with class-based voting. Hence, instead of restructuring a firm in the hands of an existing legal entity by creating a new financial structure, one can also try to salvage its going concern value by selling all its assets to another legal entity (an

[99] Douglas G. Baird & Robert K. Rasmussen, "Reply: Chapter 11 at Twilight", 56 Stan. L. Rev. 673, 699 (2003).

[100] See, for example, ABI Commission to Study the Reform of Chapter 11, 2012-2014, Final Report and Recommendations, https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h.

[101] On various alternatives to corporate bankruptcy see Adler, *supra* note 12, at 264 et seq.

investor). This entity would implement the necessary reforms of the business, having paid a purchase price for the assets out of which the firm's creditors can be paid. In order to maximize the returns to the creditors, an auction might be set up under which the investor who puts up the highest bid gets the firm's assets.

Such going concern sales were already suggested many decades ago as a viable alternative to Chapter 11,[102] and they are used by many jurisdictions' corporate insolvency regimes as one form of restructuring of a distressed firm.[103] At the same time, there are limits to this approach which reconfirm the need for a statutory restructuring proceeding directed toward the legal entity that faces financial distress. First, markets for firms do not always exist, and if they exist, they may not be very competitive and/or informationally efficient. In crisis-ridden industries, usually only a few potential buyers will be interested. These buyers will often be insiders (managers, shareholders) or competitors of the distressed firms because these are, given their industry knowledge and experience, best positioned to assess its economic prospects. At the same time, they have a strong incentive to acquire the firm as cheaply as possible, possibly at a price much lower than the value of the firm were it to be restructured in the hands of the existing legal entity. Second, asset sales sometimes do not allow the transfer of "dedicated assets" which make up a significant part of the firm's value. Such dedicated assets can come in the form of IP rights, (public) permits, or leases at favorable conditions—to give just three examples. Again, to capture the full going concern

[102] See, in particular, Douglas G. Baird, "The Uneasy Case for Corporate Reorganizations", 15 J. Leg. Stud. 127 (1986); Douglas G. Baird, "Revisiting Auctions in Chapter 11", 36 J. L. & Econ. 633 (1993). Roe has suggested to sell a 10% stake in the company as a basis to extrapolate the value of the reorganized firm, see Mark J. Roe, "Bankruptcy and Debt: A New Model for Corporate Reorganization", 83 Colum. L. Rev. 527 (1983).

[103] In Germany, for example, going concern sales can be achieved under the Insolvenzordnung either on the initiative of the insolvency administrator or as part of an Insolvenzplan.

value, the firm should be restructured in the hands of the existing legal entity in such circumstances.[104]

If a jurisdiction permits or even promotes going concern sales in insolvency proceedings, it must address the intricate governance problems raised thereby. The most fundamental of these problems is the pricing issue. More specifically, precautions must be taken to avoid sales to insiders at fire sale prices. Jurisdictions differ significantly in their approach to this problem. Under the German Insolvenzordnung, for example, creditors are involved in the sale decision (sections 160 et seq. Insolvenzordnung). A sale to insiders requires the assent (by majority decision) of the whole creditors' assembly (section 162 Insolvenzordnung). By contrast, in England and Wales, administrators have the power to carry out a pre-packaged sale without the prior approval of the creditors or the permission of the court under certain conditions, including extensive disclosure obligations (Statements of Insolvency Practice (SIP) 16). In addition, section 129 of the Small Business, Enterprise and Employment Act 2015 provides the UK Government with the power to enact legislation restricting, or imposing conditions on, administrators' powers to sell or otherwise dispose of assets to "connected persons" (such as directors of the company) in the event that the insolvency industry fails to comply with SIP 16. In comparison, the German approach places greater emphasis on ex ante controls and safeguards, and the UK approach on procedural efficiency.[105] Alternatively, or in addition to these measures, one could contemplate a fault-

[104] It may be true, as Baird and Rasmussen argue (Douglas G. Baird & Robert K. Rasmussen, "The End of Bankruptcy", 55 Stan. L. Rev. 751 (2002)), that the nature of modern firms, in particular the rise of the service sector, has reduced "dedicated assets" with respect to many (distressed) firms. However, there are still many cases where such assets play an important role with respect to firm value.

[105] For a balanced assessment of different reform proposals see John Armour, The Rise of the "Pre-Pack": Corporate Restructuring in the UK and Proposals for Reform, in Restructuring Companies in Troubled Times: Director and Creditor Perspectives 43–78 (Robert P. Austin & Fady Aoun eds., 2012).

based liability of administrators who fail to effect a sale that is in the interest of all creditors. Data on recovery rates for creditors that could help assess the merits of the respective regulatory approaches are missing.

8.5.2 Full Debt to Equity Swaps

It has already been mentioned that debt to equity swaps are an important element of modern restructuring practice (see section 8.2 *supra*). The good thing about such swaps is that they put creditors in a position in which they then all have the "correct" economic incentive to implement whatever measures maximize firm value. As creditors, they do not always have this incentive: fully secured creditors may push to liquidate the firm even if restructuring would be value-maximizing, and creditors who are out of the money will push toward a restructuring even if the firm is economically distressed and should be liquidated. It is hard to design rules on class formation and voting that make sure that such "skewed" incentives are not decisive for the outcome of the process.

As early 1988, Lucian Bebchuk suggested a radically different reorganization procedure based on a "full debt to equity swap" that would "solve" this problem and also be in line with the absolute priority rule.[106] Assume that a firm has two creditors with a claim of US$1 million each: a fully secured creditor (SC) and an unsecured creditor (UNSC). The firm has one (sole) shareholder (SH). Under Bebchuk's scheme, SC would become the sole shareholder. UNSC would get an option to acquire SC's shares at an exercise price of US$1 million. SH would get an option to acquire UNSC's option and SC's shares at an exercise price of US$2 million. This scheme preserves absolute priority. Each stakeholder would get

[106] Lucian A. Bebchuk, "A New Approach to Corporate Reorganizations", 101 Harv. L. Rev. 775 (1988). Bebchuk's scheme was adopted by Philippe Aghion, Oliver Hart & John Moore, "The Economics of Bankruptcy Reform", 8 J. L. Econ. Org. 523 (1992). See also Oliver Hart, Firms, Contracts, and Financial Structure (1995), chapter 7.

exactly what she can claim under the absolute priority rule. Whoever ends up as the sole shareholder of the firm will implement the restructuring plan that maximizes firm value.

Bebchuk's scheme is elegant and in line with fundamental principles of corporate insolvency law. At the same time, to date it has not been implemented in the real world of restructuring. The simple reason is probably that policy makers worldwide stay clear of all proposals that force all creditors to exchange their debt against an equity position. In many jurisdictions, such an involuntary swap would violate fundamental constitutional guarantees. In others, political lobbying by banks in particular prevents legislatures from moving to implement Bebchuk's scheme. If it were implemented, creditors would need to expect to find themselves in the position of a shareholder of a distressed firm whenever they extend credit to a firm with a non-trivial prospect of insolvency. This would potentially have a serious impact on their business model, and many creditors are not comfortable with that prospect. That said, however, Bebchuck's model is useful for restructuring practice because it highlights important features (and benefits) of debt for equity swaps.

9 CONTRACTUAL RESOLUTION OF FINANCIAL DISTRESS

Statutory insolvency proceedings are associated with significant direct and indirect bankruptcy costs (see section 3.3.1 *supra*). Hence, stakeholders of a financially distressed firm have a strong incentive to avoid these costs and attempt a private resolution of financial distress: the "privatization of bankruptcy" promises flexible, tailor-made, and fast solutions that come with significantly reduced bankruptcy costs.[107] Two forms of such a privatization must be distinguished: ex ante contracting about bankruptcy, and an ex post renegotiation of the firm's debt structure ("workouts").

9.1 Ex ante Contracting about Bankruptcy

[107] For a critical view see Elizabeth Warren & Jay Lawrence Westbrook, "Contracting Out of Bankruptcy: An Empirical Intervention", 118 Harv. L. Rev. 1197 (2005).

There would be no need for a statutory bankruptcy procedure if all of the firm's creditors and the firm were able to contractually agree ex ante on the procedure that would be applicable if the firm entered a—contractually specified—condition of financial distress. In reality, this is not feasible as some creditors, for example those who have a claim based on tort, do not have a contractual relationship with the firm at all. Nevertheless, scholars have designed schemes that would give contracts with individual lenders an *erga omnes* effect vis-à-vis the whole creditor community.[108] Instead of a full-blown statutory insolvency procedure, the statutory rules would then operate as a backup to legitimize certain private schemes under specified conditions.

Another, probably more realistic form of ex ante contracting about bankruptcy would be to allow firms to choose the applicable bankruptcy regime in their charter.[109] This could be done by either allowing firms to choose the bankruptcy forum—with the applicable bankruptcy law being that of the forum—or by giving firms the option to directly pick a particular bankruptcy regime out of a "menu" of different regimes provided for by the competent lawmaker. The former regime would be easier to implement—no need to agree (as between states) on the "menu" —and it also has the advantage that it directly incentivizes states to improve their domestic bankruptcy procedures and make them more competitive. Moreover, in contrast to ex post forum shopping by COMI manipulations in times of crisis, picking the forum ex ante in the corporate charter makes the choice visible to all creditors,

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[108] Alan Schwartz, "A Contract Theory Approach to Business Bankruptcy", 107 Yale L. J. 1807 (1998).

[109] Pioneering work in this field has been undertaken by Rasmussen, see Robert K. Rasmussen, "Debtor's Choice: A Menu Approach to Corporate Bankruptcy", 71 Tex. L. Rev. 51 (1992); Robert K. Rasmussen, "A New Approach to Transnational Insolvencies", 19 Mich. J. Int'l. L. 1 (1997); Robert K. Rasmussen, "Resolving Transnational Insolvencies through Private Ordering", 98 Mich. L. Rev. 2252 (2000). See also Horst Eidenmüller, "Free Choice in International Company Insolvency Law in Europe", 6 Eur. Bus. Org. L. Rev. 423 (2005).

allowing them to adjust. A critical issue with respect to this form of contracting for bankruptcy is charter amendments. These would need to be subject to a super-majority requirement. To further reduce the danger of opportunistic maneuvers on the eve of bankruptcy, a "waiting period" of a couple of months before the amendment takes effect probably also makes sense.

9.2 Ex post Renegotiation of Debt Structure

Ex ante contracting for bankruptcy regimes is still very much a scholarly enterprise, not a real-life phenomenon. By contrast, ex post renegotiation of the debt structure of a firm that finds itself in financial distress is an important fact of restructuring practice worldwide.[110] Such "workouts" face many challenges, of which the free-rider (or hold-out) problem probably is the most important one: all creditors have a common interest in a success of the restructuring process, but each individual creditor of course wants to maximize her economic benefit, i.e., reduce her contribution to the common good. This strategic incentive problem of a multi-party prisoners' dilemma is "solved" by statutory insolvency procedures that impose a stay on creditors' enforcement actions. Out of court, no such general statutory regime exists. No legal duty forces creditors and/or shareholders to cooperate in a workout.[111] Hence, workout negotiations are destabilized by the free-rider problem.

Creditors can address this issue by putting "majority voting clauses" in common debt instruments such as syndicated loans or bond indentures. Such clauses allow a majority of the creditors—based on voting rights—to agree on debt reductions even if a minority objects. Some jurisdictions are more accommodating of these clauses than others. For example, US law does not allow a reduction of the principal claim by majority decision in a bond indenture

[110] See, in general, Westbrook et al., *supra* note 8, at 165–81; Finch, *supra* note 39, chapter 7.

[111] Eidenmüller, *supra* note 34, at 254 et seq.

(15 U.S.C. § 77ppp),[112] but section 5 of the German *Schuldverschreibungsgesetz* (2009) does.

In any event, such clauses are helpful only with strategic/opportunistic actions of certain creditors that are part of a specific debt instrument. They do not address the free rider problem as between the creditor community as a whole, i.e., regarding creditors of different debt instruments. Various attempts have been made to ameliorate this problem by "soft law" tools. One of these is the so-called London Approach to out-of-court restructurings, which achieved a certain prominence with respect to the restructuring of City firms in the 1980s and 1990s.[113] Another soft regulatory instrument is the INSOL Principles for a global approach to multi-creditor workouts (2000).[114]

These instruments are helpful especially in settings with a relatively homogeneous and stable creditor community such as, for example, in cases where a firm is financed primarily by bank debt. However, debt structures worldwide have changed significantly compared to what they looked like in the City of London two or three decades ago. Bond financing has become much more widespread, also with respect to smaller firms. Debt is traded on secondary markets, and new activist investors have entered the scene, especially hedge funds and private equity funds. Credit default swaps (CDS) are available to protect against insolvency risks, changing the incentives of insured creditors or other holders of these instruments. Hence, firms today face workout scenarios where the creditors are extremely heterogeneous and deeply fragmented, have very different interests (effects of CDS, hedge

[112] For a critical view, see Mark J. Roe, "The Voting Prohibition in Bond Workouts", 97 Yale L. J. 232–79 (1987).

[113] See Eidenmüller, *supra* note 3, at 236 et seq.; John Armour & Simon Deakin, "Norms in Private Insolvency: The London Approach to the Resolution of Financial Distress", 1 J. Corp. L. Stud. 21 (2001).

[114] https://www.insol.org/pdf/Lenders.pdf. INSOL is the International Association of Restructuring, Insolvency & Bankruptcy Professionals.

funds as active investors ["loan to own"], etc.), and the composition of the creditors is permanently changing (due to debt trading). Workouts have become more difficult than a couple of decades ago.[115]

If a workout fails because of strategic maneuvers of hold-outs, one way to save at least some of the benefits of an out-of-court restructuring is a "slim statutory reorganization" procedure that is initiated only to get a restructuring plan passed by a majority vote. These types of procedures are often termed "pre-packaged bankruptcies" because most of the issues except the acceptance of the pre-negotiated plan have already been resolved before the bankruptcy petition is filed.[116] The technique of pre-packaged bankruptcies is most advanced in the US where the vote on the plan can also be taken out of court—only plan confirmation requires initiation of a bankruptcy procedure and court approval ("pre-voted pre-packaged bankruptcy").[117] If this is not feasible, the drafted and pre-negotiated plan will be subject to a vote after the bankruptcy petition has been filed ("post-voted pre-packaged bankruptcy").[118] If a full-blown "pre-packaged bankruptcy" is not feasible, the Chapter 11 process can at least

[115] See Douglas G. Baird & Robert K. Rasmussen, "Antibankruptcy", 119 Yale L. J. 648 (2010); Horst Eidenmüller, "Privatisierung der Insolvenzabwicklung: Workouts, Covenants, Mediation—Modelle für den Insolvenzstandort Deutschland?", 121 Zeitschrift für Zivilprozess (ZZP) 273, 280 et seq. (2008).

[116] On pre-packaged bankruptcies see, for example, John J. McConnell & Henri Servaes, "The Economics of Pre-Packaged Bankruptcy", 4 J. Appl. Corp. Fin. 93 (1991); Douglas G. Baird & Robert K. Rasmussen, "Beyond Recidivism", 54 Buff. L. Rev. 343 (2006); Eidenmüller, *supra* note 3, at 437 et seq.

[117] See 11 U.S.C. § 1126(b); Eidenmüller, *supra* note 3, at 438.

[118] See Eidenmüller, *supra* note 3, at 438 et seq. For an overview of pre-packaged administrations in England, see the Graham review into pre-pack administration (June 2014), available at https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration.

be streamlined by so-called restructuring support agreements. These are usually concluded between the debtor and other key players, often senior secured lenders.[119]

10 REASONS FOR THE JURISDICTIONAL DIVERGENCES

Insolvency laws worldwide differ significantly—as should be apparent by now. This is true both with respect to corporate and individual insolvencies. Crucial issues of corporate insolvency law, such as the opening and governance of insolvency proceedings, the ranking of claims, the position of secured creditors, and the type and structure of rescue proceedings, are regulated very differently in the jurisdictions that are the focus of this chapter (US, England, France, and Germany). What are the reasons for these jurisdictional divergences? Answering this question can inform projects that aim at harmonizing (corporate) insolvency laws (see section 11 *infra*). If, for example, competitive pressures (regulatory competition) gradually push jurisdictions to adopt particular "solutions" to corporate insolvency law problems, harmonization might not be necessary. And if certain divergences are rooted in different regulatory philosophies or even in differences between the "deep normative structures" of particular societies, then harmonization might be positively harmful—at least from the perspective of those jurisdictions whose regimes are replaced by harmonization.

The reasons for jurisdictional divergences with respect to important corporate insolvency law issues have yet to be studied (empirically) in detail. It is probably true that competitive pressures are influencing corporate insolvency lawmaking, but their intensity is far from clear. The latest major reform of the German Insolvenzordnung was explicitly motivated, for example, by the fact that some German firms "forum shopped" to England, seeking access to a more attractive restructuring regime than that in place in Germany before

[119] See Douglas G. Baird, "Bankruptcy's Quiet Revolution", 91 Am. Bankr. L. J. 593 (2017) (advocating a process control by bankruptcy judges that focuses on the flow of information needed to apply Chapter 11's substantive rules).

the reform.[120] At the same time, it would be a gross overstatement to say that market pressures (in Europe) are so strong that we can identify a clear trend toward certain uniform procedures.

Forces that hinder further convergence are, for example, strong lobbying by well-organized stakeholder groups, different regulatory or insolvency philosophies, and "functional" reasons such as differences in financing structures. There are probably many other causes influencing the degree of jurisdictional divergences, and their explanatory force will always be a function of the specific regulatory problem and jurisdiction(s) studied. Insolvency administrators, for example, are a very powerful lobby group in a country like Germany that, for a long time, did not recognize debtor in possession-like proceedings. Hence, it does not come as a surprise that it took Germany so long to introduce such proceedings and that, in practice, they are still a very rare phenomenon. By contrast, the fresh-start philosophy is characteristic for insolvency policy and practice in the US (see section 3.3.2 *supra*). It would require a paradigm shift to move to a regime that starts from the premise that, in the great majority of cases, insolvency is not an "accident" but the consequence of negligent if not fraudulent management actions. Finally, concentrated debt structures reduce the need for a debtor-friendly restructuring procedure, as has already been pointed out (see section 3.3.3 *supra*). Whether this really *explains* the existence of such procedures in jurisdictions with fragmented and dispersed debt ownership is another question.

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[120] See Entwurf eines Gesetzes zur weiteren Erleichterung der Sanierung von Unternehmen, Bundestag-Drucksache 17/5712 of 4 May 2011, p. 17: "In der Vergangenheit haben einige Unternehmen deshalb ihren Sitz nach England verlegt, da der Geschäftsleitung und den maßgeblichen Gläubigern die Eröffnung eines Insolvenzverfahrens nach englischem Recht zur Sanierung des Unternehmens vorteilhafter erschien. Auch wenn dies Einzelfälle geblieben sind, so haben sie doch Anstoß zu einer umfassenden Diskussion in der Fachöffentlichkeit über den Sanierungsstandort Deutschland gegeben und den Blick für die Schwächen des geltenden deutschen Rechts geschärft."

If anything, the absence of empirical evidence for dysfunctional regulatory diversity cautions against too much zeal in pursuing harmonization projects in the field of corporate insolvency law. Regulatory competition with respect to corporate insolvency law systems has certain benefits of its own, and what appears "dysfunctional" may be an expression of completely different (but legitimate) insolvency philosophies, as will be seen in the concluding section of this chapter.

11 OUTLOOK: HARMONIZATION OF INSOLVENCY LAWS

The great diversity of (corporate) insolvency systems worldwide has benefits: it creates an "international laboratory" for better solutions, spurring regulatory competition between states for the best "insolvency product." At the same time, last-minute forum shopping by firms—possibly initiated by dominant lenders—can create problems, especially for outside creditors whose interests might be compromised by the move.[121] Further, not all firms have the knowledge and money to engage in sophisticated regulatory arbitrage and, as a consequence, might not have access to an efficient domestic insolvency or restructuring regime. Hence, a case can be made for harmonization of insolvency laws, at least in the form of "minimum harmonization" that allows states to go beyond the required minimum.

Even then, however, harmonizing substantive insolvency laws will always be an exceedingly difficult enterprise, given the heterogeneity of bankruptcy philosophies (objectives of insolvency laws, governance of proceedings, ranking of claims, etc.) and the legitimate resistance of states to harmonization if it is felt directly or indirectly to impact negatively on their respective autonomous regulatory policy. It is not surprising, therefore, that "early" harmonization efforts focused rather on jurisdictional and private international law rules and not on issues of substantive law as a first step. The guiding philosophy with

[121] For a very critical view on forum shopping (on the eve of bankruptcy) see Lynn LoPucki, Courting Failure (2005).

respect to these projects was and is that, as a start, predictable and stable jurisdictional rules should be established and cases should be decided on the basis of the same or at least similar rules, regardless of the forum in which the insolvency procedure takes place. In Europe, the outcome of these efforts was the European Insolvency Regulation of 2002, which was recast in 2015.[122] The UNCITRAL Model Law on Cross-Border Insolvency (1997) attempted to provide a blueprint for states to harmonize their cross-border insolvency regimes on a global scale.[123]

More recently, efforts to also harmonize substantive insolvency laws have gained greater momentum. Early on, it was again UNCITRAL that moved first with the "Legislative Guide on Insolvency Law" (2004)[124] and its special provisions on "Group Insolvencies" (2010).[125] However, these are, like the 1997 Model Law, not binding legal instruments but merely blueprints for states who wish to reform their domestic regimes based on what might be considered international best practice. The European Union, as with the European Insolvency Regulation, plans to move one step further: in 2014, the European Commission issued a "Recommendation on a New Approach to Business Failure and Insolvency",[126] and

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[122] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast), OJ of the EU of 5 June 2015, L 141/19. For an overview see Kristin van Zwieten, An introduction to the European Insolvency Regulation, as made and as recast, in Commentary on the European Insolvency Regulation (Reinhard Bork & Kristin van Zwieten eds., 2016); Gerard McCormack, "Something Old, Something New: Recasting the European Insolvency Regulation", 79 Mod. L. Rev. 121–46 (2016).

[123] http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html. The Model Law was supplemented in 2011 by rules on the "Judicial Perspective" when applying the Model Law, http://www.uncitral.org/uncitral/uncitral_texts/insolvency/2011Judicial_Perspective.html.

[124] https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf.

[125] http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part3-ebook-E.pdf.

[126] 2014/135/EU, OJ of the EU of 14 March 2014, L 74/65.

it has proposed, in 2016, a binding legal instrument (a Directive) as part of its plan to complete the capital markets union.[127] The driving force behind this initiative is the idea of giving firms in all Member States of the EU access to efficient pre-insolvency restructuring proceedings.[128] By and large, the substantive insolvency regimes of the Member States would be left intact, potentially reducing the political resistance that is to be expected. However, important elements of the proposed restructuring regime are subject to criticism. The draft directive is flawed because it (i) creates a refuge for failing firms that should be liquidated; (ii) rules out going-concern sales for viable firms; (iii) is, in essence, a twisted and truncated insolvency proceeding but without strong court involvement from the beginning and without the tools needed for the court to guarantee a fair outcome of the process.[129] Further, there would be a stifling effect on regulatory competition between the Member States and on the benefits that could bring ("laboratory for the best solutions")

[127] Commission Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, COM (2016) 723 final (22 November 2016).

[128] See Recital (1) of the draft directive (*supra* note 127): The directive aims at "[...] ensuring that viable enterprises in financial difficulties have access to effective national preventive restructuring frameworks which enable them to continue operating; that honest over indebted entrepreneurs have a second chance after a full discharge of debt after a reasonable period of time; and that the effectiveness of restructuring, insolvency and discharge procedures is improved, in particular with a view to shortening their length."

[129] For a detailed discussion, see Horst Eidenmüller, "Contracting for a European Insolvency Regime", 18 Eur. Bus. Org. L. Rev. 273 (2017).

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