



AMERICAN  
BANKRUPTCY  
INSTITUTE

## 2017 International Insolvency & Restructuring Symposium

# **INSOL International: Special Effects — The Theory and Practice of Special Insolvency Regimes**

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## Special effects: Theory and practice of special insolvency regimes

1. What's wrong with pari passu?
  - All creditors know where they stand
  - They will be treated equally with other creditors at the same level of priority
  - Secured and preferential rights are well understood by the market
  - Collective procedures like administration in the UK or Chapter 11 in the US rely on creditors agreeing a plan on a level playing field
  - Special administrations are a relatively novel invention and defy centuries of tradition
2. But pari passu has been compromised significantly over many years:
  - Utilities – in UK since 1986 utility companies have been obligated to supply so long as they are paid post-petition – they cannot hold the company to ransom over post debts
  - Preferential creditors – particularly employees in most countries, especially in Europe.
  - Ipso facto clause restrictions which prevent ongoing/contractual creditors from enjoying the same rights to limit their exposure as other creditors.
  - Ex post facto ability to change priorities and apportionments to creditors – e.g. pensions law in the UK and other countries
  - Overriding of insolvency rules to protect financial markets – e.g. Part VII of the UK Companies Act



### 3. Why is special administration necessary?

Special Administration is appropriate for 5 principal reasons:

- When the company is so complicated that it simply cannot be resolved by normal means e.g. investment banks.
- When the company's disorderly collapse would cause widespread damage to other market participants in the market itself – e.g. central counterparties, clearing banks
- Where the company performs critical functions which would cause disproportionate damage or hardship to the public and business – e.g. railways
- Where the company fulfils a vital social need which transcends financial considerations e.g. further education, housing associations
- Where the entity has a very high degree of political significance and there are political imperatives which need to be respected - e.g. Chapter 9 in the US



### 4. What are the purposes of a special administration?

e.g. Banking Act 2009 (UK)

- Protect UK financial systems
- Protect reputation of UK financial systems
- Protect depositors
- Protect public funds
- Avoid interfering with human rights
- NB – no mention of critical functions – payroll, cash machines, business flows etc.

e.g. Energy Act 2004

- Secure the company's systems
- Continue supply
- Rescue as going concern or transfer of growing concern to a third party



5. Safeguards for creditors
  - Protection of set-off and setting
  - “no creditor worse off” principle
  - Regulation and government control
6. International aspects
  - Recognition
  - Enforceability
  - Coordination between jurisdictions



## Special Insolvency Regimes: Germany

- The German Insolvency Code (Insolvenzordnung; InsO) provides for uniform insolvency proceedings (Insolvenzverfahren) that can be applied to all types of private companies, e.g. partnerships (GbR, OHG and KG), limited liability companies (GmbH) or stock corporations (AG), irrespective of their business.
- This regime can also be applied to special “entities”, such as banks and insurance companies (with some procedural/material particularities, as outlined in more detail below).
- State organisations (i.e. the Federal Republic of Germany, states, municipalities, etc.) cannot become insolvent themselves. However, if state organisations use one of the aforementioned types of company for their (business) activities (i.e. utility companies, airlines, public transport, hospitals, etc.) and such a company becomes insolvent, InsO will be applicable.
- Generally, insolvency proceedings demand the strict pari passu treatment of creditors:
  - There is typically no preferential treatment of fiscal claims.
  - Apart from the outstanding wages of employees (arising within the three month period prior to the petition to open insolvency proceedings) being paid by the German Labour Agency, employees do not receive any special treatment in insolvency proceedings.
  - The existing pension liabilities of employees are covered by the German Pension Protection Fund (Pensionssicherungsverein a.G.).

SPECIAL INSOLVENCY REGIMES: GERMANY



## Special Insolvency Regimes: Germany

- There are specific rules for the insolvency of financial institutions and insurance companies which are primarily based on EU legislation:
  - Banks
    - Special cross-border insolvency provisions under the Winding-up Directive (2001/24/EC)
  - Transposition: InsO and *Kreditwesengesetz (KWG)* dated 16 December 2003
    - Further European Frameworks:
  - Single Resolution Mechanism Regulation (Regulation (EU) no 806/2014, **SRM**)
  - Bank Recovery and Resolution Directive (2014/59/EU, **BRRD**)
    - Scope of BRRD was aligned with Winding-up Directive (2001/24/EC)
  - Transposition: *Sanierungsabwicklungsgesetz (SAG)* dated 18 December 2014
  - Insurance companies
    - Special cross-border insolvency provisions under the Directive 2009/138/EC (originally Winding-up Directive (2001/17/EC))
  - Transposition: InsO and *Versicherungsaufsichtsgesetz (VAG)* dated 10 April 2015
- Primary material impact:
  - Application to open insolvency proceedings over the assets of a bank or insurance company restricted to the competent regulator alone.
  - Only one insolvency proceeding allowed within the European Union (no secondary proceedings).

SPECIAL INSOLVENCY REGIMES: GERMANY



## National restructuring procedure for banks (*Kreditreorganisationsgesetz*)

- The German *Kreditreorganisationsgesetz (KredReorgG)* dated 9 December 2009 pre-dates the BRRD/SAG and SRM.
- KredReorgG provides for a three step (rescue) mechanism for bank crisis situations:
  - Restructuring proceeding
    - Possibility to provide bridge financing with priority ranking in case of insolvency down the line
    - Infringement of creditor and shareholder rights not possible
  - Reorganisation proceeding
    - Infringement of creditor and shareholder rights possible (haircut, standstill, debt-to-equity swap, etc.)
  - Transfer proceeding
    - Compulsory transfer of (part of) the business to another bank by state order
- Measures under KredReorgG are partially wider than those required under BRRD; however, KredReorgG and SAG can be applied in parallel.

SPECIAL INSOLVENCY REGIMES: GERMANY





## Further relevant aspect

- Due to a flood crisis which affected several parts of Germany in 2013, the legislator ratified a law allowing for reconstruction aid (*Aufbauhilfegesetz* – came into force on 30 May 2013 / ceased to apply on 1 April 2014) in order to address these unique circumstances.
  - For companies affected by the floods, the directors' obligation to file for the opening of insolvency proceedings within three weeks was abrogated until 31 December 2013 (see Article 3 para. 1 of the *Aufbauhilfegesetz*).
- After the financial crisis in 2008, the German legislator modified the definition of over-indebtedness, as set out in sec. 19 of InsO.
  - Before 2008: The debtor was over-indebted if its assets did not cover its existing liabilities.
  - After 2008: Over-indebtedness exists if the debtor's assets no longer cover its existing liabilities, unless the debtor's business has a positive continuation forecast (*positive Fortführungsprognose*).
- Draft Directive of the European parliament and of the council dated 22 November 2016 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*).

SPECIAL INSOLVENCY REGIMES: GERMANY



## Special insolvency regimes; the Netherlands

- Special insolvency regimes:
  - Clearing systems;
  - Banks;
  - Insurance companies;
  - Bodies of state e.g. municipalities and provinces;
  - Utilities;
- EU Legislation: Finality (98/26/EG), Collateral (2002/47/EG) and Clearing Systems (2009/44/EC), the liquidation of banks (Directive 2000/12/EU) and insurance companies (Directive 2000/17/EU);
- European Framework: the Bank Recovery and Resolution Directive (Directive 2014/59/EU BRRD) and Single Resolution Mechanism Regulation (Regulation (EU) no 806/2014 SRMR); effective in the Netherlands as of 26 November 2015;
- Intervention act (14 June 2012). Used on 1 February 2013; nationalization of listed Bank / Insurer conglomerate SNS Reaal: affecting equity and debt holders of SNS Reaal: currently litigation regarding compensation payable by the Dutch State
- Relationship with EU Insolvency Regulation (Regulation (EU) 2015/848 of 20 May 2015); article 1, para 2; article 12;
- Application; only by regulator or institution; not by third parties, Amsterdam court has exclusive jurisdiction



## The BRRD and the bankruptcy process in respect of a bank

- The BRRD and the SRMR deal with the failure of credit institutions and investment firms;
- Implemented in the Dutch Financial Markets Suspension Act, The Dutch Civil Code, Dutch Bankruptcy Act;
- Provides authorities with tools to intervene sufficiently early and quickly;
- To ensure: continuity of institutions financial and economic functions, preserve stability of financial system; minimize impact on economy and financial system: protect public funds;
- Special rules: (i) to effect bail in of equity and debt instruments, (ii) transfer of viable parts of the business, (iii) no retroactive effect of the commencement of the procedure (zero hour rule), (iv) suspension of enforcement (v) finality of orders, (vi) protection of set off / netting arrangements, (vii) exception for financial collateral arrangements;
- Adjustment to priority rules: bail in, protection of the rights of deposit holders;
- Priority claim by regulator in respect of payments made under deposit guarantee scheme;
- Special conflict of law rules; in bankruptcy code and financial markets supervision act regarding (i) applicable law (ii) recognition of effect of foreign procedure, (iii) powers of foreign liquidator/office holder (iv) cooperation;



## The Emergency Procedure (*Noodregeling*)

- Pre dates the BRRD and SRM; only Dutch central bank may ask court for application;
- Prevents enforcement of obligations by the bank or insurance company;
- Court may order:
  - I. Whole or partial transfer of obligations of Bank
  - II. Partial or full liquidation of Bank
  - III. Combination of transfer or liquidation
- Transfer (parts) of the business, transfer or amend (credit) agreements, insurance contracts;
- Agreements that are secured cannot be amended;
- Exception for financial collateral and netting arrangements;
- Book entry securities (including derivatives) are protected;
- Since introduction of BRRD the possibility for the court to order the (partial) transfer of the business only applies to insurance companies; transfer of assets during the case: still possibly. Unlikely to have practical relevance in light of BRRD;
- Intervention act (*Interventiewet*) continues to apply to insurance companies;
- For insurance companies, like for banks also the bankruptcy (*faillissement*) procedure is still available (almost identical provisions on applicable law/recognition);
- Deviation from ordinary priority rules to protect the position of policy holders;



## DETROIT Chapter 9

- **Detroit filed for Chapter 9 protection in July 2013** with over **\$18 billion in debt**, making it the **largest municipal bankruptcy in U.S. history** at the time. Detroit's bankruptcy filing followed a declaration of financial emergency and Kevyn Orr being appointed as Emergency Manager by Michigan Governor Rick Snyder. Orr worked to negotiate with creditors, insurers, unions and pensioners to negotiate a plan to move the city forward.
- **Key features of Chapter 9 include the automatic stay, a claims resolution process, and a plan for adjustment of debts.** The standards for plan confirmation in chapter 9 cases are a combination of the statutory requirements of 11 U.S.C. § 943(b) and certain portions of 11 U.S.C. § 1129 (the chapter 11 confirmation standards) made applicable in Chapter 9, including that the plan must be in the best interests of creditors and is feasible.
- Similar to a Chapter 11, most bond debt is not serviced during a Chapter 9 proceeding. **Special revenue bonds**, by contrast, **continue to be secured and serviced during the pendency of the Chapter 9 case through continuing application and payment of ongoing special revenues.** If special revenues are available, holders of special revenue bonds should expect to receive payment on those bonds during the Chapter 9 case.
  - Special revenue financed projects are intended to be separate from a municipality's general finances, and bonds secured by a lien on pledged special revenues should remain unaffected by a Chapter 9 case. This concept is included directly in Chapter 9.



## DETROIT Chapter 9

- Bankruptcy Judge Steven Rhodes **confirmed a plan of adjustment for Detroit in November 2014** follow extensive negotiations. The plan **cut about \$7 billion of debt due**, including impairing pension claims. Detroit originally attempted to divert various streams of special revenues, but following objections from bond insurers and special revenue bondholders, the city reversed course at the confirmation hearing and agreed to reinstate all special revenue debt in full.
- **Key lessons from Detroit bankruptcy include:**
  - Taxes pledged for repayment of general obligation bonds cannot be diverted without the consent of bondholders.
  - Municipal obligations secured and payable from special revenues cannot be impaired.
  - Pension debt can be impaired, because federal law trumps state law.
  - Creditors can push municipalities in Chapter 9 to monetize municipal assets.





## Puerto Rico and PROMESA

- By **2014**, Puerto Rico had over **\$70 billion of unsustainable debt** -- General Obligation (GO) Bonds backed by the full faith and credit of the Commonwealth; bonds issued by the Government Development Bank; sales tax backed bonds; and public corporation bonds, which allowed for the development of highways, an electrical grid, sewer and water development, public buildings, schools, and other infrastructure development.
- By **2015**, Puerto Rico was nearing default on its GO bonds, and there was no path forward to sustain other debt payments. To address the crisis, **Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA)**, signed by President Obama on **June 30, 2016**, ahead of a default by PR on over \$1 billion of GO debt, among other liabilities.
- **PROMESA, a hybrid Chapter 9 and Chapter 11**, is applicable only to U.S. Territories (PR, Guam, U.S. Virgin Islands, American Samoa, Commonwealth of Northern Mariana Islands).
- PROMESA put in place an **Oversight Board to manage the fiscal crisis**. The Board has extensive authority and oversight of PR's financial and social reforms. The Board has the power to commence Chapter 9 like proceedings (via **Title III**), or negotiate out of court restructurings (via **Title VI**). The Board has the power to file reorganization plans and approve or disapprove the incurrence of new debt.



## Puerto Rico and PROMESA

- **Title VI**, a Creditor Collective Action, is a **voluntary debt restructuring** where creditors divide into pools distinguished by legal priority or security arrangements. Each pool votes on a qualifying modification for restructuring the debt. 2/3 of the outstanding principal amount in each pool must vote to accept the Plan, and the Plan must be approved by the District Court.
- **Title III**, an Adjustment of Debts, **incorporates many provisions of Chapter 9 and Chapter 11** of the Bankruptcy Code. A plan of adjustment can be filed by PR or its instrumentalities or by the Board, and confirmed if it complies with the incorporated bankruptcy law provisions, respects the priorities established under Puerto Rican law, is in the best interests of creditors, is not illegal, the debtor has legislative, regulatory or electoral approvals, and is feasible. The Court must also consider whether available remedies under non-bankruptcy laws and the Constitution Of Puerto Rico would result in greater recovery for creditors, and the plan must be consistent with the Fiscal Plan adopted by the Oversight Board.
- **On May 3, 2017, the Board filed a Title III for the Commonwealth of Puerto Rico**, currently pending in the US District Court for the District of Puerto Rico, following by a Title III for the Puerto Rico Sales Tax Financing Corporation on May 5, the Puerto Rico Highways and Transportation Authority on May 21, the Employees Retirement System on May 21, and the Puerto Rico Electric Power Authority on July 2. The Board is actively negotiating Title VI restructurings for other instrumentalities.



## Ireland

- Irish Bank Resolution Corporation Act 2013
  - Joint Special Liquidators to IBRC
- Insurance (No. 2) Act 1983
  - Administrator to an insurance company
- Companies (Amendment) Act 1990
  - Examinership
- National Asset Management Agency Act 2009
  - Statutory receiver



## Event-led, responsive rather than proactive

- IBRC– end the financial exposure of the State
- Administration
  - preserve cover under insurance policies
  - PMPA Motor Insurance Group and
  - Quinn Insurance
- Examinership
- NAMA Avoid collapse of the Goodman Group
  - Cure deficiencies in security and provide an enhanced enforcement remedy



## Special Liquidation of IBRC

- Commencement – on Minister for Finance making a Special Liquidation Order
- Appointment – Minister nominates (and can remove) Joint Special Liquidators (“JSLs”)
- Notification requirement
- Directions – Minister may issue instructions as to how the winding up is to proceed (such instructions have been given) and may direct the JSLs to do or to refrain from doing anything in connection with the winding-up
- Effect – all powers removed from directors and officers and contracts of employment of every employee terminated



## IBRC cont'd

- Litigation
  - Restricts availability of injunctive relief against the JSLs
  - Stay on all existing proceedings and no new proceedings without Court approval
  - Protection for subsidiary companies and automatic removal of any liquidator or examiner
- Companies Act
  - Modified form of statutory rules on liquidation apply (roles of the High Court and Central Bank reduced)
  - Loan Sales – Act provides for the sale of assets and liabilities irrespective of any legal restriction or prohibition



## IBRC cont'd

- Security
  - Deemed to cure deficiencies in security
- Recognition
  - The special liquidation is a CIWUD event so that the liquidation is recognised in each EU member state