

Analyst

Faith Bartlett
+44 171 417 6289
fbartlett@fitchibca.com

Table of Contents	Page
Executive Summary	1
The impact of insolvency legislation on loan and bond ratings	
France	2
Germany	2
UK	3
US	3
Comparison of Insolvency Regimes	4
Key areas affecting recoveries	5
The first stage - Security	
France	6
Germany	8
UK	9
US	10
The second stage - Priority	
France	11
Germany	12
UK	13
US	13
The final element - Control	
France	14
Germany	15
UK	16
US	17
Appendices	
France	19
Germany	22
UK	24
US	27

The London, Paris and Frankfurt offices of Freshfields and the Chicago office of Bell, Boyd & Lloyd assisted in the preparation of this report.

October 1999

■ **Executive Summary**

This article considers the impact of insolvency regimes on the rights of secured creditors and therefore on the ratings of secured loans. Most secured loans are to sub-investment grade or 'leveraged' companies, as opposed to investment grade companies, which typically borrow on an unsecured basis. The four jurisdictions covered in this study include the three countries that have had the greatest number of LBOs ('leveraged buyouts') and therefore the most 'leveraged loans' in Europe, namely France, Germany and the UK. These insolvency regimes are then compared to the regime that exists in the US. It is intended that this study will be the first in a series reviewing the impact of the various insolvency regimes in Europe on loans.

The starting point for a loan rating is an entity or unsecured rating, which measures the likelihood that the borrower will default on its debt. The methodology used to arrive at the entity rating is the same as that employed to rate unsecured bonds¹. The loan rating is then 'notched up' from the entity rating based on the key structural characteristics of the loan and the likely level of recoveries in a distressed scenario. For example, a senior secured loan to a B quality company could be notched to B+, BB-, or even BB, based on the composition of the company's capital structure, the value of its security and the covenants contained in the loan documents.

A loan rating is an indication of the expected loss that an investor can expect to experience on the asset. The expected loss is a function of the probability of default and the severity of loss. The expected loss on a loan is significant to investors who often have the option to invest in either the loan or the high yield bond of a particular issuer. Since high yield bonds have higher coupons than loans, the expected loss on a loan must be low enough to make it a better "relative value" compared to a bond from the same company. In the US, Fitch IBCA research has shown that the recovery rate on leveraged loans is 80%, on average, compared to 40% for high yield bonds, thereby making the expected loss on loans significantly lower than that for bonds². As a result, leveraged loans have become an extremely popular asset class among US investors in recent years and should also develop a significant investor base in Europe as the various insolvency regimes and their impact on default and recovery rates become better understood.

¹ See Fitch IBCA research 'Corporate Rating Analysis' dated 16th September 1998 available on Fitch IBCA's website www.fitchibca.com.

² See Fitch IBCA research "Syndicated Bank Loan Recovery Study" dated 22nd October 1997 available on Fitch IBCA's web site www.fitchibca.com.

The Impact of Insolvency Legislation on Loan and Bond Ratings

The effect of different insolvency regimes on a loan's structure and the value of available collateral will affect the likely level of recoveries from a secured loan. As recoveries are key in determining the level of notching above the entity rating for a secured loan, this will vary from country to country, as is summarised in Table 1. The frequency of maximum notching expresses our opinion of how often a secured loan will be awarded the maximum amount of notches above the entity rating. For example, we believe that there is a strong likelihood that a secured loan to a UK corporate will be awarded 3 notches, whereas in the US this is only likely to occur in exceptional circumstances.

Table 1: Notching above entity rating for secured loans

	France	Germany	UK	US
Notches above entity rating for secured loans	0-2	0-3	0-3	0-3
Frequency of maximum notching	Low	Medium	High	Low

FRANCE

Of all the jurisdictions studied, France is the most pro-debtor, and hence the least favourable jurisdiction for secured loan and bond creditors. This is evidenced by the fact that while security is available in theory, a secured creditor is not necessarily afforded priority above other groups of creditors in either the timing of payment or distribution of realisations. Additionally, secured creditors should be aware that security can be set aside if it was created during the 'Suspect Period'.³ This significantly reduces the value to creditors of any security taken.

This lack of priority results in secured creditors having a relatively weak negotiating position in

³ The court determines the Suspect Period once the borrower has entered court-led Mediation proceedings. It can be up to 18 months long and runs from the date the borrower is deemed to have stopped making payments to creditors ('Cessation of Payments') and ends with the date the borrower entered Mediation proceedings.

either a restructuring or a liquidation. As a result secured creditors, whether loan or bondholders, have relatively little control over these processes and may be compelled to release security or see other creditors paid in preference to themselves.

Hence, Fitch IBCA believes the level of notching available to senior loans in France will be between 0-2, which is lower than available in other jurisdictions. Additionally, Fitch IBCA believes that the majority of loan ratings will only achieve notching at the lower end of this scale. As a result the rating differential between loans and bonds is likely to be less in France than in other countries, due to lower notching of loans.

GERMANY

The regime in Germany has only recently been implemented (1st January 1999) and hence it is difficult to be sure of its precise impact on loan ratings. The regime was designed to include some of the debtor friendly aspects of the US regime, without significantly disadvantaging secured creditors. Our research has shown that this is indeed the case, with the general bias of the regime being between those in the UK and the US.

Hence, Fitch IBCA believes that there will be a similar level of notching in Germany as has been experienced in the US (0-3 notches). However, there is a likely to be an increased frequency of notching at the upper end of this scale, reflecting its stronger creditor bias than the US due to the right of 'separate satisfaction'.⁴

⁴ The right of a secured creditor in nearly all circumstances to realise its secured assets and receive the proceeds, subject to realisation costs.

UK

The level of security, priority and control that is afforded a secured creditor in the UK makes it the most pro-creditor jurisdiction studied. In summary a creditor can take security over all a company's assets both current and future through fixed⁵ and floating⁶ charges. It is difficult for a liquidator to challenge this security and these charges give the creditor considerable control over these assets. In the case of assets covered by a fixed charge, the company is unable to sell these assets without the creditor's permission.

In terms of realisations, only expenses of the insolvency proceedings are paid before the secured creditor. The only exception to this is the payment of statutory preferential creditors⁷ out of floating charge realisations. As a result, Fitch IBCA will notch more loans in the UK with a greater frequency of three notches than there has been in the US.

There is likely to be a greater differential between the ratings of loans and bonds in the UK than has been the case in the US, due to the relative strength of the secured creditor. This is certainly the case currently, where UK structures typically have bondholders structurally and contractually subordinated to the secured creditors, placing the bondholder in a weaker position than his counterpart in the US.

US

The US regime tries to maintain a balance between the rights of secured creditors and borrowers. Outside of court-led proceedings this balance is reasonably equal as both parties have alternatives. The borrower can seek the court's protection from its creditors, which does not carry the stigma that it does in Europe.

⁵ A charge that is attached to fixed assets such as land, plant, property and equipment and receivables.

⁶ A floating charge covers the current assets and the business of the borrower.

⁷ These are defined in the Insolvency Act and relate to pre-appointment unpaid balances of employees' wages (maximum £800 per person), employees' holiday pay (maximum £800 per person), employees' salary, employer's salary tax and sales tax.

Alternatively the secured creditor can seek to enforce its security.

This balance of power moves in favour of the borrower once it has entered Chapter 11 proceedings and the secured creditor can no longer exert significant control over the process. The control is largely in the hands of the borrower and the court. However, if the borrower moves to Chapter 7 proceedings, the balance of power moves back towards the secured creditor, who can work with the trustee to realise its security, whereas unsecured creditors and the borrower have little or no influence.

As a result, the level of notching available for a secured loan in the US is 0-3 notches. While it is possible to achieve 3 notches, this rarely happens as it represents a situation where a secured creditor will receive both principal and accrued interest in full. This is a rare occurrence due to the lower level of priority afforded secured creditors under Chapter 11, compared to that which exists in the UK.

Comparison of Insolvency Regimes

Fitch IBCA believes that there are three key criteria that highlight the impact of an insolvency regime on a secured creditor. These are security, priority and control. Table 2 gives an overview of the position of a secured creditor in the jurisdictions studied.

An important point for all creditors to be aware of when evaluating the effect of insolvency regimes is that the relevant regime is the one where the assets are based rather than the law which governs the loan documents. Thus, a creditor should not necessarily take comfort from the fact that the loan documents are governed by English law, if the majority of the corporate's assets are in a less pro-creditor jurisdiction such as France.

Table 2: Overview of Insolvency Regimes

	France	Germany	UK⁸	USA
Main Insolvency Procedure	Court controlled restructuring	Court controlled administration	Receivership ⁹	Chapter 11
Security	Security is available. However, the regime adversely impacts the value of the security taken through limiting priority and control.	The regime supports the practice of taking security.	The regime strongly supports the practice of taking security.	The regime supports the practice of taking security.
Priority	Security can be set aside if taken during the “Suspect Period” ¹⁰ . Additionally the court is able to set aside security and priority.	Can be set aside in certain circumstances but typically secured creditor retains right to separate satisfaction on secured assets.	Difficult to challenge. Floating charge realisations are subject to statutory preferential claims	Security can be primed by super-priority DIP ¹¹ funding if adequate protection is given. Portion deemed unsecured can also be ‘crammed down’ ¹² where the loan is undersecured.
Control of Insolvency Procedure	Court	Court and creditors	Secured creditor through the Receiver	Court and debtor

⁸ The term the UK is used for ease of reference. However, readers should be aware that this covers England, Northern Ireland and Wales only, as Scotland has its own insolvency law.

⁹ This is the main enforcement procedure used in the UK by secured creditors. However, the number of receivership appointments is currently at an historic low. The main Insolvency Procedure in terms of appointments is liquidation.

¹⁰ See footnote 3

¹¹ Debtor in Possession. This refers to the funding of the debtor i.e. the borrower who remains in control of the business under US Chapter 11 insolvency proceedings.

¹² The US Bankruptcy Code states that where a loan is deemed to be greater than its supporting collateral, the amount of this excess can be treated as an unsecured claim. This means that the requirement that a secured creditor retains security in the restructuring of equivalent value to the security that already exists, only applies to the secured part of its claim and not the undersecured (or unsecured) element.

As can be seen from the above table, the differences between the treatment of secured creditors in the three European jurisdictions studied by Fitch IBCA are considerable. It is not only the specific laws, but also the general bias of the insolvency legislation and the way it is practised, which varies between countries. It is this variance that makes it extremely difficult to evaluate the level of likely recoveries in a cross-border insolvency situation. Hence, one can speculate that there will come a time when it is necessary for the different jurisdictions to harmonise their insolvency legislation. Fitch IBCA believes that this is more likely to occur through countries co-operating and recognising each other's insolvency legislation, rather than rewriting the legislation to produce European-wide insolvency laws. The recognition process between the US and the UK was accelerated by large cross-border insolvencies such as Maxwell. It may be that it will take the occurrence of a large European cross-border insolvency to compel a similar recognition process to take place across Europe.

The recent interim report issued by the UK Department of Trade and Industry indicates the UK government's recognition of the pro-creditor nature of the UK insolvency regime. The UK government has stated its intention to revise the regime to allow basically viable businesses to survive short-term financial difficulties. Such moves would serve to reduce the difference between the bias of the insolvency regimes in the UK and other European jurisdictions.

Methodology of Loan Ratings

When deciding to lend money to a corporate borrower, a creditor has two main financial considerations. Firstly, receiving interest on a timely basis and secondly receiving full repayment of its principal. The entity rating is based on traditional credit analysis and addresses the timeliness of payment and the likelihood of default¹³. It reflects the position of an unsecured creditor in a corporate's capital structure. However, loans and bonds can be secured on corporate assets, particularly where the corporate

is leveraged or non-investment grade. This places the creditor in a different and hopefully improved position in the event of a corporate default. A secured loan or bond rating therefore reflects this position and focuses on the likely level of recoveries a secured creditor would receive in restructuring or insolvency proceedings.

Recovery rates are obviously affected by a variety of factors, not least the relative size of the company, the industry it operates in and the depth of its financial problems. These characteristics affect recoveries in a similar manner in all countries. However, recovery rates vary significantly across national boundaries. Fitch IBCA believes that the key factor causing this variance is the domestic insolvency regime. Insolvency regimes vary considerably between jurisdictions, and nowhere more so than in Europe, from the strongly pro-creditor outlook of the UK to the pro-debtor regime that exists in France.

This article considers the prevailing insolvency regimes in three European countries: France, Germany and the UK, and compares these to the regime in the US. We consider the effect of these regimes on the security, priority and control available to a secured creditor to assess the bias of the regime. We then evaluate how these different regimes impact on the notching of loans above the entity rating. The appendices to this article cover the legal framework in more detail for an informal restructuring, a formal restructuring and a liquidation in each jurisdiction.

Key Areas Affecting Recoveries

When Fitch IBCA rates a loan, the starting point is always the entity rating, which reflects an unsecured position in the capital structure. The loan is then notched up to reflect the additional benefits of being a senior secured creditor in the corporate's capital structure.

It is the structural aspects of a secured loan which allow it to be notched above the entity rating, in particular the capital structure, the collateral, and the covenant package. The value of these structural aspects to a secured creditor

¹³ See Fitch IBCA Corporate Rating Methodology and Fitch IBCA Corporate Rating Analysis

depends on the entity rating itself. The higher the likelihood of default, the lower the entity rating and the more important collateral is to a creditor.

The key concern for creditors is the level of recoveries they can expect from a secured loan that has entered restructuring or insolvency proceedings. These recoveries are dependent on a number of factors specific to the company, including the industry, its size and market position and its financial state. However, overriding all of these is the prevailing legislation covering insolvent companies. The legislation sets the ground rules for dealing with insolvent companies and is the background for informal restructuring. The stronger the priority of the secured creditor under legislation, the higher its ultimate recoveries are likely to be.

The legislative background will have an effect on all aspects of the loan, from its capital structure and covenant package to the ultimate recoveries from an insolvent company. It is difficult to accurately notch a bank loan without a full and comprehensive understanding of the security and insolvency regime of the applicable jurisdiction. As a trading area, Europe has many different insolvency regimes, which differ considerably in their approach from the US and between themselves.

As mentioned earlier, creditors should focus on the insolvency legislation in the jurisdiction where the assets securing the loan are based. The law that governs the documents or the legislation applicable in the jurisdiction where the holding company is domiciled has little bearing on the recovery process of these assets.

Given that the likely level of recoveries is key to the notching of bank loans, we need to identify the drivers which affect these recoveries. Fitch IBCA believes that the key drivers are the security available, the priority that security holds and the level of control a secured creditor can exert over the realisation process. We will consider these points in turn for the three European countries studied and the US.

The First Stage - Security

The first stage in ensuring that a creditor achieves maximum recoveries is for it to take security over as many of the assets, both current and future, of the borrower as possible. The more assets the creditor has security over and the less open this security is to challenges, the greater the potential recoveries. Whilst it is possible to take security in each of the jurisdictions reviewed, the scope of this security and its effectiveness differs between them. This is due to the overall bias of the insolvency legislation, such that in the US and Germany, the legislation supports the taking of security. In the UK, both legislation and common law is even stronger in its support of taking security, whereas in France it significantly diminishes the value of the security taken.

FRANCE

In overview, the legislation in France does not support the taking of security for corporate loans. It is important to appreciate that this does not mean that security is not available, but rather that it is of less value in France than it would be in other jurisdictions due to the lack of priority.

Guarantees

In common with other jurisdictions, the security typically required by a creditor will depend on the borrower's economic position. For instance with small owner / managed companies, banks will commonly ask for personal guarantees. As in other countries, these personal guarantees are often of little financial worth but serve to ensure that the director's / owner's personal interests are aligned with those of the secured creditor.

In terms of corporate guarantees, parent company or downstream guarantees are frequently taken by creditors. These may be in the form of a guarantee, an undertaking to pay or a 'comfort letter'. Typically, the stronger the reputation of the parent company, the weaker the form of corporate guarantee that is available.

Upstream guarantees are not yet common in France, although in theory they are available. The problem with taking corporate guarantees in

France is that the directors of the companies giving the guarantees have to be careful not to fall foul of the 'misuse of corporate assets' rules. Misuse is a criminal offence and is punishable by five years' imprisonment and / or a large fine.

For the directors to avoid committing this offence there are several requirements the company must meet. The most difficult is that there should be some valuable consideration for providing the guarantee, that the transaction should not create an imbalance between the obligations of the guarantor and the obligations of the borrower, and that it should not exceed the financial capacity of the guarantor. The usual way to satisfy this test is to limit the guarantee to the net assets of the guarantor. This reduces the value of the guarantee and hence the available security.

Fixed Assets

There are two methods by which a creditor can take security over property assets held by the borrower. The most common one is a mortgage on the buildings ('hypothèque'). Further security is available if the borrower receives a rental income from these buildings. In this instance, the borrower can assign its rights to the rental stream to the secured creditor ('delegation'), allowing it direct rights against these receivables.

Current Assets

A 'Bordereau Dailly' is the method by which a borrower's receivables are assigned to the secured creditor. Both current and future debts can be assigned by this method. The debtors do not have to be notified at the time a Bordereau is entered into and can continue to pay funds to the borrower. In the event that the secured creditor does not believe the borrower will be able to repay the loan, it can notify specific debtors to pay it directly, bypassing the borrower. However, if this notification occurs during the 'Suspect Period'¹⁴, then the court can set aside this security. This significantly impacts the value of security, as receivables frequently constitute a significant proportion of recoveries

for secured creditors.

If the secured creditor is a bank then it can request a pledge over the borrower's accounts in its bank as part of the security package. This gives the secured creditor set-off rights against the funds in the pledged accounts and allows it to be paid in preference to other creditors. Pledges over bank accounts can be used in conjunction with a delegation or a Bordereau Dailly, so that the borrower pays any sums received into the pledged accounts. This increases the value of the pledge as a form of security.

With respect to other assets of the borrower, such as stock, goodwill, shares and the business itself, it is possible to take security over these assets through a 'nantissement du fonds de commerce'. However, the secured creditor does not necessarily know what assets are covered by this charge until it tries to enforce its security. Enforcement requires a court order and the instigation of court-led insolvency proceedings, which reduces the effectiveness of the security.

Threats to Security

The most expensive and onerous registration requirements are for mortgages, which must be made in front of a notary who then registers it in a specific register. Registration costs are predominantly based on the value of the loan. Frequently a creditor will request a mortgage but then will not register it until it is concerned about the financial position of the borrower. This delay may allow a later mortgage to be registered before it, resulting in the later mortgage taking priority over asset realisations.

One of the biggest threats to security is the court's ability to set aside transactions that occur in the 'Suspect Period'. The court determines the length of this period when the borrower petitions it to enter insolvency proceedings.

¹⁴ See footnote 3

It runs from the date of ‘Cessation of Payments’¹⁵ to the commencement of insolvency proceedings and can be up to eighteen months long. The legislation states that any actions taken by the borrower in this period, including the granting of security can be set aside by the court. This is obviously a significant risk for a secured creditor, as it can result in all of its security being set aside, with the exception of security given to support new money.

Whilst a creditor’s security cannot be diminished without its consent, a borrower has easy access to court-led Mediation and formal insolvency proceedings. This is significant, as once the court is involved it will usually issue a stay against all current and future actions against the borrower, including enforcement of security. As discussed below, a secured creditor receives little priority in a liquidation. Hence, the borrower’s easy access to Mediation (including a stay of actions) and the limited priority of secured creditors in a liquidation, reduces their negotiating power. This often leads to a secured creditor releasing security in a restructuring. Despite the fact that legally such a course cannot be forced on them by other creditors, in practice, secured creditors have little negotiating power to enable them to resist such demands.

GERMANY

The new insolvency regime in Germany supports the taking of security by creditors by allowing ‘separate satisfaction’ on these assets. As a result the majority of corporate assets are available and are taken as security for a loan, as they are of value to a creditor.

Guarantees

Whilst upstream guarantees are not typically part of a security package in Germany, they have become more common for recent corporate acquisition and leveraged buyout loans. However, creditors should be aware that there may be some reluctance to give corporate

guarantees. This is due to the current legal uncertainty as to whether such a guarantee would be seen as a “payment to a shareholder”. Payments to shareholders are forbidden under the Limited Liability Companies Act if they result in a company’s net assets being insufficient to cover its liabilities. If this were shown to be the case, the Managing Director would be personally liable to pay damages. There are conflicting opinions in Germany on the likelihood of such a claim, but until the situation is resolved, the availability of corporate guarantees may be limited. If the creditor deems it beneficial, it can also require personal guarantees (‘Burgschaften’) to be given by directors/owners.

Fixed Assets

A creditor will typically require charges over immovable property such as land. In theory, there are two methods for taking such a charge, a ‘grundschuld’ or a ‘hypothek’. In practice a grundschuld is usually the method used. This is similar to a charge or mortgage over the specific property and has the additional benefit of being able to be assigned or transferred without the underlying debt (unlike the hypothek). While taking these charges is not expensive, both charges need to be registered, which can take up to six weeks.

Current Assets

As in other jurisdictions, it is possible to take security over various classes of current assets. This is done through a lien or a chattel mortgage over each class of asset (‘Sicherungsabereignungen’) or through assignments (‘Sicherungsabtretungen’). It is possible to have a ‘blanket assignment’ over all current assets. This security is capable of covering both existing and future assets, including assets that are traded in the normal course of business, such as inventory. These charges do not need to be registered. In addition, shares of a limited company can be taken as security through a lien (‘Pfandrechte’) over the shares.

¹⁵ This is determined by the court once the borrower has entered Mediation proceedings. It is the date that the borrower is deemed to have stopped making payments to its creditors.

Threats to Security

As with France, the legislation does not allow a creditor's security to be diminished without its consent. The key difference is that a secured creditor is entitled to 'separate satisfaction' (the right to enforce security and receive the proceeds less realisation costs) on its secured assets. This applies even in a liquidation and gives a secured creditor much greater negotiating power in resisting attempts to diminish its security in a restructuring than would be the case in France. Even in a court led restructuring, when the Administrator can prevent the sale of secured assets that are crucial to the business, the secured creditor is entitled to receive compensation for any loss in value in its secured asset and its security remains in place.

This position is reinforced by the fact that both the borrower and the secured creditor can initiate insolvency proceedings.

UK

The UK legislative regime and banking practice strongly supports the taking of security. The result is that any assets, current and future of the borrower and other group companies are potentially available to a creditor as security for a loan. These assets have significant value through the priority afforded secured creditors by the legislation.

Guarantees

In the case of smaller companies, it is not only personal guarantees from directors that may be taken but potentially also mortgages over personal assets. In common with other jurisdictions one may question how much this security adds in terms of value, but creditors may derive comfort from the commitment it ensures from the directors.

A creditor may request corporate guarantees from any group company that it believes contains value. In addition, where there is significant value in another group company the creditor may obtain separate specific security over its assets. This puts the secured creditor in a much stronger position than if it relied on its

fixed charge over the borrower's shares in its subsidiaries. Separate security gives the secured creditor a direct first priority claim on the assets rather than an equity claim, which would rank last in the liquidation of the subsidiary.

For such guarantees and security to be valid there needs to be some corporate benefit to the guarantor companies. In assessing this benefit directors cannot merely consider the interests of the group as a whole but must consider each company individually. These considerations should consider not only current and future shareholders, but also creditors, particularly where a company is in a vulnerable financial state. However, in practice, it is often to the advantage of one company to support other group companies.

Fixed Assets

Existing and future immovable assets such as property, plant and equipment, shares, goodwill and receivables are all available as security under a 'fixed charge'. The borrower is then unable to dispose of these assets without the consent of the secured creditor. In addition to the debenture containing the fixed charge, the secured creditor can also take specific security over particular assets if it so wishes. This can be done by way of a deed with respect to land assets or a chattel mortgage for high value assets, such as large plant and equipment. These mortgages may contain additional protection, including more extensive and restrictive covenants in relation to these assets, than are contained in the debenture. These covenants enhance the control of the asset, rather than its value to the secured creditor.

Current Assets

In addition to the fixed charge, a creditor will usually require a general 'floating charge' over all the remaining undertakings, inventory, property and assets of the borrower. This charge is not attached to specific assets but rather hovers over groups of assets, covering both current and future assets and the business itself. The borrower is able to deal in these assets in the normal course of business, without requiring the consent of the secured creditor. The floating

charge crystallises on enforcement of the security.

Due to the priority of payment rules, a secured creditor's recoveries will be higher where more assets are covered by the fixed charge. To this extent, it is important to note that the terms on which an English court is prepared to recognise a fixed charge on receivables are onerous and subject to change. In the event that the fixed charge is rejected, the receivables would still be covered by the floating charge. However, the secured creditor would only receive payments from these realisations after the statutory preferential creditors¹⁶ had been paid.

Threats to Security

The validity of security is only likely to be challenged by a liquidator, who is typically appointed once secured assets have been realised and the secured creditor paid. The liquidator can challenge actions taken by the company within a certain timeframe prior to insolvency, including the granting of security.

While the legislation provides opportunity for a number of challenges on the validity of security, in practice relatively few are made. The most significant one secured creditors should be aware of is the liquidator's ability to challenge any additional security, including floating charges, taken within the 12 month period prior to a company entering into insolvency proceedings. The exception to this is where additional consideration has been provided by the creditor, then security up to the value of this new money remains valid. However, this can raise doubts about additional security taken by creditors during a workout.

US

As with the European countries reviewed, the security available to a creditor in the US will depend on the size, financial strength and asset base of the borrower and on the type of loan it requires. Overall, the US system favours the taking of security for loans.

¹⁶ See footnote 7

Guarantees

There are a number of different types of guarantees available to US creditors, the most common being surety or unconditional performance guarantees. These are the most valuable guarantees to a secured creditor, as they enable it to pursue the guarantor immediately after an event of default by the borrower.

Guarantees from individual shareholders are only likely to be available as security if there are only a small number of shareholders. In which case the shareholders may pledge their equity in the borrower to the secured creditor. In most instances, the secured creditor will require a guarantee from the parent company and upstream guarantees from any subsidiaries that contain either significant asset value or generate a substantial income.

For these guarantees to be valid the guarantor must receive a real benefit from its undertaking and it must not become insolvent as a result of the guarantee. To ensure that the guarantees taken are valid, they are usually limited to a percentage of the guarantor's net assets, placing an upper limit on their value to a secured creditor.

Fixed Assets

A creditor can take a mortgage lien over the borrower's property assets. However, this carries the risk that the secured creditor could become liable for certain costs under environmental legislation. In addition, the registration fees for mortgage liens can be substantial. As a result mortgage liens are usually only taken where the loan is not fully supported by current assets and/or the property is material to the business of the borrower or has a high market value.

Secured creditors may also choose not to take security over fixed assets due to the requirement that enforcement against these assets takes place through a judicial sale¹⁷. This is a more complex

¹⁷ A judicial sale requires the secured creditor to issue a lawsuit against the borrower and other creditors, who can then challenge the validity of its charge. This process is explained in detail in appendix 4.

and potentially more time-consuming and expensive process than the non-judicial sale process, which exists for other asset classes.

Current Assets

Security over current assets is usually the first form of security taken by a creditor. The Uniform Commercial Code ('UCC'), which has been adopted by all states, has simplified the process of taking security over current assets. It also determines the priority of competing claims over current assets.

The UCC requires secured creditors to perfect their security to prevent subsequent creditors gaining better priority over the assets. Perfection of security is accomplished by the creditor filing notice of its security to specified government offices. However, for some assets, such as cash, the secured creditor must actually take possession of the asset for its security to be perfected.

A further form of security that is typically taken is the assignment of the borrower's interests in any contracts which are material to its business.

Threats to Security

Even if a creditor has perfected its security by filing notice of its interest with various government offices, there are some classes of asset, such as cash, where possession of the asset will override perfected security without possession. This could result in other creditors being able to claim higher priority on assets that a secured creditor had assumed were available to support its loan.

When a borrower is in financial difficulty it will often seek protection from its creditors by entering Chapter 11 proceedings. Chapter 11 is designed to give the borrower time to negotiate a restructuring plan with its creditors and then exit the proceedings as a going concern. As a result, secured and unsecured creditors are forced to negotiate against each other. Hence, challenges to security are most frequently raised by unsecured creditors seeking to diminish a secured creditor's negotiating position.

The Second Stage – Priority

The taking of security provides a creditor with comfort that its loan is supported by assets with value. However, security in itself is not sufficient to ensure recoveries. In the absence of direct enforcement rights against specific assets¹⁸, it is the priority of payment from asset realisations which is the key. Whilst available security is partly influenced by legislation, the priority of claims in a liquidation is entirely based on legislation. Hence, the differences in priority between countries are wider than the differences between available security.

When we consider priority we are concerned with the ranking of separate claims against the same pool of assets in insolvency proceedings. The higher the priority of a creditor the greater its recoveries are likely to be. Priority is obviously linked to security, but in a number of jurisdictions having security is not sufficient, if the legislation provides that other creditors are paid out at the same time or prior to your claim. It is also important to recognise that the level of priority afforded a secured creditor in a liquidation influences the control it is able to exert over an informal restructuring.

FRANCE

The order of claims in insolvency is determined by the interplay of several laws. Hence, it is difficult to state an absolute order of priorities, which may vary from case to case. However, the general principles of priority are shown in Table 3.

As can be seen, the French regime places little weight on any security held by a creditor. This lack of priority for secured creditors diminishes the value of the security taken and limits the likely level of recoveries.

¹⁸ The security documentation in the UK and Germany gives the secured creditor direct enforcement rights over the secured assets, without requiring court involvement.

Table 3: Order of Priority under French legislation

- Salaries and sums due to employees
- Claims arising after the start of the insolvency proceedings, including tax and social security debts
- Funding provided after the start of insolvency proceedings
- Secured debts, by date of registration not date of creation
- Unsecured debts

As discussed earlier, a key concern for secured creditors is that any security taken in the Suspect Period can be set aside. Given that creditors tend to delay taking security until insolvency is imminent, this can have a significant impact on secured creditors. If their security is set aside they will rank last in the priority list, alongside other unsecured creditors.

The lack of priority afforded to a secured creditor in a liquidation limits the priority it can claim in a restructuring, either with or without court involvement. If a secured creditor tries to insist on priority treatment in an informal restructuring, then the borrower can apply to the court to enter Mediation. Once the court has appointed a Mediator, he can apply for a stay on all actions, including enforcement of security, rendering the secured creditor powerless.

In the majority of cases it is the borrower only who is able to petition the court to instigate Mediation or insolvency proceedings. This ease of access to proceedings and the lack of priority for security significantly diminish the likely recoveries by a secured creditor.

GERMANY

The new German Insolvency Law, introduced on 1st January 1999, states that the priority of payment of claims in a liquidation is as shown in Table 4.

The secured creditor is not included in this priority list due to its separate satisfaction rights. These apply at all times prior to and during insolvency proceedings. A secured creditor is entitled to receive the proceeds from the sale of secured assets up to the full amount of its claim.

Table 4: Order of Priority under German legislation

- Liabilities of the insolvency estate, which include:-
 - the costs of the insolvency proceedings (costs of the court, the Administrator and the members of the creditors committee),
 - the costs of the social plan*,
 - other liabilities of the estate entered into after the commencement of Insolvency Proceedings (realisation costs, trading expenses, post appointment wages, rents, lease payments)
- Other creditors
- Subordinated creditors (including interest on debts, costs incurred by creditors due to their involvement in the insolvency proceedings, fines and equity).

* The social plan is the agreement with the employees, which compensates them for any adverse changes as a result of a restructuring of the company. See Appendix 3 for more detailed explanation.

The costs of realisation, a flat 9%, are deducted from the proceeds. The only exception to this is when the borrower is in insolvency proceedings and the Administrator determines that the secured assets are crucial to the business. In these circumstances, the secured creditor may be prevented from enforcing its security, but the Administrator must compensate the secured creditor for any loss in value through the use of the secured asset. Additionally, the security remains intact so that when the asset is eventually sold, the secured creditor will receive the proceeds (less costs).

The priority of a creditor's claims on its secured assets cannot be affected during any form of restructuring without its consent. In a court-led restructuring all creditors vote on the proposal in accordance with the size of their claim. Given the strength of a secured creditor's priority and negotiating power through its rights to separate satisfaction, it should be able to maintain its security with respect to these assets, unless there is some benefit to it in releasing the security.

UK

The priority of claims in insolvency proceedings is set out in the Insolvency Act and is unaffected by any previous restructurings or the type of insolvency procedure. The priority cannot be altered by any party, including the court.

The order of priority of payments from asset realisations as laid out in the legislation is shown in Table 5.

Table 5: Order of Priority under English Law

- | |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none">• Expenses of the Insolvency – receiver's/administrator's costs, repayment of post appointment funding, trade debts incurred, post appointment wages• Fixed Charge Creditors (including accrued interest) from the realisations from fixed charge assets in order of priority determined by the Intercreditor deed.• Preferential Creditors (pre-appointment employees' wages, to a maximum of £800 per person, pre-appointment holiday pay, to a maximum of £800 per person, pre-appointment sales tax, pre-appointment employee and employer salary tax).• Floating Charge Creditors (including accrued interest) from the realisations from floating charge assets in order of priority determined by the Intercreditor Deed.• Unsecured Creditors• Shareholders |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

The strength of this order of priority is one of the greatest benefits to a secured creditor in the UK. It is this priority alongside the right of almost immediate enforcement that enables secured creditors to negotiate from a very strong position in any form of restructuring. This absolute priority serves to ensure that there is little a lower priority creditor can do to move up the scale and hence, may not even be granted a role in any restructuring negotiations.

As indicated earlier the only avenue open to other creditors to change this priority of payment is for the security to be deemed invalid. Such a challenge is only likely to be made by a liquidator on very specific grounds.

US

The order of priority in the US is set out in Chapter 7 of the United States Bankruptcy Code and is shown in Table 6 below.

Table 6: Order of Priority under US Law

- | |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none">• Super-priority claims e.g. DIP funding• Administrative claims – professional fees and post-appointment creditors• Priority claims – employee claims for unpaid wages, holiday and sick pay and taxes• Secured claims• Unsecured claims• Shareholders |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

This order affords a secured creditor reasonable priority, although its position can be leapfrogged by a super-priority DIP loan. The existing secured creditor usually advances this loan. In cases where it is another party who provides the loan, the secured creditor has to consent to it taking super-priority security or the borrower has to demonstrate that the secured creditor has adequate security for its loan.

The main threat to a secured creditor is if its security and hence its priority is 'crammed down'. This occurs when the secured creditor is undersecured on its loan; i.e. the loan exceeds the value of the security. In these circumstances, the Bankruptcy Code allows the borrower to treat the undersecured element of the loan as an unsecured debt. So the requirement for a restructuring plan to provide a secured creditor with equivalent security to that which already exists, only applies to the then secured part of the loan and does not include the unsecured element.

The Final Element – Control

A key element in maximising recoveries is the control that a secured creditor can exercise over the restructuring or insolvency proceedings. The greater its control the better the result is likely to be for it, both in terms of timeframe and the level of recoveries it is likely to receive. Control is equally important prior to any restructuring or insolvency proceedings, as it enables a secured creditor to monitor the performance of the

borrower. Control is achieved through access to regular information and the requirement to comply with covenant tests.

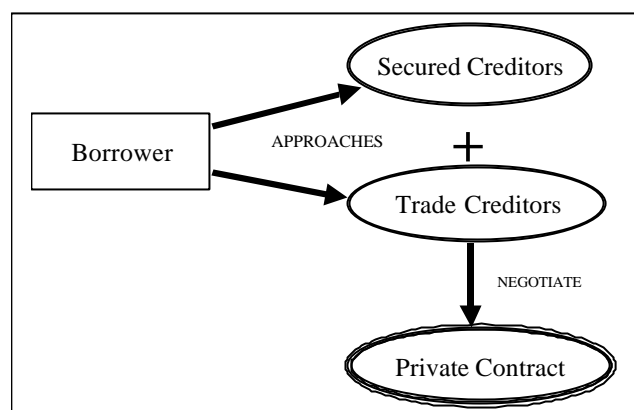
The stronger and more restrictive the covenants contained in the loan documentation the greater the control that can be exerted by the secured creditor. Performance based covenants allow the secured creditor to monitor the financial status of the borrower. In the event of a deterioration in performance, which results in a breach of the covenants, the secured creditor is usually empowered to take further action. However, the extent of control available to the secured creditor both before and during any restructuring or insolvency proceedings varies considerably between jurisdictions.

The control that a secured creditor can successfully exercise is influenced firstly by its priority in the distribution of realisations, which is primarily determined by legislation, and secondly by the relative ease of access for either the borrower or the creditor to insolvency proceedings. If the priority of a secured creditor is strong and it has easy access to insolvency proceedings then its control will be significant. However, if its priority is uncertain and the borrower has easy access to insolvency proceedings (especially as a debtor-in-possession) and a stay of actions, then the secured creditor is in a considerably weaker position both before and prior to any proceedings.

FRANCE

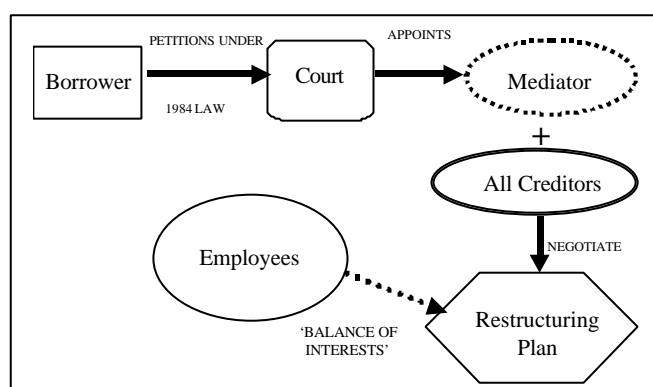
While security held by a creditor cannot be diminished prior to formal insolvency proceedings without its consent, its ability to exercise or enforce such security is severely limited. Without the power to exercise and enforce security it is difficult for a secured creditor to have significant control in either informal or formal insolvency proceedings.

Diagram 1: Informal Restructuring in France



In the event of an informal restructuring (see Diagram 1), a secured creditor remains able to enforce its security. However, the borrower can at any time petition the court to enter either Mediation (see Diagram 2) or insolvency proceedings.

Diagram 2: Formal Restructuring in France

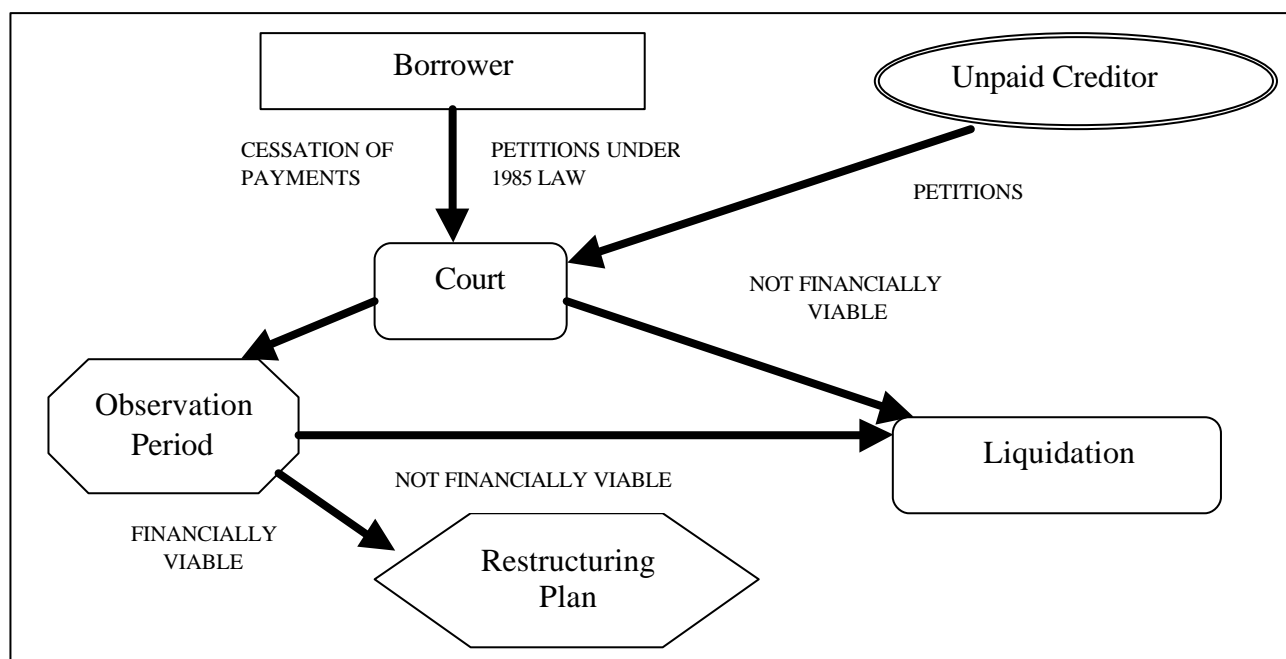


The court-appointed Mediator can then ask the court to order a stay of actions, which it will usually agree to do. This stays all actions, including those by a secured creditor, initiated prior to the court order and prevents a secured creditor starting any further proceedings to enforce its security. This removes a significant bargaining chip from the hands of the secured creditor and gives it to the borrower. Since any efforts to enforce security can be stopped by the borrower petitioning the court, the secured creditor has little control over the restructuring or its security. The secured creditor's consent is needed to a restructuring plan in a Mediation but it has no further ability to control the proceedings.

Once a borrower has reached a 'Cessation of Payments' it is required to enter insolvency proceedings (see Diagram 3). It will then be placed under Observation to determine whether it is financially viable, in which case a restructuring plan can be put in place. Or, alternatively whether it should be put into liquidation.

commencement of insolvency proceedings (the only time a creditor can petition the court). However, as demonstrated these proceedings do not favour the priority of secured creditors. Hence, it can be seen that a secured creditor in France has limited control over the borrower or its security, to the extent that other parties such

Diagram 3: Insolvency proceedings in France



In the Observation Period, a secured creditor can be appointed as one of a maximum of five Supervisors. This position gives it rights of access to information, but no control over the proceedings. During the Observation Period, the Supervising Judge can order that a secured asset is sold. The secured creditor may receive some funds from this asset realisation. However, the court can require these funds be paid back to court at a later date for distribution to other creditors. The court may even require a bank guarantee to demonstrate the secured creditor's ability to repay these distributions.

In addition, there are no provisions in French law for the supervision of the borrower whilst an agreed restructuring plan is in force. A creditor can apply for the renegotiation of the plan if it believes that the borrower is not in compliance. In the event that the borrower is in financial default under the plan, a creditor can request the

as employees and shareholders can promote their case at its expense.

GERMANY

As explained earlier, a secured creditor in Germany remains entitled to separate satisfaction on its secured assets even when the borrower is in insolvency proceedings. Access to insolvency proceedings (see Diagram 4) is open to both the creditor and the debtor, but there is less of an incentive for the debtor to use this option, given that the secured creditor retains its rights to separate satisfaction. This ensures that secured creditors can take a strong negotiating position throughout any restructuring or Insolvency Proceeding.

A secured creditor can exert reasonable influence in a court based restructuring. Creditors consent via the creditors assembly is

needed for any restructuring plan to be implemented. Voting in this assembly is determined by the size of a creditor's claim against the borrower. Given that a secured creditor's claim is often the largest, this allows it reasonable control of the proceedings. In the event that the restructuring is complex, a creditors' committee will be established. This committee is required to include representation from secured creditors, alongside large creditors, minor creditors and employees. The committee acts to support and supervise the Administrator and hence, the involvement of the secured creditor again allows it an element of control over the process.

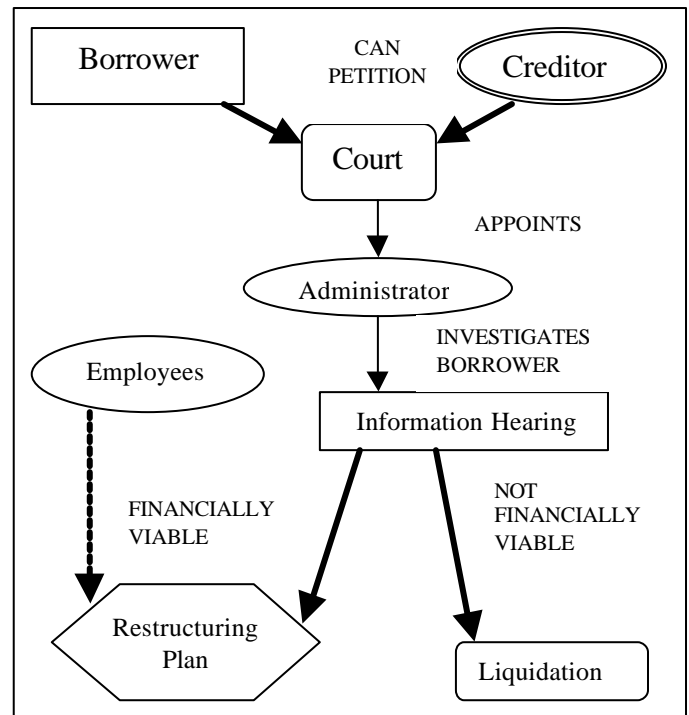
A secured creditor in Germany does therefore have significant control over the enforcement of its security, although this control is not as strong as it is in the UK. The key difference is that while other creditors cannot force proposals on to a secured creditor this applies both ways. Hence, other creditors can reject a proposal that the secured creditor approves of, forcing the borrower into liquidation.

A further factor to be aware of is that employees in Germany can influence insolvency proceedings. They have the right to be kept informed of any material changes to the borrower and its business. Their consent is required to any changes to the Works Agreement, which governs matters such as working hours, pensions and wages. Before a restructuring plan can be implemented, the Administrator has to negotiate a social plan with the Works Council to compensate employees for any changes under the restructuring. This can take a considerable time to negotiate, delaying the restructuring to the detriment of the borrower and its creditors, secured or otherwise.

UK

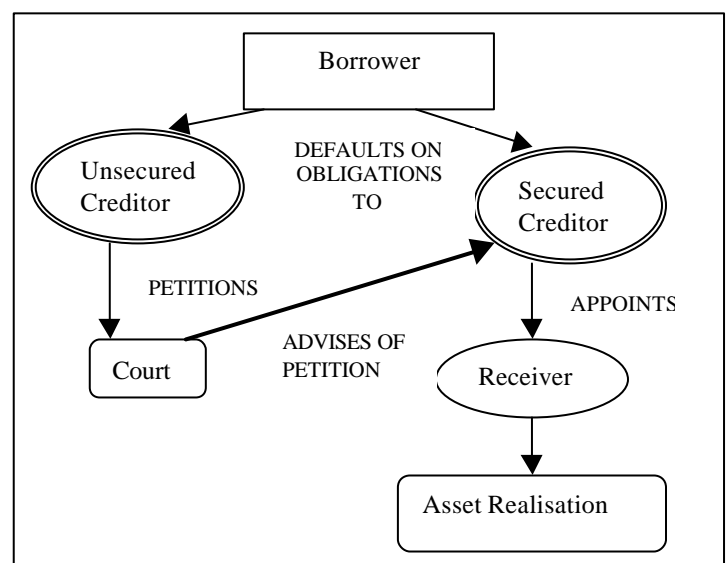
The absolute priority of a secured creditor at all times and its ease of access to insolvency proceedings (see Diagram 5) ensures that control is firmly in the hands of the secured creditor.

Diagram 4: Insolvency proceedings in Germany



Loan documentation in the UK often includes a series of restrictive covenants limiting the actions of the company, in addition to supplying the secured creditor with ongoing information about the performance of the company. For leveraged loans the company will also have to comply with a series of financial ratios which are designed to monitor the ongoing performance of the company.

Diagram 5: Insolvency proceedings in the UK



While some loan documents give the company a limited period of time to remedy a breach of covenant, typically once there has been a breach the secured creditor is in a position of control. It is entitled to receive additional information, including accountant's reports, meetings with management, to cancel any undrawn commitments, to demand repayment or to appoint a Receiver.

In practice, the London Approach (see Appendix 3) proposes that no precipitate action is taken without full information. However, its priority over asset realisations puts the secured creditor in a very strong position and there is little that any other creditors can do to affect this.

The legislation and documentation allow a secured creditor to appoint an Administrative Receiver under a floating charge, or a Receiver over fixed charge assets, to act on its behalf to realise the secured assets. Neither appointee has any obligations to the other creditors of the company. Whilst he is required to realise a fair price for the assets, this need not necessarily be the best price. He is appointed by the secured creditor, he reports to the secured creditor and he realises assets on behalf of the secured creditor.

Even in the event that an unsecured creditor petitions the court to appoint an Administrator, if the secured creditor has a floating charge it is able to intercede. The secured creditor will have five days after the petition in which to appoint an Administrative Receiver over the company. This will prevent the appointment of an Administrator, who would have acted on behalf of all creditors.

US

While an informal restructuring is frequently initiated by the borrower, the secured creditor typically has a reasonable amount of control over the process. The borrower's main negotiating strength is its ease of access to formal court-led restructuring through Chapter 11, whereas the secured creditor remains able to enforce its security either through judicial or non-judicial proceedings.

This balance of power usually means that the borrower drives the timing and the direction of the restructuring, but the secured creditor guides the outcome of the negotiations. In an informal restructuring, there are few parties able to exert any meaningful influence over the process to the detriment of the secured creditor. The exceptions to this are the borrower itself, the unsecured creditors and political entities, which act as checks to the control that can be exerted by the secured creditor.

Unsecured creditors can exert pressure by threatening to file an 'involuntary petition'¹⁹ with the court for the borrower to be placed into Chapter 11 proceedings. This will result in the imposition of an automatic stay and prevent the secured creditor from being able to immediately enforce its security. Alternatively, unsecured creditors sometimes threaten a secured creditor with a lawsuit for damages as a result of the secured creditor's improper degree of control over the borrower.

If the borrower is a large employer in an area or it operates in a regulated industry, political or governmental bodies can exert pressure on a secured creditor to choose a restructuring which is beneficial to their interests.

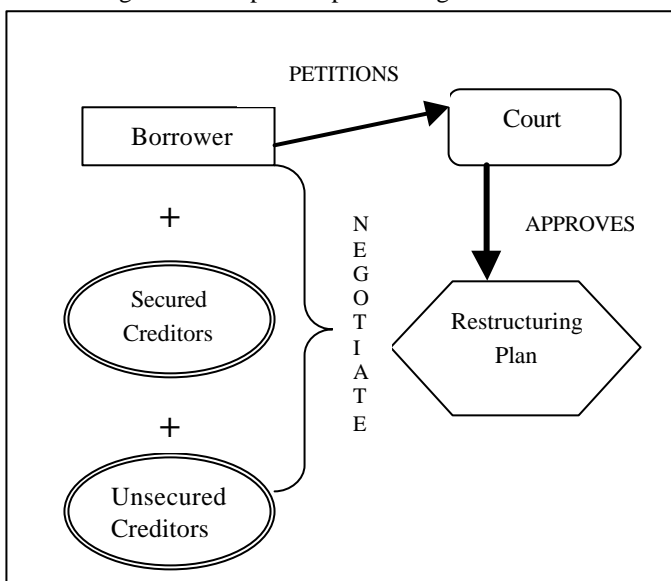
Once a borrower is in Chapter 11 proceedings, there is an automatic stay against all creditor actions, including enforcement. This removes a significant part of a secured creditor's influence. However, it still retains a reasonable amount of control, as the borrower is often forced to approach the secured creditor for additional funding ('DIP' loan), which can allow the secured creditor to influence the budgetary process of the borrower and the pace of the bankruptcy proceedings. If the secured creditor feels the borrower is not adequately protecting its security, it can apply to the court for relief from the stay. If relief is granted, the secured creditor is allowed to enforce its security outside of the proceedings. Such relief is somewhat uncommon. Finally, the secured creditor can

¹⁹ Three or more creditors with total claims in excess of \$10,000 over any collateral they may hold may present an involuntary petition under Chapter 11 to the court.

block any restructuring plan which does not provide it with as much value as its security is worth on the date the plan is to be confirmed. These rights allow the secured creditor to have reasonable influence in the restructuring negotiations.

In Chapter 11, a secured creditor will have to negotiate with the existing management of the borrower and a committee of unsecured creditors. This committee represents the interests of all unsecured creditors and is often opposed to the efforts of the secured creditor to retain as much of the value of the borrower's assets as possible. It frequently tries to challenge the validity of the secured creditor's security or to diminish it through the process of 'cramming down' security. The committee can exert a strong influence over the restructuring as the court places significant emphasis on its view in deciding whether to approve the proposal.

Diagram 6: Chapter 11 proceedings in the US

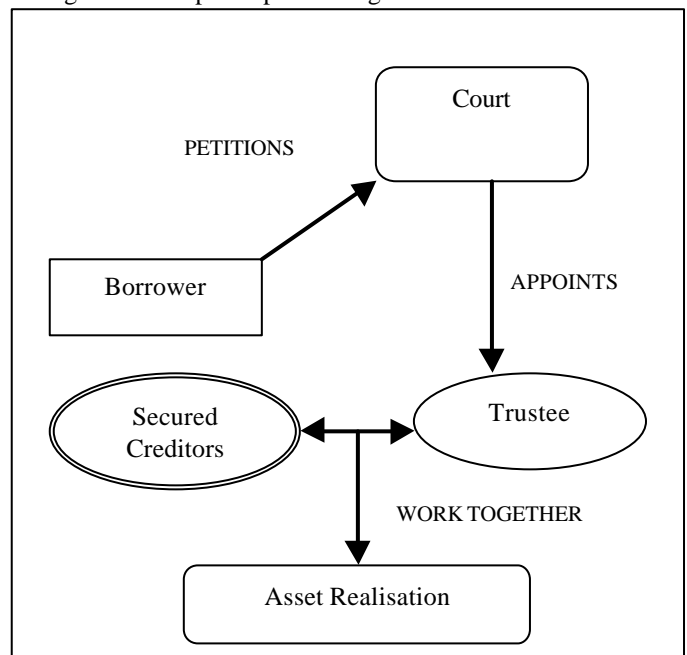


Overall, Chapter 11 is not particularly favourable to a secured creditor. The borrower remains in possession of the security and any enforcement actions are stayed. The borrower and the court and unsecured creditors have strong influence over the outcome of the restructuring. Indeed the court typically does not like overly aggressive secured creditors. These factors all limit the control a secured creditor can exert over a restructuring in the US. Hence, it is not uncommon for a secured creditor

to be pressurised into releasing security or agreeing easier terms for the borrower.

Chapter 7 is the process by which the borrower's assets are liquidated and distributed to its creditors. The management of the borrower are replaced by a trustee in bankruptcy, who takes possession of the assets. While the secured creditor has no control over its security, the trustee usually works with the secured creditor to determine the most efficient realisation process. Unsecured creditors have little influence in Chapter 7 proceedings. So while its security may have been weakened in Chapter 11 proceedings, a secured creditor does have influence over the realisation of its remaining security in Chapter 7. However, Chapter 11 proceedings are significantly more common than Chapter 7 proceedings.

Diagram 7: Chapter 7 proceedings in the US



APPENDICES: Insolvency Legislation

Introduction

This study reviewed the insolvency regimes in terms of their impact on the key elements of security, priority and control. These appendices give an overview of the legislation in each country, covering informal restructuring, formal restructuring and realisations (or liquidations).

These appendices are not designed to be a definitive guide to the insolvency legislation in each jurisdiction, but rather an outline of the relevant proceedings. They focus less on the position of a secured creditor than the previous sections and broaden the view to consider the proceedings as a whole.

APPENDIX 1

FRANCE

The main legislation governing insolvency in France is contained in Law No 84-148 of 1st March 1984 and Law No 85-98 of 25th January 1985, both of which were modified in 1994. The majority of restructuring historically has occurred with court involvement, however there has been a recent shift towards less formal proceedings without recourse to the court.

Informal Restructuring

It is possible for a borrower to restructure its debts without the involvement of the court. Whilst in theory any party can initiate this process, in practice it is usually the borrower who approaches its creditors to renegotiate its debts. Although secured creditors can initiate the process if they have concerns over the borrower's financial position.

Whilst the restructuring can occur without the court's involvement, an interested party can ask the court to appoint an expert ('mandataire administrative hoc') to assist in the process. Such an appointment is at the discretion of the court and its sole input is to nominate the expert. The expert can make suggestions or proposals, but he has no legal authority and his suggestions

are not binding on any party. The benefit of his involvement is that he can exert some moral influence over the parties and help to ensure that any eventual agreement is complied with.

Control over the informal restructuring process varies between cases as it depends on the relative negotiating strengths of the parties involved. In practice, typically the borrower and the largest creditors will have the most control. Whilst shareholders may have no specific rights, if a resolution is required which has to be authorised by the shareholders, this will give them some negotiating power. This can potentially result in them being able to negotiate a more favourable position, as was the case in the Eurotunnel restructuring.

Similarly, employees generally have no specific rights. Although, they are entitled to be kept informed and consulted about important decisions, such as the closure or sale of a branch or activity. Whilst employees and shareholders would seem to have little power, the fact that the legislation does not afford much recognition of the priority of secured creditors, weakens their negotiating position. This can mean that other groups of creditors can exert influence over the restructuring and the secured creditor to enhance their position at its expense.

It is not possible in an informal restructuring for the security held by a creditor to be diminished without its consent. During this period the secured creditor remains able to enforce its security. Nevertheless, the secured creditor may find itself being compelled to give such consent to avoid formal insolvency proceedings instigated by the borrower, which afford it little protection.

The subsequent setting of the Suspect Period by the court may impact on actions taken by the borrower during a restructuring, if it was deemed to have occurred within this period. However, additional security provided for new money given to the borrower in a restructuring cannot be set aside.

Formal Restructuring – The 1984 Law and Mediation

The borrower can petition the court under the 1984 Law to enter a formal restructuring process or mediation. The legislation is aimed at restructuring a company's legal and economic situation through a voluntary corporate arrangement ('reglement amiable') and applies where the borrower has not ceased making payments to its creditors.

The borrower is the only party able to initiate formal restructuring proceedings. The only course of action open to certain other interested parties is to initiate alert proceedings ('procedure d'alerte'). This avenue is only open to shareholders, auditors, the Works Council, the court or accounting associations. Any of these parties can initiate alert proceedings if they become aware of facts that could compromise the borrower's future. This is only an informative procedure to notify other interested parties of the existence of certain facts that may be of concern and the borrower is not required to take any remedial action. The issue of alert proceedings is an event of default under typical banking documents. However, if this were to trigger insolvency proceedings, then public policy will not allow this event to constitute an event of default. So enforcement of security is not an option for a secured creditor.

Once the borrower has petitioned the court, it must decide whether the company's difficulties are capable of being remedied. If it believes they can it then appoints a Mediator and in some cases it will also appoint an expert. If the court believes the financial problems cannot be remedied then it will open formal insolvency proceedings.

The expert's role is to examine the financial state of the borrower and to conduct confidential interviews with parties who may have useful financial information on the borrower. These parties frequently include the banks and accountants. The Mediator is usually appointed for a maximum period of four months, although this can be extended. His role is to act as facilitator in the negotiations between the borrower and its creditors, with the aim of procuring a restructuring agreement.

The key aspect of the court's involvement is that it can, at the request of the Mediator, order a stay of all actions and proceedings against the borrower. The result is the borrower is then prohibited from making any payments to any creditors whose claims arose before the court's ruling and from granting any further security over its assets. The stay includes any proceedings previously initiated by the secured creditor and prevents it from enforcing its security. The stay lasts as long as the Mediator's appointment. After this period either an agreement has been reached between the borrower and its creditors, in which case the stay will remain in place as long as the agreement, or no agreement has been reached, in which case the creditors can reassert their rights.

A creditor, irrespective of its security, can only influence the restructuring by refusing to consent to the Mediator's proposals. Unanimous consent is required to a restructuring plan, so while a secured creditor cannot have a dilution of its security forced upon him, it may be difficult to refuse to consent if everyone else has agreed. Hence, restructuring agreements often include either stays or waivers of debts.

Whilst employees and shareholders have no specific voting rights, they do have some influence. The Mediator is required to agree a 'balance of interests' which compensates the employees for any detrimental effects of the restructuring plan. This can delay the implementation of the agreement, which may be time critical. In these circumstances employees may be able to negotiate a better deal for themselves. Similarly if shareholder consent is needed by the borrower to carry out some of the aspects of the plan, then the shareholders will have the opportunity to ensure they receive some benefit from the restructuring plan.

Throughout this period the directors remain in control of the borrower. However, the restructuring plan may require that they are replaced or it may impose certain restrictions on the actions of the management.

Despite the involvement of the court in this process, the restructuring agreement reached by the parties is a private contract. There is no

specific provision within the 1984 law for the supervision of the borrower whilst the restructuring agreement is in force. The creditors can ask for a renegotiation of the agreement if they are not satisfied with the borrower's conduct. Alternatively, if the borrower is in financial default, the creditors can petition the court for the termination of the agreement and the commencement of insolvency proceedings.

Insolvency proceedings under the 1985 law: Observation & Liquidation

The 1985 Law states that a borrower, which has ceased making payments to its creditors, has 15 days in which to file a request with the court for the commencement of insolvency proceedings. Unlike the 1984 law any unpaid creditor may also file a request with the court to start insolvency proceedings against a borrower. Additionally, the court of its own volition or the Public Prosecutor are also able to initiate these proceedings.

The proceedings are overseen by a Supervising Judge ('juge commissaire'). Once the court has opened the insolvency proceedings, the Judge has to decide whether or not the business is financially viable. If he decides that it is not, then he will make an immediate order for the liquidation of the borrower. If he believes it may be financially viable, then an Observation Period ('periode d'observation') will commence.

An Administrator ('administrateur') will then be appointed by the court to investigate the affairs of the borrower during this period. The Observation Period can last for up to twenty months. At the end of which the Administrator will make proposals for the future of the borrower.

During the Observation Period the borrower is not permitted to make payments to any pre-insolvency creditors, including secured creditors. Secured creditors are not permitted to enforce their security and all existing actions or proceedings are suspended. The exception to this is security that gives secured creditors direct rights over certain sums of money, such as a delegation or Bodereau. This can be enforced

without being subject to the stay. Additionally, secured creditors are allowed to accrue interest on loans with a duration in excess of one year. Debts incurred during this Period which were authorised by the Judge, will be paid by the borrower or will rank third in the priority of payments in a subsequent liquidation, behind sums due to employees and the costs of insolvency.

Existing management may remain in control of the borrower during the Observation Period or the Judge can invest the management of the company in the Administrator. The Judge can authorise the sale of secured assets or the payment of a creditor with security over an asset, if he believes this asset is key to the company. Whilst this initially sounds good for secured creditors, those creditors which are paid must provide a bank guarantee to secure eventual repayment of the amounts received to the court for distribution to other creditors as determined in a subsequent liquidation. So while a secured creditor may initially have some of its debt repaid in return for the release of security, these funds are not necessarily for it to retain as the court may order a different distribution of assets.

All creditors, irrespective of security, are represented in the insolvency proceedings by two court appointed parties, the Creditors' Representative and the Supervisors. The Creditors' Representative checks and challenges the claims filed by creditors. All creditors must file their claims within two months of the official commencement of insolvency proceedings (as defined by the publication of the judgement in a paper called the BODACC). This can result in many creditors not filing claims. Failure to file within this period results in the claim being extinguished and the creditor losing all rights to payment. Secured creditors, however, are notified by the Creditor's Representative of the commencement of insolvency proceedings.

After the two month filing period the Creditor's Representative will check all the claims. If he challenges them the cases will be brought before the Judge who decides whether to accept or reject a claim. The creditor or the Creditor's Representative can then challenge this decision

within ten days.

The second group which represents the creditors are the Supervisors ('controleurs'). These are nominated by the Judge who can choose between one and five Supervisors from those creditors who requested nomination. If there is more than one Supervisor then the different classes of creditor should be represented. The Supervisors are permitted to see any documents sent to the Administrator or the Creditor's Representative but they have no official power.

In common with both informal and formal restructurings, shareholders do not have any specific rights in the insolvency proceedings. However, experience shows that they receive better treatment than that usually afforded shareholders in other jurisdictions, often at the expense of creditors. Employees' representatives and the Works Council, through an appointed representative, do have a right of appeal against any decisions that order the liquidation of the company. Additionally, employees have the highest priority of payment in a liquidation, limiting their downside.

Once the Observation Period has been completed, the Administrator presents his proposals to the court. The Administrator can propose a restructuring plan if he believes the borrower is financially viable. Alternatively, if he does not believe it is financially viable, the Judge will order the liquidation of the company and the realisation of all its assets for distribution among the creditors. The realisation may include the repayment of funds previously paid to secured creditors as consideration for the release of their security over certain assets.

Liquidation can also occur where a borrower has defaulted on its financial obligations under a formal restructuring agreement or where an unpaid creditor petitions the court and can prove that the borrower has actually ceased business.

In a liquidation the court will fix the date of the Cessation of Payments ('cessation des paiements'). This can be up to eighteen months prior to the start of the insolvency proceedings. This date is important as it is the period between the date of Cessation of Payments and the start

of insolvency proceedings which is the Suspect Period. This is the period during which many acts taken by the borrower, including the granting of security, can be set aside by the judge.

The priority for distribution is determined by a number of laws, not merely the 1985 law. The precise order does vary but generally it is along the following guidelines:-

- salaries and amounts due to employees
- costs of insolvency proceedings
- post-appointment debts including company and social taxes
- secured creditors by date of registration of charge
- unsecured creditors

APPENDIX 2

GERMANY

As of 1st January 1999, a new Insolvency Code replaced the old Bankruptcy Code and Reorganisation Code. The new code was published in advance of its enactment to allow everyone to become familiar with it. The regime was intended to incorporate some of the debtor friendly aspects of the US system, without significantly disadvantaging secured creditors.

Informal Restructuring

Any party can initiate an informal restructuring, although it is frequently the borrower that will approach its creditors to renegotiate its debts.

As there is no legal framework governing the process, the balance of power between the interested parties depends on their negotiating strength. In the event that the restructuring is particularly complicated a 'creditors' committee' can be elected to represent the interest of the creditors in the restructuring process. The scope of the committee's rights depends on the individual agreement between the borrower and the creditors. Depending on the actual restructuring agreement a trustee can be appointed. His responsibilities will vary from case to case, but he can be empowered to realise assets or merely to supervise the borrower.

A secured creditor cannot be compelled to take part in an informal restructuring. It may choose to take part and can, by virtue of its claim, often one of the largest, have a strong influence on the restructuring. A secured creditor remains able to enforce its claims against the company and exercise its security during the informal restructuring process. This ensures its views are taken into account.

The creditors may choose to establish a rescue company ('Fortführungsgesellschaften') to take over the business of the borrower. These companies are usually then owned by the creditors who can then influence the company as its shareholders.

Employees may be able to exert some influence in an informal restructuring, as their consent via the Works Council is needed for any material change in the works agreement. This agreement covers a wide range of issues including working hours, wage structure and pensions. The employees continue to have co-determination rights in a restructuring, so it is necessary to negotiate a 'balance of interests' or social plan with the Works Council. The plan is intended to compensate the employees for any adverse changes resulting from the restructuring. If it is not possible to reach agreement then a Conciliation Board will decide on a social plan. The company is not permitted to implement the restructuring agreement until a 'serious attempt' has been made to reach a plan, which can delay the process considerably. This ensures the employees have some negotiating power during the restructuring.

The restructuring agreement is based on the principle that all creditors of the same class are treated equally. While some creditors may seek to try and improve their relative position, other creditors of the same class typically only consent to the agreement on the principle of equal treatment. If this equal treatment does not occur a creditor is entitled to rescind the agreement.

Any creditor providing additional funding required by the restructuring is entitled to demand priority of repayment. However, this can only be achieved with the consent of the creditors as part of the agreement. This may

result in the secured creditor being leapfrogged in terms of priority of payment, as is the case with DIP funding in the US.

Restructuring with Court Involvement

Section 16 of the Insolvency Code gives three reasons for the initiation of insolvency proceedings by a borrower. These are the inability to pay debts as they fall due, the impending inability to pay debts as they fall due and where liabilities of a company exceed its net assets. The borrower can initiate insolvency proceedings for any of these three reasons. A creditor, however, can only initiate insolvency proceedings on the grounds of a borrower's inability to pay debts as they fall due or overindebtedness.

Once a case is filed with the court for the opening of insolvency proceedings, the court can appoint an interim administrator. The interim administrator replaces the existing management and is required to continue the business of the borrower. He is empowered to both administer the company and to dispose of the borrower's assets if appropriate.

Once the insolvency proceedings have been opened, the management of the borrower is then transferred to a court appointed Administrator. The Administrator is supervised by the court, which can demand information or reports at any time or dismiss him if he does not fulfil his duties. Creditors are able to elect an alternative Administrator if they wish at the first creditors' assembly, however in the majority of cases they accept the court's choice.

The Administrator's role is to put a proposal to the court for the restructuring of the borrower. The only other party entitled to put such a plan to the court is the borrower itself. The court and all the creditors have to accept the restructuring plan for it to become effective.

Once the borrower is in insolvency proceedings a creditors' assembly, including all creditors, is established. The voting rights of each creditor are determined by the size of their claim. The assembly has the right to vote on:-

- the appointment of the Administrator;
- the continuation or cessation of the borrower;
- important measures for which the Administrator wishes to have the creditors' sanction ;
- the acceptance of an insolvency plan; and
- the appointment of a creditor's committee and the election of its members.

The appointment of a creditor's committee is optional and tends to happen only on larger cases to assist in the restructuring process. The committee will have representatives from secured creditors, large creditors, minor creditors and employees. It supports and supervises the Administrator and receives information from the borrower. The Administrator will need to obtain the consent of the committee if he is proposing to undertake any significant transactions and before each distribution of money to creditors.

Prior to the approval of a restructuring plan, a secured creditor can demand separate satisfaction on its secured assets. The secured creditor can either realise these assets itself or the Administrator will realise them and pass on the proceeds less a flat 9% realisation charge. However, if the Administrator believes a particular secured asset is essential to the business of the borrower, he can prevent its disposal by the secured creditor. In this instance, the Administrator is required to pay compensation to the secured creditor for any loss in value of the security.

The Administrator is required to report on the borrower's situation at the Information Hearing. He then indicates whether there is a chance for all or part of the business to continue. He will present his restructuring plan and his opinion of likely realisations for creditors.

The restructuring plan may include the borrower taking on additional debt. This debt will take priority over existing creditors. However, the restructuring plan will also establish an overall amount for such loans that must not exceed the value of the borrower's assets. The plan may also include the dilution, restriction or deletion of security.

If the creditor's assembly votes against the restructuring plan then the borrower will be liquidated. The Administrator will then realise the assets of the borrower for distribution to the creditors.

Liquidation

In the event that the creditors do not accept the proposals for a restructuring or that the Administrator himself proposes a discontinuation of the business, the borrower will be placed into liquidation.

The secured creditor still retains the rights to separate satisfaction on all its secured assets. It will receive the proceeds from these assets less a 9% flat realisation fee charged by the Administrator.

The remaining realisations are distributed as follows:-

- a) Liabilities of Insolvency
 - court costs
 - Administrator's costs
 - costs of social plan with employee compensation
 - other post appointment debts including rent and salaries
- b) Unsecured Creditors
- c) Other creditors
 - Interest on claims
 - Creditors' costs
 - Fines and Penalties
 - Shareholders' claims

APPENDIX 3

UK

The pro-creditor nature of the insolvency legislation in the UK has been recognised as not being conducive to restructuring companies. This was shown to be the case in the last recession. As a result there have been moves recently to ensure companies are not liquidated too hastily.

The London Rules

A restructuring in the UK is not typically done through the legal framework of an Administration, due to the stigma attached to any insolvency procedure. In the 1990s the Bank of England, along with banks operating in the UK, developed the London Approach to Corporate Workouts.

The London Approach is an unwritten framework rather than a detailed set of rules. It has no formal status, it is not statutory and the Bank of England has no powers of enforcement. The main elements are that:

- banks should remain supportive when they are informed that a company is in financial difficulty i.e. they do not immediately appoint receivers;
- decisions about a company's long term future should only be made on the basis of comprehensive information, which is shared among all the banks and other parties to a restructuring;
- banks should work together to reach a collective view on whether and on what terms a company should be given a financial lifeline; and
- the seniority of claims continues to be recognised, but there is an element of 'shared pain' whereby all of the creditors in the same category are treated equally.

A restructuring is typically achieved through negotiations between the key parties behind closed doors. This prevents the business from being affected by the stigma of insolvency, which would probably destroy the business the parties are trying to save. However, it is important to recognise that the secured creditor(s) have the strongest negotiating power as a result of their priority. This negotiating power ensures they have significant control over the process because they are able to withdraw at any time by appointing a receiver.

Insolvency proceedings

The insolvency legislation in the UK is contained in the Insolvency Act 1986 ('Insolvency Act') and the Companies Acts of 1985 and 1989. The Insolvency Act is supported

by the Insolvency Rules 1986.

The Insolvency Act recognises two key tests to determine whether a company is insolvent; an ability to pay its debts as they fall due and where its net assets are less than its liabilities. Once insolvent there are several routes for the company; receivership, administration or liquidation, depending on the perceived future for the company.

In outline, receivership is the method used by secured creditors to realise their security, administration is a court controlled appointment with the purpose of either reorganising the company or realising assets for all creditors and liquidation is the process by which a company is dissolved and all funds realised and distributed.

This article focuses on receivership and administration as these are the most applicable for creditors with security. Receivership is the most common method used by secured creditors to enforce their security as demonstrated by the fact that in 1998 there were 1,713 receivership appointments compared with only 338 administration appointments²⁰.

Receivership

As previously discussed, the security available to a creditor consists of charges over fixed assets such as property, plant and equipment and floating charges over current assets and the business itself. These charges are commonplace and inexpensive to obtain and register.

The fixed charge enables the secured creditor to appoint a receiver over the charged assets, while the floating charge entitles the secured creditor to appoint an administrative receiver over the current assets and business of the borrower. The administrative receiver is able to manage the business and can continue to trade the borrower whilst it is in receivership with a view to selling it as a going concern. It is important to note that in both these cases it is the secured creditor who makes the appointment and chooses the appointee, who acts solely for the secured creditor.

²⁰ DTI Statistics Directorate Press Release

Once an Administrative Receiver has been appointed the directors' powers are suspended and other creditors tend not to enforce their claims. The Administrative Receiver has wide ranging powers, which include trading the business, dismissing employees, selling assets and, acquiring assets

The Administrative Receiver or Receiver realises the assets for the benefit of the secured creditor. While he has a duty to other creditors to achieve a fair or reasonable price for these assets, this does not have to be the best price. The secured creditor has significant control over the receivership as it receives regular reports from the appointee, who will also consult it on major decisions.

In the event that additional funding is required for the receivership, this is usually provided by the secured creditor. These funds will rank as expenses of the Administrative Receiver and will be paid out first from realisations, along with other expenses of the receiver. Once all the charged assets have been realised, the Receiver will distribute any funds realised under the fixed charge to the fixed chargeholder. Any realisations from floating charge assets will first be used to pay the statutory preferential creditors and any surplus is paid to the floating chargeholder. The secured creditor is permitted to accrue interest on its debts during receivership and this interest will rank alongside the secured debt for repayment i.e. at the top of the payment priorities.

The company will then typically be placed in liquidation and a liquidator appointed. The liquidator will realise any further assets, adjudicate claims by unsecured creditors and distribute any funds to unsecured creditors and shareholders.

Administration

An alternative insolvency procedure is administration. The company, the directors or any creditor can petition the court for an administration order directing that the company should be managed by an Administrator. The order is made on the grounds that the company is or is likely to become insolvent. One of the aims

of administration is to allow companies to be reorganised or refinanced.

The Administrator is appointed by the court and acts on behalf of all creditors. As a result the secured creditor has less control over an administration than it would over a receivership. However, a floating chargeholder has the right to be informed of the impending appointment of an Administrator. It then has five days in which to appoint an Administrative Receiver if it so wishes. Once an Administrative Receiver has been appointed, the court is no longer able to appoint an Administrator. Hence, the secured creditor has the power to ensure that it retains control of the process.

An Administrator, once appointed, manages the business and the directors' powers are suspended. He has a minimum of three months in which to put proposals before the court and the creditors on the future of the borrower. All creditors are entitled to vote on these proposals, in accordance with the size of their claim.

The proposal can be for the Administrator to sell the assets of the company, including the secured assets. However, the priority of payment remains unchanged. Realisations from fixed charge assets will be paid to the fixed charge creditor and realisations from the floating charge will be paid to the floating charge holder after the preferential creditors have been paid. So although the secured creditor has less control in an administration than in a receivership its priority of payment is not affected.

Administration was intended to act as a moratorium for the company against its creditors, to allow it time to review its financial situation before deciding whether to reorganise or liquidate the company. It is the closest procedure to Chapter 11 that exists in the UK. In practice few companies have emerged from administration intact to trade again as a going concern, with the same group of banks and shareholders.

APPENDIX 4

US

The US insolvency regime tries to afford a creditor protection, whilst attempting to allow a borrower sufficient opportunities to restructure itself. To achieve this balance no one interested party has overriding control of the insolvency proceedings and the involvement of the court serves to encourage all interested parties to resolve their differences.

Informal Restructuring

In the US an informal restructuring can be initiated by the borrower or by any creditor, secured or otherwise. If the company is relatively large, it tends to be the borrower who instigates the process, as it has greater knowledge of the financial position.

There is typically no court involvement in an informal restructuring. The exception is where the parties have decided on a 'pre-packaged plan of reorganisation'. This occurs where the parties have agreed the terms of the restructuring and the borrower enters Chapter 11 insolvency proceedings to seek the court's approval of the agreement, which will then become binding on all creditors. court approval is not automatic and if it feels that all creditors have not been fully informed then it can delay or reject the proposal. However, pre-packaged proposals are usually very quick and can be finalised within thirty days.

Throughout the informal restructuring, the secured creditor remains able to enforce its security. This can be done through judicial foreclosure, which is required for property and fixtures. This process requires the secured creditor to bring a lawsuit against the borrower and any other creditor asserting a lien against the assets. The defendants to this lawsuit are allowed time to respond and can challenge either the validity of the lien or the existence of a default under the loan. Once any challenges have been decided, the secured creditor will ask the court for a judgement of foreclosure and an order of sale. The judicial sale will take place soon after. The asset is usually sold to the

secured creditor for an amount less than its debt. In the event of challenges, the process can take a considerable length of time and prove very expensive.

Non-judicial sales of assets apply where the security consists of current assets. If there is a mixed pool of security, then both types of proceeding will be required. For a non-judicial sale, the secured creditor notifies the borrower and any junior secured lenders of its intent to dispose of the assets. The sale has to be advertised in a 'commercially reasonable manner' and a public auction is held. As with the judicial sale, the purchaser is usually the secured creditor for an amount less than its indebtedness.

Chapter 11

Chapter 11 of the US Bankruptcy Code provides for the reorganisation of an ongoing business. There are two methods by which a borrower can enter into Chapter 11 proceedings. The most common is a 'voluntary petition' by the borrower. The alternative is where three or more creditors, with aggregate debts in excess of \$10,000 over the value of any security make an 'involuntary petition' to the court to place the borrower into Chapter 11 proceedings.

Entering into Chapter 11 proceedings results in the automatic stay against virtually all creditor actions, including foreclosure, non-judicial sales and collection lawsuits. Chapter 11 is designed to force all the relevant parties, essentially the borrower, the secured creditors and the unsecured creditors, to negotiate with each other to achieve an agreement which will allow the borrower to exit from Chapter 11 proceedings and trade as a going concern. While the court has significant control over the proceedings, it does not decide on the restructuring plan.

A borrower can remain in Chapter 11 proceedings for a considerable length of time. Although typically the longer it spends in these proceedings the less likely it is to exit successfully. The requirement for additional funds while in Chapter 11 proceedings will vary between borrowers. However, any party providing DIP funding will require first priority

charge over highly liquid assets. It is unlikely that such assets are not already subject to some form of prior charge. This 'super-priority' charge cannot be imposed above an existing charge unless the borrower can demonstrate that the secured creditor is adequately protected either through excess collateral or by a replacement charge. A secured creditor can still object to this if it feels it is not receiving adequate value.

It is frequently the existing secured creditor that provides additional funding. This will usually result in new loan documentation, which is subject to the court's approval. The provision of extra funds allows the secured creditor to try and influence the direction of the restructuring.

Chapter 7

Chapter 7 is the part of the Bankruptcy Code that deals with liquidating the borrower's assets, settling claims and distributing proceeds. As with Chapter 11, typically it is the borrower that initiates the process by filing a 'voluntary petition' with the court. Alternatively, three or more creditors with unsecured debts in excess of \$10,000 can file an 'involuntary petition' with the court. Frequently, a borrower will enter Chapter 7 proceedings after an unsuccessful Chapter 11 process.

Once a borrower enters Chapter 7, the management team is dismissed and a court-appointed trustee takes possession of the borrower's assets. The trustee has almost complete control over the Chapter 7 proceedings. However, he will typically work with the secured creditor to determine the best method of realising the borrower's assets. The unsecured creditors, employees and shareholders have virtually no control over the Chapter 7 proceedings.

Within Chapter 7 the automatic stay against creditor actions remains in place. Hence, the secured creditor is reliant on the trustee to realise its security, although it will usually be liable to pay the costs of realisation. If the secured creditor and the trustee are unable to agree the best method of realisation, then the secured

creditor can apply to the court for relief from the stay. This is more likely to be granted in a Chapter 7 case than in a Chapter 11 case.

In calculating its claim, the secured creditor will be allowed to accrue interest on its loan, but only up to the value of its security but no more. Hence, if its security is worth less than its debt then it will not be allowed to accrue any interest.