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RESTRUCTURING BUSINESS IN DIFFICULTY, IN DOMESTIC AND INTERNATIONAL LAW

(PHD THESIS SUMMARY)

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Abstract

By this thesis I have in mind to address a current and important topic faced by most of the world's economies, namely insolvency, and to present the "bright side" of this phenomenon (socially and economically perceived as a disaster), that is the prevention of insolvency, where possible, and the new "second chance" concept, in order to bring a substantial input to the creation of a "rescue culture" from insolvency and bankruptcy. My research has focused on the time and space presentation of the national and international, particularly European legislative and economic context, being therefore a comparative law approach. There is no point in the lawmaker losing valuable time "inventing the wheel", since the legislation, the rule of law and the doctrine of international law abound by legislative models, treaties, conventions, guidelines and recommendations, whose effectiveness and practical application have demonstrated that are good models that can be easily adapted to the realities of the post-December national economy?

Therefore, the choice of my doctoral research theme - "Restructuring of a company in difficulty, in domestic and international law" - was not a random one, but I had a specific purpose in mind, being driven when drafting the thesis to find answers and solutions, to form my own opinion on the measures and procedures that should be adopted both in the European and the national legislation, but especially to design a formal and practical framework, unanimously accepted at national level by all those involved in the field of insolvency prevention (debtors, creditors, professionals, legal professions, etc.), that keeps pace with the times.

I have thus structured the Thesis in seven chapters, each with sections and, as the case may be, subsections, the seventh chapter containing several *de lege ferenda* proposals, as result of my practice and my work for more than 20 years in the banking system.

In chapter I, which I called "The Company in Difficulty," I tried to put insolvency and its most serious consequence, bankruptcy, in the context of trade emergence, showing that bankruptcy has always been associated with those involved in commercial activities since the earliest times, and that, unfortunately, debtors have not always been treated by creditors in the best circumstances, on the contrary, they have been ostracized for many centuries.

By pointing out these archaic approaches, I actually wanted to show how much have law and society changed and evolved over millennia and how wrong were the past

approaches that put money and profit above the human being, stigmatizing humans. Today, this "relationship" has reversed the individual and his human, social and economic condition, the "second chance," being put above all. In fact, this cumulation of factors has laid the foundations for the "rescue culture," new to all today's people, and we have the task to develop it, transforming it into a natural and normal approach of modern social and economic policies.

I have also approached in the first chapter the conditions that an enterprise must meet in order to be considered as a "company in difficulty", that is the national and European legal framework, starting from the reality of the company that is not capable, from its own resources or with funds that it can get from its shareholders or creditors, to reduce its losses and which, without the intervention of the law, will "lead" it to go out of business. It is known that the life of a company is a succession of circumstances that lead to more or less difficult situations. Some of these can be prevented and avoided even before they happen, others, the serious ones, are sometimes hard to bear and become even fatal for the company. So, maintaining in good financial standing, respectively in the situation of continuing the exploitation of activity in conditions of effectiveness and efficiency and achieving the proposed objectives, requires a permanent adjustment of the management mode by the company and its managers in order to compensate for the changes the socio-economic environment produces on the way in which the company operates. Failure to take account of these changes and the absence of adequate management tools will compromise maintaining the company's good financial standing.

I then described the notions of insolvency and state of insolvency caused by the cessation of payments, since the insolvency procedure is an essential feature of the state of insolvency, where in the first regulation of the Romanian commercial law, in order for the bankruptcy procedure to be initiated, the debtor should have ceased the payments or be unable to meet its commercial debts. Since the entry into force of the first Romanian Commercial Code and until 1993, the concept of cessation of payments has not been defined, the legislator being pleased to state that a trader who has ceased payments for his commercial debts is bankrupt. With the liberalization of the market economy and the introduction of the commercial credit, the doctrine and jurisprudence after December 1989 was required to determine the content of the notion of cessation of payments.

Next, in the same chapter, I made a parallel between insolvency and economic laws in order to show that a healthy economic environment, populated with viable businesses and providing economic growth and welfare for citizens, is only possible through balanced and

corelated economic, fiscal and social laws and policies, judicially and properly legislated or elaborated, which can then be applied by all stakeholders. If so, then any turbulence or economic or financial crisis would have far-reaching effects and less dramatic economic and social consequences.

In Section 1.7., I have presented some of the reasons that make it necessary to prevent insolvency, starting from the concrete situation in the economy after the economic crisis, when the need to prevent companies from becoming insolvent was felt more and more acutely, this proving to be a measure both for the benefit of the debtor and the creditors. Therefore, after the crisis has passed and economies have been cleared through insolvency and bankruptcy, it is clear that new policies are being developed to encourage insolvency prevention. In the past, the main purpose of insolvency proceedings was the recovery by liquidation of the debtor's assets, in order to enable creditors to recover their claims. This approach is currently outdated both at European and national level.

At legislative level but also in practice, the focus is currently on setting up measures and procedures to prevent insolvency and to enable, in advance, the recovery of the debtor business. It is therefore beneficial for the debtor and even creditors to anticipate that there is a risk of insolvency and to take early action, together or separately, to restore the business and thereby avoid as much as possible and to the advantage of all stakeholders, the insolvency.

Further, in section 1.8. I have looked up at persons directly or indirectly affected by insolvency because not only debtors, borrowers and creditors are the only ones affected, insolvency effects are domino effects, affecting both horizontally and vertically not only the economic actors, but the whole society ("snowball effect" or "butterfly effect" may be suggestive in better describing the insolvency consequences). "Butterfly effect" means that any deed is related to another deed in the sense that an action leads to other actions that lead to other actions and so on. It is like a small snowball (hence the alternative name of "snowball effect") which rolls over and is getting bigger and bigger. A small fact leads to an amplified result. When the first action changes, the result from the respective action change and other actions result.

In short, any action leads to a consequence. The name of the effect was invented by Edward Norton Lorenz, an American mathematician particularly known for his pioneering works in the field of chaos theory developed by him in 1960. A theory elaborated by Lorenz, graphically transposed, which can be compared to the butterfly wings flapping. Through insolvency, whether or not followed by bankruptcy, the employees, the business partners of

the debtor in insolvency (who may also turn into insolvency due to failure to fulfil their claims), the state budget, the credit institutions, the stock exchange etc. also suffer.

At the end of the first chapter, I referred to the responsibility of censors, statutory and financial auditors, members of the board of directors and the supervisory board, and of other supervisory institutions, in preventing insolvency, making it clear that their more solid, concrete and permanent involvement in the activity of the society has the role of observing and highlighting in advance certain aspects that may lead to the conclusion that the company is facing difficulties, has own negative capital, the economic and financial indicators are on a downward path, it has ceased payments or is in a manifest state of insolvency. If all these issues are captured in time, early recovery plans can be implemented, plans that may save the business or at least most part of it.

In chapter two, I have extensively dealt with the modalities and procedures for preventing insolvency and promoting financial recovery of the company in domestic law, focusing mainly on the current regulations in force, namely the new law on insolvency prevention and insolvency, which may be considered a first "code" of insolvency, although it is not a true codification of all the laws in the matter. As a *de lege ferenda* proposal, the legislator might however think in the future to encompass all the normative acts dealing with the matter in a "code". In section 2.1. I have thus described the new legal framework on insolvency in Romania in terms of its impact upon the business environment, then I dealt with theoretical and practical aspects regarding the judicial and extrajudicial restructuring of public enterprises, as well as how the administrative-territorial units may be economically and financially recovered in the situation of a financial crisis and insolvency as well as the theoretical and specific regulatory aspects of the recovery and resolution of credit institutions and investment firms, in the context of European legislation in the field. The recovery and resolution procedures for credit institutions and investment firms are special procedures, derogating from the common insolvency law, they put the systemic risk into macro-economic context, on the "too big to go bankrupt" or "too big to fail" principle, setting up the criteria for the establishment and operation of the bridge bank as a new entity that takes over "good assets" after "bad assets " have been isolated.

The concept "too big to fail" is thus based on the idea that some businesses are so important to the nation that it would be disastrous for the economy if they were allowed to fail. This term is often used in connection with the largest companies of a nation, usually banks, because if these banks failed the economy would face serious problems. By declaring a company "too big to fail" or go bankrupt, it means that the government might have to help it

financially if the company is in a difficult situation either because of the company's problems, or the problems outside the company. While rescue or government intervention measures could help the company survive, some opponents believe this is counterproductive and it simply helps a company that should be left to fail.

It is assumed that the economic situation in 2009 would have been the best possible outcome of the way the 2008 crisis effects were addressed, at least according to the reasoning that if the United States Government (followed later by governments around the world) hadn't saved companies that were "too big to go bankrupt" and taxpayers' money hadn't been used to help big companies avoid bankruptcy and consequently, avoid a greater harm that would be propagated throughout the world economy, the whole economic eco-system during and after 2009 would have been far worse. However, Government support was selective, and even if some companies were helped, they did not resist, going finally bankrupt and other companies did not receive any help, being left to fail, hence the criticism of this approach.

Large financial companies such as AIG and Bank of America, as well as major non-financial companies such as General Motors and Chrysler, have received government aid, yet both companies in the automotive industry have demanded bankruptcy a few months after they were rescued. Other companies, such as Lehman Brothers or Washington Mutual Bank, have not received any help when they tried to avoid collapse, even if they asked for it. And other companies, like Ford, had the chance to ask for help, but in the end they did well on their own merits.

Later, there was criticism of the insurance giant AIG's salvage with public money, as it was not too big to fail, and the authorities later recognized that when approving the rescue plan they did not know that the AIG managers would have been paid millions of dollars each in performance-based bonuses, although the company was facing collapse, or that after receiving the state aid, they used the money for protocol and entertainment actions or other bonuses.

The same situation happened in Europe, where almost all governments used public money to help their banks, except for Romania where not even a money from public funds was injected to help any bank, not even for the two state-owned Romanian banks, CEC Bank and Eximbank.

In order to prevent this from happening again and public money to be used to save companies with poor, undemanding management, the states of the world, governments, have begun a series of consultations to identify solutions and regulations that can be used to prevent similar situations or mitigate the effects of future crises. Thus, among the many

proposals, one of the most relevant ones is the G20 Global Plan for Recovery and Reform, which states that the Member States have agreed to:

- strengthen financial regulation to rebuild trust;
- fund and reform the international financial institutions to overcome this crisis and prevent future ones; to strengthen supervision and financial regulation; to establish consistency and a systematic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires; to promote ownership, integrity and transparency;
- to offer protection against risk across the financial system;
- to establish a new Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain, and the European Commission;
- to extend regulation and oversight to all systemically important financial institutions, instruments and markets including, for the first time, systemically important hedge funds;
- to take action against non-cooperative jurisdictions, including tax havens; regulation must prevent excessive leverage and require buffers of resources to be built up in good times;
- to improve the quality, quantity and international consistency of capital in the banking system; to require accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and develop a single set of high-quality global accounting standards;
- to extend regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest and to adopt remuneration policies to discourage excessive risk-taking.

The bridge-bank is a new credit institution set up according to the decision of the National Bank of Romania and held by the Bank Deposit Guarantee Fund as sole shareholder, which takes over the assets and liabilities of a bank whose activity is considered to affect the proper functioning of the financial system in our country. The establishment of a bridge-bank aims to maintain financial stability by ensuring depositor protection and the continued provision of banking services by the bank to its taken over customers. The bridge-bank financing comes from the private sources of the Bank Deposit Guarantee Fund. Involvement of public sources can be achieved only in the form of a loan granted by the

Ministry of Public Finance to the Bank Deposit Guarantee Fund, the conditions for granting and repaying the loan being determined by Government Decision.

In chapter three I described the methods and measures for preventing the company's insolvency and for the company financial recovery in the European law where, when the financial crisis started in 2008, the bankruptcies came one after other in a great number, economic agents in financial difficulty and situations difficult to resolve being present everywhere. More and more companies have entered and are still entering the abyss of insolvency, from which they can hardly come out, and finding the means of recovery is a real challenge. Most of the time, insolvency is a non-return journey. The fear of insolvency and disturbance of the normal dynamics of business processes have marked the last few years of economic life, thus among the many insolvency cases ended in bankruptcy we also find companies with significant years of work behind. On the other hand, some businesses have managed to float on the "threatening waves" of a "tsunami-hit" business environment, just like "skilful surfers," overcoming the fear of bankruptcy and directing their businesses to an area where legislative gaps have proven to be their chance for recovery.

The financial crisis has highlighted the significant lack of adequate tools to effectively manage the difficulties faced by various market players across the European Union. The high level of integration and interconnection of markets at Union level has made many of the companies in our country to often carry out their operations across national borders, which has raised the level of difficulty as regards introducing and implementing regulatory instruments.

Under this critical economic and legal situation, the European Commission has included a revision of the Insolvency Regulation in its Work Program and the European Parliament adopted in October 2012 a European Parliament Resolution with recommendations to the Commission on insolvency proceedings in the context of EU company law requesting the revision of the European Insolvency Regulation and recommending the harmonization of certain specific aspects of insolvency law and company law. The review will be adopted together with a report on its implementation, in line with the review clause in the regulation.

I also presented the issues raised by cross-border insolvency in the context of the economic crisis, which led to the need to revise Council Regulation (CE) no. 1346/2000 on cross-border insolvency. Following the stakeholders' consultation and impact assessment, the European Parliament and the Council adopted on 20 May 2015 the Regulation (EU)

2015/848 on insolvency proceedings, which was directly implemented in the Member States starting 26 June 2017.

I further described the concept of "a new chance" introduced by Commission Recommendation 2014/135/EU on a new approach to business failure and insolvency and the effects on the Romanian business environment of the implementation of the Commission Recommendation 2014/135/EU on a new approach to business failure and insolvency. In fact, my intention was that the whole thesis should make this new concept and new approach (in fact, the regulation itself is new, as the approach has existed in the practice of Anglo-Saxon law for several decades), a corollary of extrajudicial proceedings to prevent insolvency, or if "damage" has been done, stakeholders, particularly creditors, are fully aware that a pro-active approach, according to the thesis motto: *"We'd better support a man who owes us almost three hundred thousand francs, and get these three hundred thousand francs back in three months, rather than speeding up his bankruptcy and get only six or eight percent of the capital"*, preferable in the medium and long term, rather than a radical approach *"Unfortunately, either because of hatred or blindness, all of Morrel's partners did not think the same way, while some others were even thinking the opposite"*.

In chapter four I described the international legal framework on insolvency as a comparative law approach, presenting the evolution of insolvency regulation at international level, starting with the international treaties and conventions on insolvency: the Montevideo Treaties of 1889 and 1940, the Havana Convention of 1928, the Nordic Bankruptcy Convention of 1933, Model International Insolvency Cooperation Act – MIICA, the Istanbul Convention of 1990, the OHADA Uniform Act of 10 April 1998 organizing collective proceedings for wiping off debts. This compendium of treaties and conventions dating back more than a century shows a concern of the states of the world to ensure trades and economic stability, being clear that only by an unanimously accepted fair and balanced regulation, including on compliance with payment discipline and obligations under commercial contracts, may sustainable and durable economic growth be achieved.

I further presented the benefits brought by the UNCITRAL Model Law to regulation and procedures on cross-border insolvency, which, while not having the legal effects of a genuine law, from the point of view of the constitutional hierarchy of laws and normative acts, it has represented and still represents an important international guide and, even for a long time, it was the only regulation of this nature in the field of international trade.

The thesis would not have the same academic value from the point of view of the doctoral research activity, if I did not analyse and present within it the legal ways to prevent

insolvency and redress companies in different European jurisdictions, as for example, the United Kingdom, France, Switzerland, Germany, Austria, Spain, Italy, Sweden, Estonia, Latvia and Lithuania, with the US Rescue Law known as *"Chapter 11"* as a benchmark. By comparatively studying the different legal systems, I have found that there are also some notable differences but also many similarities, that, in the context and orientation given by the Community legislator, on cross-border insolvency and "a second chance", prove that a rescue culture spreading into society is required. Let us not forget about the new trend after the economic-financial crisis, that of insolvency of non-professionals, with substantial debt cuts, with a view to socially reinsert the individuals affected by crisis, unemployment, etc., which let us think about the Biblical approach on "*sabbatical debt forgiveness*" (that is, once every seven years)!

In chapter five, I presented the international legal framework on the evolution of European law internationally, cross-border insolvency and a comparative law approach. With the development and globalization of trade, companies have crossed national borders, developing themselves outside the country of origin, in order to increase profit. It has become clear that cross-border regulations must be created in order to reorganize the activity of these companies. At international level, legislative diversity in the field of insolvency has amplified the need to create a general legislative framework, as well as the need to harmonize legislation in the field. The insolvency field, as part of the international trade law, is constantly expanding and changing, thus, at the level of states of the world, insolvency knows different procedural forms, although everywhere in the world it refers to the same underlying problem, namely the debtor's entry in a situation of cessation of payments.

Considered as a precursor to lawmakers in the field of common-low transgressing the borders of a single state or jurisdiction, the United States Uniform Commercial Code of 1962 governs *inter alia* the *solvency proceeding*, declaring the assignment for the benefit of creditors, as well as any procedure designed to liquidate patrimony or clarify the situation of that person, namely the Insolvency Act of 1986 of the United Kingdom of Great Britain and Northern Ireland, include regulations on insolvency being provided even a simplified procedure where creditors who are not paid can, without formalities and without delay, take over all the assets of their debtor and sell them.

In Europe, instead, (and for example in the German law system) the insolvency was firstly regulated in the German Commercial Code (*Handelsgesetzbuch*) in 1897 and later in the Insolvency Code (*Insolvenzordnung*), in force since 5 October 1994. The new law on

insolvency replaced the Bankruptcy Code in 1977 and intended to change the focus from liquidation to reorganization.

As regards insolvency regulation in the main European states, it became apparent that the last decade brought about a change in the approach within the meaning of judiciary prevention and reorganization, the European Commission has among its priorities the development of an effective and efficient legal framework for insolvency facilitating a sound business environment that supports trade and investment, helping to create and maintain jobs, and helping economies to withstand economic shocks, in order to reduce the levels of non-performing loans and unemployment, in a moment of maximum crisis, of alarmingly high levels.

In chapter six I analysed and presented the modern means of efficient and effective restructuring of the company in difficulty, both those regulated by normative acts such as the temporary holding of shares/social parts by banks in the debtors' share capital and some international financial institutions recommendations and guides or from my own experience, of more than 20 years in the activity of recovering bank claims. Debt to equity swap (Anglo-Saxon-based approach) in a context in which economic constraints may transform a credit into a too large burden, in the debtor company may be a viable solution. In any of the forms it can take, the swap involves increasing the share capital of the debtor company and releasing the new shares in exchange for discharging the initial claim. The essential premise of the swap is the existence of a loan that has become difficult to bear for a commercial company, or whose repayment raises serious problems, for the overcoming of which the debtor company could resort to a capital increase or a refinancing.

With regard to the first option, shareholders might have reservations before accepting that their investment is used to pay off debts rather than to develop the business of the company. The company may also seek a refinancing, but its price could be much higher, on the one hand due to the more difficult market conditions and on the other hand due to the high risk that the credit institution would be expected to take. For these reasons, refinancing could aggravate the initial problem of over-indebtedness over the medium and long term as it will increase existing costs. In this context, the lending credit institution may also assess its options and position towards the debtor company.

Transfer of assets of the debtor in difficulty to a special-purpose vehicle, which is a special purpose entity, set up as a subsidiary company with an asset/liability structure and legal status that makes its obligations secure, even if the parent company goes bankrupt, designed to serve as a counterparty in order to isolate the financial risk; transfer of assets of

the debtor in difficulty to a special-purpose vehicle transferring the debtor's assets in difficulty to a specialized vehicle;

The "pre-packaged" insolvency is a tool for rescuing an insolvent business in financial difficulty and must be *a priori* planned by the debtor in agreement with the main creditors through a transaction that must be legally valid. The agreement must take place before the formal opening of proceedings by court's decision and the formal appointment of an insolvent practitioner. It is an extra-judicial and voluntary alternative to rescue a company that can be financially rehabilitated from liquidation. The prerequisites for a pre-packaged insolvency agreement are the state of insolvency and the enterprise's intention to restructure its business in order to rescue it and give it a second chance.

Mediation of bank claims, starting from the French model where the Bank of France is a key player in the mediation process whose principles are competence, neutral position, accessibility, promptness and transparency. The credit mediator in France is a network of 105 local mediators. The credit mediation office is based on the competence and neutrality of mediators and has improved cooperation between donors and borrowers. They also benefit from national SME Development Fund support, which can provide guarantees in the lending process.

I regret to say that neither the Romanian legislator, nor the specialized courts or insolvency practitioners, nor the business environment, have taken important steps in prioritizing such approaches from other countries, preferring instead the insolvency "shelter", although statistically it is obvious that insolvency is not a "panacea", but in 98% of insolvency cases, they fail into bankruptcy, that is, a "palliative treatment" is applied until the physical disappearance of the company, that is the removal of the company from the Trade Register. Bankruptcy effects are therefore spreading in the chain, as a domino, in economy and society, meaning fewer tax collections to the state budget, unemployment, the disappearance of some economic agents and even outlets, economic involution and disparities in the regional development of the country as compared to other Member States.

In the final chapter, the seventh, I presented the concrete problems faced by the Romanian business environment, even if, statistically, the number of insolvent companies is decreasing, yet viable and bankable businesses (which meet the financial conditions to access credits) are fewer and fewer (more than half of the companies in operation have negative own equity, and one in three is unprofitable, registering losses). I also presented a few *de lege ferenda* proposals, aiming to improve the legal framework in the field of insolvency, in

general, and to prevent insolvency by granting a "second chance, starting from my experience in the banking system.

In order to emphasize that insolvency may support the return to the economic cycle of companies in financial difficulty, through cooperation between all interested parties - debtors, creditors, employees, associates or shareholders, insolvency practitioners - and by implementing effective and feasible extrajudicial restructuring or judicial reorganization measures, I have exemplified three of the cases of Romanian companies that have been granted the "second chance": Oltchim, Galli-Gallo and Mondex.

The conclusions drawn from the research made by me when preparing this thesis were that insolvency is most of the time intentional and demanded by debtors when it should in fact be avoided, and that there are very few situations in which debtors and creditors are working together to identify the best way for society to recover. That is why it is imperative, both socially and for a sustainable and durable economy, which all parties involved in an insolvency proceedings or procedure to avoid insolvency to cooperate in good faith to restore the company's activity or, should these procedures fail, the honest businesses restart commercial activities, without the "stigma" of bankrupt or bankruptcy, forever.