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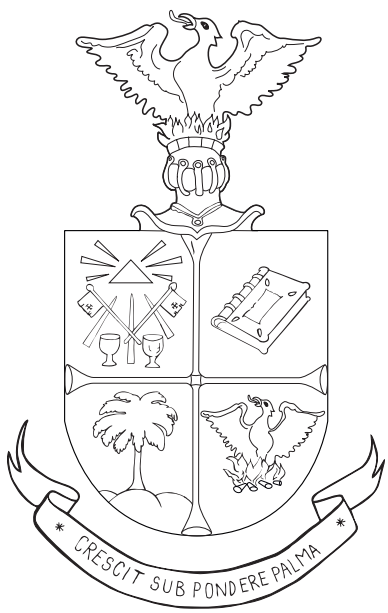

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Recovery of a Debtor In Financial Difficulties at the Pre-Insolvency Stage[1]

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Abstract

The paper entitled "Recovery of a Debtor in Financial Difficulties at the Pre-insolvency Stage" analyses the issue of pre-insolvency and hybrid proceedings, which, unlike Council Regulation (EC) No 1346/2000 of 29 April 2000 on insolvency proceedings (OJ L 160, 30.6.2000, p. 1), fall within the material scope of Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) (OJ L 141, 5.6.2015, p. 19). These are proceedings which, under the law of some Member States of the European Union, may be opened and conducted for a certain period of time on an interim or provisional basis before a court issues an order to open insolvency proceedings. These proceedings are an alternative to formal insolvency proceedings. Their aim is to recover the financial situation of a debtor facing bankruptcy.

Key words

insolvency, bankruptcy, pre-insolvency proceedings, hybrid proceedings, insolvency proceedings

1. Introduction

Since 2005, in line with the renewal of the Lisbon Strategy, the European Union (the "EU" or the "Union") authorities have been focusing their efforts on ensuring sustainable growth by creating an environment in which businesses are encouraged to create more jobs. Every business activity involves a certain degree of risk. Success and failure in business are intrinsically linked to each market economy.[2] Creating a more favourable environment

1 This work was supported by the Slovak Research and Development Agency under the Contract no. APVV-19-0419.

2 Communication from the Commission to the Council, the European Parliament, the

for financially vulnerable businesses may be one of the prerequisites for reducing business failure. Taking into account the objectives of the Lisbon Strategy, EU Member States should seek to ensure that entrepreneurs who are facing bankruptcy or became bankrupt are given a second chance, as not every bankruptcy is caused by fraud or personal inability of the debtor.[3]

The activities of businesses cross the borders of the Member States of the Union. According to statistics, about one-quarter of insolvency proceedings have a cross-border element.[4] Creating a more favourable environment for vulnerable businesses is also linked to the need to improve the legal framework for cross-border insolvency proceedings by streamlining, simplifying, and speeding up these proceedings. One of the key measures to improve the functioning of the internal market is the modernisation of the rules on cross-border insolvency proceedings in the European area, aimed at facilitating the survival of businesses in financial difficulties and giving them a second chance.

In order to promote the rescue of economically viable businesses and to give a second chance to businesses in financial difficulties, Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) (OJ L 141, 5.6.2015, 19) (the "Insolvency Regulation" or the "Regulation") was adopted, which provides a legal framework for the conduct of cross-border insolvency proceedings in the European Union and provides for the coordination of multiple proceedings with a foreign element concerning the same debtor.

2. Material scope of the Insolvency Regulation

The material scope of the Regulation is defined in a general way to cover not only Member States' insolvency proceedings which are winding-up in nature and the purpose of which is to realise the debtor's assets and to end the debtor's business activities, but also proceedings the purpose of which

European Economic and Social Committee and the Committee of the Regions. Overcoming the stigma of business failure – for a second chance policy. Implementing the Lisbon Partnership for Growth and Jobs. COM(2007) 584 final. Brussels, 5.10.2007.

3 Modern SME policy for growth and employment, Commission of the European Communities, COM(2005) 551 final, 10.11.2005.

4 Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee. A new European approach to business failure and insolvency. Brussels, 12.12.2012, COM(2012) 742 final.

is to reorganise, recover and give the debtor a second chance.[5] The Regulation applies not only to bankruptcy proceedings, restructuring proceedings and proceedings concerning discharge of debt, but also to pre-insolvency and hybrid proceedings.[6] Therefore, when interpreting the Insolvency Regulation, it is more correct to use the broader term "insolvency proceedings" instead of "bankruptcy proceedings".

Unlike the previous legislation, which was Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (OJ L 160, 30.6.2000, 1) ("Regulation No 1346/2000"), the Insolvency Regulation does not require in every case that a debtor be divested of its assets and that an insolvency practitioner be appointed in the proceedings. The Insolvency Regulation also applies to proceedings in which a debtor remains in possession of its assets and no insolvency practitioner is appointed. It follows that the Regulation applies to proceedings in which the debtor's assets and affairs are only subject to control or supervision by a court.[7] The Insolvency Regulation defines who is considered a debtor in possession. A debtor in possession is a debtor in respect of which insolvency proceedings have been opened which do not necessarily involve the appointment of an insolvency practitioner or the complete transfer of the rights and duties to administer the debtor's assets to an insolvency practitioner and where, therefore, the debtor remains totally or at least partially in control of its assets and affairs.

In some EU Member States, certain insolvency proceedings may be characterised as proceedings in which a debtor is in possession of its assets. The divestment of the debtor's assets is optional in some States (e.g. Austria), and in some States a partial divestment of the debtor's assets is applied (e.g. Finland, Belgium, the Netherlands, Slovenia), where certain disposals of assets have to be approved by an insolvency practitioner. The reason for introducing proceedings in which a debtor is in possession of its assets is to reduce the costs of insolvency proceedings (if no insolvency practitioner

5 Ďurica, Milan: *Konkurzné právo na Slovensku a v Európskej únii (Issue 3.).* Bratislava, Eurokódex, 2012, 702.

6 Mucciarelli, Federico: A New Insolvency Regulation at Last. *European Company Law*, 2016, 13(2), 44-45; Preliminary opinion of the Ministry of Justice of the Slovak Republic on the Proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) No 1346/2000 on insolvency proceedings; COM(2012) 744 final – 2012/0360 (COD) of 21 January 2013.

7 Piekenbrock, Andreas: The future scope of the European Insolvency Regulation. *International Insolvency Law Review*, 2014, 5(4), 424.

is appointed, there is no need to pay the insolvency practitioner's fees and expenses). Another reason is the fact that the debtor knows its business activity best and can propose measures that could lead to its recovery. According to the Heidelberg-Luxembourg-Vienna Report, proceedings in which a debtor is in possession of its assets were introduced in Germany in 1999 but are less used in practice (about 1% of all cases). An application for debtor-in-possession proceedings can only be rejected by the court if there are known specific circumstances that might lead to the proceedings being disadvantageous to creditors (e.g. it can be proven that the debtor has been disposing of its assets prior to the filing of the application).[8] Unlike Regulation No 1346/2000, the Insolvency Regulation also applies to pre-insolvency and hybrid proceedings. Compared to the previous legislation, the material scope of the Insolvency Regulation has been extended.

As regards the opening of proceedings, the insolvency laws of the different Member States differ on the question of jurisdiction to open insolvency proceedings.[9] As a general rule, a court is the authority having jurisdiction for opening insolvency proceedings. An exception to this rule is that, under some national laws, jurisdiction for insolvency matters may be conferred on national authorities other than courts. The Insolvency Regulation responds to this situation by providing for the jurisdiction not only of the courts but also of other bodies which, under the national law of EU Member States, are empowered to act in insolvency matters. For the purposes of the Insolvency Regulation, the term "court" means not only a judicial body of a Member State but also any other competent body of a Member State empowered by national law of that State to open insolvency proceedings, to confirm such opening or to take decisions in the course of insolvency proceedings.[10] It follows that the term "court" is understood more broadly in European insolvency law. The Insolvency Regulation explicitly sets out the matters in which a court, and not another body of a Member State, is given exclusive jurisdiction. In this context, the Regulation provides for the

8 Hess, Burkhard–Oberhammer, Paul–Pfeiffer, Thomas: *European Insolvency Law: The Heidelberg-Luxembourg-Vienna Report: on the Application of Regulation No 1346/2000/ EC on Insolvency Proceedings (External Evaluation JUST/2011/JCIV/ PR/0049/A4).* München, C. H. Beck, 2014, 52.

9 Göpfert, Burkhard: *International Jurisdiction in European Insolvencies,* 2004. [cit. 2017-04-15]. Available on the internet: https://www.iiiglobal.org/sites/default/files/11-_International_Jurisdiction_0.pdf (15. 08. 2021.)

10 Hess–Oberhammer–Pfeiffer op. cit. 43.

exclusive jurisdiction of a court in pre-insolvency and hybrid proceedings. The exclusive jurisdiction of a court (and not of another body) is established in proceedings under Article 1(1)(c) of the Regulation in which a temporary stay of individual enforcement proceedings is granted by a court or by operation of law, in order to allow for negotiations between the debtor and its creditors, provided that the proceedings in which the stay is granted provide for suitable measures to protect the general body of creditors where no agreement is reached.[11]

3. Pre-insolvency and hybrid proceedings

The Insolvency Regulation also applies to proceedings that, under the law of some Member States, are opened and conducted for a certain period of time on an interim or provisional basis before the court issues an order to open insolvency proceedings. These pre-insolvency and hybrid proceedings were not covered by the previous Regulation No 1346/2000. Pre-insolvency and hybrid proceedings are governed by the law of the EU Member State within the territory of which insolvency proceedings have been opened (insolvency statute). From a temporal point of view, the basis for determining the insolvency statute is the moment when the proceedings are opened. In particular, the insolvency statute governs the opening, conduct and closure of insolvency proceedings. The insolvency statute is a set of legal rules governing the agreement between a debtor in financial difficulties and its creditors concluded in the course of pre-insolvency or hybrid proceedings. Pre-insolvency and hybrid proceedings are governed by the law of the Member State within the territory of which the proceedings have been opened (*lex fori concursus*).

The Insolvency Regulation provides *expressis verbis* that it also applies to situations where a temporary stay of individual enforcement proceedings is granted by a court or by operation of law in order to allow for negotiations between the debtor and its creditors, provided that the proceedings in which the stay is granted provide for suitable measures to protect the general body of creditors in order to ensure the greatest possible satisfaction of creditors where no agreement between the debtor and its creditors

11 Bělohlávek, Alexander: *Evropské a mezinárodní insolvenční řízení: Nařízení Evropského parlamentu a Rady (EU) č. 2015/848 o insolvenčním řízení. Komentář.* Praha, C. H. Beck, 2020, 51.

is reached. Pre-insolvency and hybrid proceedings aim to achieve a debt adjustment in relation to creditors, for example by reducing the amount to be paid by the debtor to its creditors, reducing the interest rate or extending the payment period granted to the debtor.[12] Pre-insolvency and hybrid proceedings are characterised by the fact that during the negotiation of a debtor in financial difficulties with its creditors, the debtor is protected from individual enforcement by creditors during this period, which is limited in time by law.

Pre-insolvency proceedings can be characterised as proceedings in which a debtor facing bankruptcy is given the opportunity to recover at a pre-insolvency stage, as a result of which it avoids formal insolvency proceedings.[13] Pre-insolvency proceedings are an alternative to formal insolvency proceedings. Their aim is to recover the financial situation of a debtor facing bankruptcy. Therefore, it is not a condition for the opening of such proceedings that a debtor is bankrupt. These proceedings apply to a debtor who is in financial difficulties, as a result of which it is facing bankruptcy. Some Member States (Austria, Belgium, Estonia, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Malta, the Netherlands, Poland, Spain, Sweden, and the United Kingdom) have national legislation governing pre-insolvency proceedings. These procedures are applied before insolvency proceedings are opened, i.e. at the pre-insolvency stage. They allow for the recovery of a debtor to take place before the bankruptcy order. Pre-insolvency proceedings give a second chance to a debtor to recover its financial situation, unlike insolvency proceedings, which are winding-up in nature.[14]

Pre-insolvency proceedings come into play in the event of probable insolvency, and they are, as a rule, proceedings without an insolvency practitioner appointed. In these proceedings, a debtor remains in possession of its assets. The debtor is temporarily granted protection from creditors (a moratorium), which consists of a temporary stay of enforcement proceedings against the debtor to allow the debtor to negotiate with its creditors. During the moratorium, the debtor may not be declared bankrupt, and its restructuring may not be allowed. Two conditions must be met for the con-

12 Bewick, Samantha: The EU Insolvency Regulation. *International Insolvency Review*, 2015, 24(3), 172.

13 Brinkmann, Moritz: *European insolvency regulation. Article-by-Article Commentary.* München, Verlag C. H. Beck oHG, 2019, 28.

14 Boon, Gert Jan: Promoting Business Rescue in Europe. *International Insolvency Law Review*, 2016, 7(1), 1.

duct of pre-insolvency proceedings to take place. Firstly, suitable measures must be taken to protect the general body of creditors. These are measures to prevent the debtor's assets from being diminished in order to ensure the greatest possible satisfaction of its creditors. The second condition for the conduct of these proceedings is that they are preliminary to insolvency proceedings.[15] The moratorium period granted to a debtor is intended to serve the purpose of out-of-court and group settlement of disputes with creditors. In some Member States, the moratorium is granted by a court[16] or directly by operation of law.[17] Pre-insolvency proceedings can result in successful negotiations with creditors leading to an agreement with them. If the debtor's negotiations with its creditors during the moratorium fail (no agreement between the debtor and the creditors is reached), this will result in the opening of insolvency or restructuring proceedings, either directly by operation of law or the law provides that the debtor is obliged to file an application for the opening of such proceedings.[18]

Pre-insolvency and hybrid proceedings must be of the type listed in Annex A of the Insolvency Regulation. Pre-insolvency and hybrid proceedings are temporary. The Insolvency Regulation does not specify the length of these proceedings. Their length is governed by the law of the Member State within the territory of which such proceedings have been opened (*lex fori concursus*). In general, they last several months. Since these proceedings are applied at the pre-insolvency stage, the condition of a debtor's insolvency is not required. It is sufficient that the debtor is in financial difficulty. The term "debtor in financial difficulty" is not the same in the laws of different Member States. In general, it can be stated that it is a debtor who is not yet insolvent but is faced with the prospect of insolvency.

According to the degree of court intervention, proceedings allowing a debtor to avoid formal insolvency proceedings vary from one Member State to another. These may be proceedings in which a court has no influence on the conclusion of an out-of-court arrangement with creditors. In such proceedings, a court cannot determine the content of the arrangement between a debtor and its creditors. The creditor cannot be forced by the court to change the content of the arrangement with the debtor. These

15 Ikrényi, Ivan: *Nariadenie o insolvenčnom konaní. Komentár*. Bratislava, C. H. Beck, 2020, 61.

16 For example, Greece, Spain.

17 For example, France, Italy, Malta.

18 Bělohlávek op. cit. 11.

are voluntary negotiations between the debtor and its creditors, without the court being able to influence the content of the arrangement concluded with the debtor. The concept of out-of-court proceedings does not include court supervision. In pre-insolvency proceedings, the debtor in financial difficulties renegotiates the terms of its contracts with its creditors. The debtor negotiates more favourable terms which may result in a rescheduling of payments, a reduction of interest rates, contractual penalties, partial discharge of debt, or a new loan, this all without court supervision. In pre-insolvency proceedings, the court has no influence on the conclusion of the arrangement between the debtor and its creditors. Out-of-court proceedings represent a voluntary arrangement concluded between the debtor and its creditors without coercion, without court intervention, and without the possibility for the court to influence the content of such an arrangement.

Some Member States provide for proceedings which contain elements of an out-of-court arrangement between a debtor and its creditors in combination with some elements of formal judicial insolvency proceedings. In this case, we are talking about hybrid proceedings, which are characterised by a certain degree of intervention by an insolvency court. Hybrid proceedings include elements of contract law and some aspects of formal insolvency proceedings.[19]

In hybrid proceedings, a debtor in financial difficulties negotiates better terms of contracts concluded with creditors under the supervision of an insolvency court (e.g. extension of the maturity of claims). Hybrid proceedings contain some elements of the so-called out-of-court proceedings (insolvency proceedings without the influence of an insolvency court) and some elements of formal insolvency proceedings, which take place under the supervision of a court. The consent of each creditor is not required to reach an agreement in hybrid proceedings; the consent of the majority of creditors is sufficient. In some Member States, the agreement between a debtor and its creditors does not have a binding effect on dissenting secured creditors.[20] A common objective of hybrid proceedings is to avoid formal insolvency proceedings, which are winding-up in nature. The means of achieving this objective is an agreement between a debtor in financial difficulties and its creditors, supervised by an insolvency court, allowing for the debtor's recovery. In some hy-

19 Moravec, Tomáš–Pastorčák, Jan–Valenta, Petr: European regulation of insolvency status in the hybrid proceedings. *US–CHINA Law Review*, 2015/12, 455.

20 Hess–Oberhammer–Pfeiffer op. cit. 63.

brid proceedings, the intervention of a court only takes place at the end of the proceedings in which a debtor is to be recovered, when the court's role is to approve the agreement reached with the creditors.

In hybrid proceedings, the debtor remains in possession of its assets under the supervision of a court or an insolvency practitioner. In most States where hybrid proceedings are applied, an insolvency practitioner is appointed whose powers are limited to supervision, mediation, and consultation. As a rule, the disposal of a debtor's assets requires the approval by a court or an insolvency practitioner. Within supervision, the court examines whether the agreement of the debtor with its creditors pursues the debtor's honest intention, whether it has been reached by fraudulent conduct and whether any group of creditors has been given special advantages that would lead to discrimination against certain creditors. During these proceedings, enforcement procedures conducted against the debtor are stayed either directly by operation of law or by a court order. During the proceedings, the debtor is granted protection against enforcement proceedings. Hybrid proceedings have the advantage of being less costly than formal insolvency proceedings.

The Insolvency Regulation does not oblige individual Member States to introduce specific types of pre-insolvency and hybrid proceedings in their national laws.[21] If a Member State has introduced pre-insolvency or hybrid proceedings in its insolvency law, the Insolvency Regulation will apply to such proceedings in addition to the applicable national laws. In the context of the financial crisis and the increasing number of natural persons who became bankrupt, some Member States introduced or enlarged existing pre-insolvency proceedings for individuals.[22] Proceedings in which negotiations between a debtor and its creditors are to take place with the aim to recover the debtor and achieve greater satisfaction of the general body of its creditors take precedence over insolvency proceedings, the aim of which is the total or partial divestment of the debtor's assets and the cessation of its business activities.[23]

As regards provisional and protective measures, it generally applies that a temporary administrator and an insolvency practitioner have the active

21 Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU [COM/2016/0723 final – 2016/0359 (COD)].

22 Hess–Oberhammer–Pfeiffer op. cit. 42.

23 Recital 11 of the Insolvency Regulation.

procedural standing (*locus standi*) to apply for such a measure in insolvency proceedings. In insolvency proceedings in which the right to dispose of a debtor's assets is not transferred to an insolvency practitioner (pre-insolvency and hybrid proceedings), the active procedural standing to apply for a provisional and protective measure pertains to the debtor. In terms of the passive procedural standing, the ordering of a provisional or protective measure will be, as a rule, directed against a third party who holds the property which is subject to insolvency proceedings. In pre-insolvency and hybrid proceedings, provisional and protective measures may also be ordered against the debtor itself (passive procedural standing), because no insolvency practitioner may be appointed in these proceedings, i.e. the right to dispose of the debtor's assets may not pass to the insolvency practitioner, but the debtor remains in possession of its assets. The purpose of these provisional and protective measures is to prevent the debtor's assets from being diminished.

4. Conclusion

In our opinion, the inclusion of provisions on pre-insolvency and hybrid proceedings in the Insolvency Regulation is beneficial. If the material scope of the Insolvency Regulation did not cover pre-insolvency and hybrid proceedings, this could result in multiple pre-insolvency or hybrid proceedings being opened against the same debtor with establishments in different EU Member States, which could have unforeseeable legal consequences, as the insolvency laws of several Member States would be in competition and conflicting orders could be issued. Thanks to the inclusion of pre-insolvency and hybrid proceedings in the Insolvency Regulation, it is possible to streamline and coordinate these proceedings, which are often cross-border in nature. At the same time, the interests of foreign creditors in these proceedings can be effectively protected. Creditors will be able to defend themselves more effectively against those acts of the debtor which are detrimental to their interests.

Since pre-insolvency and hybrid proceedings have been included in the material scope of the Insolvency Regulation, the so-called *forum shopping* should be minimised in the future. In practice, it is often the case that a debtor speculatively changes its registered office to another Member State where the conditions are better for concluding an agreement with credi-

tors at the pre-insolvency stage. In these cases, conflicts of jurisdiction then arise where the bodies from more than one Member States may exercise jurisdiction to open proceedings. The provisions of the Regulation should prevent a debtor from being able to intentionally transfer its registered office from one Member State to another Member State before the opening of pre-insolvency or hybrid proceedings in order to obtain more favourable terms for concluding an agreement with its creditors. The inclusion of pre-insolvency and hybrid proceedings in the scope of the Insolvency Regulation is intended to prevent speculation by debtors which, as a result of an intentional transfer of their registered office to another State, would result in the establishment of the jurisdiction of a court of another Member State to open pre-insolvency or hybrid proceedings. As a consequence, conflicts of jurisdiction in pre-insolvency and hybrid proceedings will be effectively avoided so that jurisdiction to open pre-insolvency or hybrid proceedings concerning the same debtor can no longer be exercised by the bodies of more than one Member State.

The Insolvency Regulation is based on the principle of giving priority to pre-insolvency and hybrid proceedings over formal insolvency proceedings. Where there is a likelihood of insolvency of a debtor (e.g. imminent insolvency caused by the loss of a contract which is crucial for the debtor's continued business activity), priority should be given to the opening of proceedings the purpose of which is to avoid the debtor's insolvency or the cessation of debtor's business activities. Accordingly, the aim of pre-insolvency and hybrid proceedings is to achieve the debtor's recovery and give it a second chance.

The previous Regulation No 1346/2000 focused more on the debtor's winding-up than recovery, causing the total value of the debtor's assets to diminish, its creditors to be less satisfied and jobs to be cut. In contrast to the previous Regulation No 1346/2000, the Insolvency Regulation has modified the basic rules for the conduct of cross-border insolvency proceedings to be more geared towards promoting the rescue of debtors in financial difficulties. The Regulation gives priority to giving debtors a second chance instead of insolvency proceedings, which are winding-up in nature. The scope of Regulation No 1346/2000 did not extend to pre-insolvency and hybrid proceedings aimed at the recovery of debtors and the restoration of their economic activity. In some Member States, the sharp increase in the indebtedness of natural persons in recent years has prompted the introduc-

tion of pre-insolvency and hybrid proceedings not only for legal persons but also for insolvent natural persons, in order to give them a second chance.

Legislation governing pre-insolvency and hybrid proceedings is found in the laws of some Member States. This legislation differs significantly from one Member State to another, which may cause legal uncertainty, in particular from the perspective of foreign creditors. Therefore, the inclusion of pre-insolvency and hybrid proceedings in the material scope of the Insolvency Regulation can be viewed as beneficial.