Author Statement

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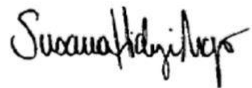
DECLARATION OF HONOUR

I declare that the paper, titled "**HYBRID REORGANIZATION PROCEEDINGS: THE BEST OF BOTH WORLDS**" is my own work, that it has been prepared independently and that all references to, or quotations from, the work of others are fully and correctly cited.



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HYBRID REORGANIZATION PROCEEDINGS: THE BEST OF BOTH WORLDS

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I. Introduction

Workouts -understood as a private agreement to achieve an informal reorganization- have existed for a long time. Some trace their existence since the Law of the Twelve Tables, in which Law VIII of Table said: “In the meantime, the party who has been delivered up to his creditor can make terms with him. If he does not, he shall be kept in chains for sixty days; and for three consecutive market-days he shall be brought before the Prætor in the place of assembly in the Forum, and the amount of the judgment” (INSOL International, 2021/2022, cit. A. Schmitt and S. Raisch, 2013).

Workouts enhance direct negotiation and are less disruptive than a formal reorganization proceeding in which a governmental authority (administrative or judicial) intervenes. Nonetheless, formal restructuring usually grants the debtor some protections such as the automatic stay and the right to reject contracts -which are not available for the workouts.

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So each scenario has its pros and cons. But is it possible to have the best of both worlds? The closest answer is a hybrid reorganization proceeding in which the court will have marginal intervention during the reorganization whereas the parties will directly negotiate a way out of insolvency. This type of solution is not only convenient for the stakeholders involved in insolvency proceedings, but also for the administration of justice since the decrease of judicial intervention reduces the courts' workload and the governmental costs for the exercise of this public power.

The prolonged closing of the productivity and limitation in consumption related with the Covid-19 pandemic provoked a global economic recession without precedents (OECD, 2021). The forecasts of these effects led the Governments to implement several measures including tax reliefs and subsidies (pg. 3). If the Government lacks the capacity to manage adequately the crisis it may be transferred from the real economic sector to the financial sector (Kargman, 2009).

Within the series of measures that have been adopted, the modifications to bankruptcy legislation in many jurisdictions has been constant (INSOL, 2020). One of the recent trends has been the implementation of regulation to promote pre-judicial and extra-judicial restructuring proceedings - not only with the aim to avoid the collapse of administration of justice- but also with the purpose of control the disruptive effects to the financial system as a consequence of a disproportionate increase of insolvency proceedings (Gurrea-Martinez, 2021). Formal bankruptcy proceedings shall be the last resort and must be seen as a tool rather than a goal in the process of resolving financial distress considering that informal alternatives generate significantly higher share returns and allow the shareholders and management to retain control and flexibility (INSOL International, 2021/2022, cit. Gibson and Birkinshaw, 2004).

This paper addresses some hybrid reorganization proceedings from different jurisdictions that will generally include marginal court intervention and direct negotiation by the parties which has been generally successful to make reorganizations more agile and effective.

II. Main Features of a Hybrid Reorganization Proceeding

Originally, the crisis was assimilated to the suspension of payments in which the debtor cannot comply with the liabilities with the available resources (Gebhardt, 2012). However, approaching the crisis early may increase the possibilities to successfully solve it and put creditors in a better position for the collection of their claims. For that reason, bankruptcy laws began to include the imminent inability to

pay as an alternative requisite to apply for an insolvency proceeding before the suspension of payments supervenes (Dasso, 2014). In that sense, the first typical characteristic of a hybrid reorganization proceeding is that the financial requirements to commence such process are usually more flexible that the requisites for a formal reorganization (such as suspension of payments) (INSOL International, 2021/2022, cit. Adriaanse, J. and Kuijl, H., 2006, page 145).

The second common feature would be that the courts have marginal intervention during the negotiation. Indeed, such procedures do not involve the bankruptcy court and, therefore, are more private and allow the debtor to keep a low profile about the financial distress.

The third usual characteristic of hybrid proceedings is that it grants the debtor more protection during the negotiation than a private workout. There could be an automatic stay that protects the debtor's assets from execution of attachment from collection proceedings -in comparison to a standstill that is voluntarily agreed upon which each creditor.

Moreover, the fourth typical feature of a hybrid proceeding is that the reorganization agreement will be binding to all creditors -including absent and dissenting creditors since there is usually a decision by the judge to approve the agreement. Conversely, a private workout will be binding only for the parties that executed it.

Also, as the fifth ordinary characteristic, during a hybrid proceeding, the management will retain control during the negotiation. It allows the debtor to retain control over the managements since no officers from the court will be appointed.

Although the regulations may include more features of these proceedings in the different jurisdictions, these would be common characteristics of a hybrid reorganization procedure.

III. Statement of Principles for a Global Approach to Multi-Creditor Workouts

Hybrid reorganization proceedings incorporate the main characteristics of workouts as their essence is based on the direct resolution of the debtor's insolvency. Thus, the "Statement of Principles for a Global Approach to Multi-Creditor Workouts" introduced by INSOL International in 2000, ultimately endorsed by the World Bank seems to be a relevant soft-law instrument to review the regulation concerning hybrid reorganization procedures (INSOL International, 2021/2022, cit. Adriaanse, J. and Kuijl, H., 2006, page 154).

In summary, there are eight principles. First, all relevant creditors should co-operate with each other to give an "Standstill Period" to the debtor for resolving the debtor's financial difficulties. Second, during the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against the debtor and conflicts of interest in the creditor group should be identified early and dealt with appropriately.

In the third place, during the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors. Fourth, co-ordination will be facilitated by the selection of one or more representative co-ordination committees and by the appointment of professional advisers to advise and assist such committees. Fifth, during the Standstill Period, the debtor should provide, and allow relevant creditors access to all relevant information relating to its assets, liabilities, business and prospects, to enable proper evaluation of the debtor's financial position.

According to the sixth principle, proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date. Seventh, information obtained for the purposes of the process and any proposals for resolving its difficulties should be made available to all relevant creditors and should be treated as confidential. And finally, if additional funding is provided during the Standstill Period or, the repayment of such additional funding should be accorded priority status as compared to other indebtedness or claims of relevant creditors (INSOL International, 2000).

These principles are extremely relevant for a proper environment to negotiate on a distress situation. However, sometimes creditors are not willing to voluntarily refrain from enforcing their rights. Thus, the protection granted by a formal reorganization -without the costs, loss of control, and other consequences- would be desirable.

IV. Hybrid Reorganization Proceedings implemented in some jurisdictions

4.1. Hybrid reorganization proceedings in Spain

Spain's bankruptcy system did govern two hybrid reorganization proceedings: the "Refinancing Agreement" and the "Extrajudicial Agreement of Payments". These proceedings allowed the debtor to continue developing its corporate purpose and avoid the mandate to request a bankruptcy proceeding (Pérez, 2018).

However, those proceedings will be replaced by the new Restructuring Plan introduced by the Insolvency Act that will be available in cases of imminent and current insolvency (Cuatrecasas, 2022). The purpose of that Insolvency Act is to implement the European Restructuring and Insolvency Directive into Spanish law (Garrigues, 2022).

The main features of this pre-insolvency proceeding are, in summary, the following: (i) the debtor may file a notice of the beginning of negotiations with its creditors, before the competent judge (Insolvency Act, articles 584 and 585); (ii) when the filing fulfills requirements, the judge may admit it with applicable effects upon the filing of the request (Insolvency Act, articles 588 and 603); (iii) the communication of the negotiations will not have effects over the debtor's management nor over its faculty of assets disposal (Insolvency Act, article 594); (iv) the debtor and its creditors may file the reorganization plan before the competent judge before the date of expiration of three-month period; (v) if the three-month period elapses without reaching a reorganization plan, the debtor must request the declaration of insolvency within the following month, unless it not be in a state of current insolvency; conversely, if a reorganization plan is filed, it will be approved whenever it fulfills all requirements pursuant to article 629 of the Insolvency Act. (Congreso de los Diputados, 2022).

This mechanism has different relevant characteristics. Indeed, the execution of securities will not be suspended nor interrupted by virtue of the beginning of the negotiations (Insolvency Act, article 595). Thus, secured creditors may foreclose their guarantees if the credit is matured, unless the secured creditor is a related party.

In addition, post-petition lending is promoted. In fact "*as long as the plan has been court-sanctioned, interim financing and new money are (i) protected from potential clawback actions, and (ii) deemed an administrative expense that is paid on a cash flow basis (50%) and ranks senior over unsecured creditors (50%)*" (Cuatrecasas, 2022, p. 5).

4.2. Britain Scheme of Arrangement and Reorganization Plan

United Kingdom implemented the Scheme of Arrangement since the Financial Crisis of 2007/2008. Despite of its success, that proceeding "*does lack one key feature that limits its effectiveness and puts it at a disadvantage compared to the restructuring frameworks of a number of other jurisdictions"* and that is cross-class cram down (Restructuring plan, 2020). Thus, the Government of UK issued some the Corporate Insolvency and Governance Act that introduces a new restructuring plan procedure that incorporates new cross-class cram down provisions. It will prevent dissenting classes of creditors (and/or shareholders) from blocking a restructuring that is in the best interests of the company (Restructuring plan, 2020).

The Corporate Insolvency and Governance Act introduced an amendment to Part 26 of the Companies Act of 2006. The purpose of the compromise or arrangement is to eliminate, reduce or prevent, or mitigate the effect of, any of the financial difficulties (Companies Act, 2006, Part 26, art. 901.A.(3).(b)).

The main features of that proceeding include: first, the application could be made by the company, any creditor or member of the company and the administrator if the company is subject to administration, (Companies Act, 2006, Part 26, art. 901.C.(2).(a,b,c,d)). Moreover, the Court will order for holding of meeting between creditors or any class of them (Companies Act, 2006, Part 26, art. 901.C.(1)). Third, the debtor has to send a notice of the summoning for the meeting, together with an statement in which explains the effect of the compromise or arrangement, and explain if there are any interests of the related parties and the potential effects over the arrangement.

In addition to the previous rules, the Companies Act establishes that the Court must approve the arrangement if it was approved by at least 75% of creditors or the corresponding class of creditors. This arrangement is binding for creditors or the corresponding class of creditors and the debtor. Specially, in this stage the Corporate Insolvency and Governance Act incorporated cross-class cram down provisions. Indeed, these provisions allow to impose a restructuring plan on creditors and/or shareholders without their consent, "*when the court is satisfied have no "genuine economic interest" in the company"* (INSOL World, 2020). In addition, the court may approve the plan when is satisfied that no members of the dissenting class(es) would be any worse off than they would be in the event of the "relevant alternative"; and at least one class of creditors or members, which would receive a payment or have a genuine economic interest in the company in the event of the relevant alternative, has approved the restructuring plan (INSOL World, 2020)(Companies Act, 2006, Part 26, art. 901.G).

4.3. Expedited Proceeding of Bankruptcy Refinancing (Procedimiento Acelerado de Refinanciación Concursal – PARC) of Peru

With the purpose to content consequences of the health emergency caused by the COVID-19 pandemic, the Peruvian Government issued the Decree 1511 of 2020 which created the Expedited Proceeding of Bankruptcy Refinancing –PARC- as a hybrid reorganization proceeding. That proceeding is administered online. Thus, the request of admission, the claims of the creditors, and meetings of creditors committee, are filed online (Cuatrecasas, 2020). In addition, it is available just for debtors who have been qualified by financial entities as in normal risk or with potential issues. (Cuatrecasas, 2020).

To access to a PARC, the debtor must file the request for an admission that will be published on the Official Journal. Upon the admission, an automatic stay will be applicable pursuant to articles 19 and 20 of the General Law of the Insolvency System ("LGSC"). Furthermore, creditors may file their claims that arouse before the beginning of the PARC, within 10 following days to the publication of the admission. The Technical Secretariat of the Commission will recognize the claims and will notice about the recognition to each creditor. Once credits are recognized, the Secretariat of the Commission will summon a meeting of creditors committee in which the agreement will be approved (Cuatrecasas, 2020).

The PARC requires positive votes from the absolute majority of the recognized creditors. The PARC concludes with the meeting despite the agreement is approved or not. In the event of default of the PARC it will be nulled and creditors may begin executive actions against the debtor. Finally, issues related to violation of priority rules, payments of credits caused before the beginning of the PARC, disposal of assets or another issue regarding breaking the principle of universality are not discussed in the PARC, but through a separate ordinary claim. (Cuatrecasas, 2020).

4.4. Emergency Negotiation of a Reorganization Agreement: the Colombian hybrid reorganization system

During the Covid-19 pandemic, the Government of Colombia issued Decree 560 of 2020 which, among other measures, implemented the Emergency Negotiation of a Reorganization Agreement. Although this type of tool is innovative in Colombia, these kinds of procedures have been created in the bankruptcy comparative law (Gurrea Martínez, 2020).

Pursuant to this procedure, the debtors directly negotiate a reorganization plan with the creditors, for a maximum term of three months, with very limited judicial intervention. The failure of the proceeding will not terminate in a mandatory judicial liquidation proceeding. The procedure is subdivided into four main stages: 1. Notice of negotiations beginning; 2. Negotiation of the agreement; 3. Approval hearing; and 4. Reorganization agreement effects (Hidvegi, 2021).

Upon the admission of the notice of negotiations, the debtor must inform the creditors through e-mail or any adequate mechanism (Decree 842 of 2020, article 6). During the negotiation stage, the following effects will take place to promote an adequate environment for the negotiation (Hidvegi, 2021):

- Stay of the actions for the collection, repossession, or enforcement of security interests against the debtor (Hidvegi, 2021). Unlike a traditional reorganization proceeding, in this hybrid reorganization proceeding the bankruptcy judge may not lift precautionary measures ordered over the debtor's assets.
- The debtor must refrain from disposing its assets, create securities or collateral, or engage in any act outside from the ordinary course of its business, without prior and explicit judicial authorization.
- The bankruptcy judge will not intervene during the negotiation or resolve any disputes in that stage. This is one of the main features of this type of procedure that differentiates it from an ordinary reorganization.
- The debtor may postpone payment of post-petition claims, if necessary, without being deemed to be in arrears. Nonetheless, these obligations must be paid within the month following the confirmation of the agreement or failure of the negotiation. However, postponement is not available for labor and pension obligations and obligations with the social security system (Hidvegi, 2021).
- Negotiations may be partial by involving only a category or some categories of creditors that are relevant to solve the insolvency, without affecting other creditors. The obligations with uninvolved creditors will have to be paid in the ordinary course of business (Hidvegi, 2021).

Upon the filing admission, the debtor has three (3) months to file the agreement before the bankruptcy judge duly voted. Upon the expiration of the negotiation period, the bankruptcy court will confirm the agreement that fulfills the requirements set forth by Law 1116 of 2006. If the creditors do not reach an agreement, or if such is not confirmed, the negotiation will be deemed as failed and the debtor may file an ordinary reorganization or liquidation petition.

V. Conclusion

The pandemic has accelerated the implementation of tools that promote the agile resolution of insolvency thereby combining the principles of workouts and the protection granted by formal reorganization proceedings. Therefore, this type of proceeding takes the best of both worlds. On the one hand, from the private workout perspective, the debtor retains control during the negotiation, and has the opportunity to directly settle with its creditors. Nonetheless, the environment for negotiation may be affected by the continuation of the enforcement of securities or the termination of contracts. Moreover, in the end, if some creditors refuse to accept the agreement, it will not be binding for them.

On the other hand, from a formal reorganization point of view, the debtor will have the protection from executions and termination of contracts, and the eventual agreement will be binding even for absent and dissenting parties. However, during such a procedure the debtor will be exposed to lose control of the business, will invest more resources, and will have more exposure because of the publicity of the judicial process.

In the middle we find the trend to have a hybrid proceeding that gets the best of both worlds. Thus, as the reorganization proceedings shall be based on transactional solutions and avoid unnecessary litigation and costs, this alternative seems to be convenient for every jurisdiction -even if it cannot be applied in every situation. As a public policy, hybrid proceedings may also save costs since the courts will have less workload given the limited intervention.

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