Autumn 2021

IFLR

Scottish independence: Brexit all over again?

A second referendum may well be on the horizon, which could lead to a number of difficult regulatory and economic decisions

Africa Awards

Merger Control

Securities Tokenisation

R&I Report

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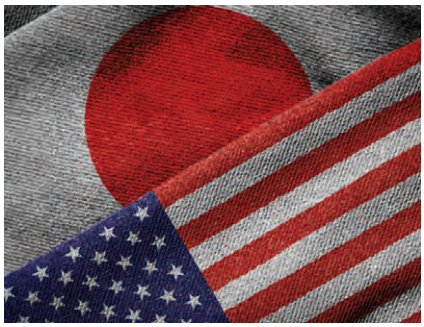

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Banking and finance

Corporate

Corporate insolvency & restructuring report

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"It might be that in due course trading patterns look different, it depends on what Scotland's relationship with the EU would be, but the idea that Scotland would simply rejoin the EU is naïve"

Economist John Kay discusses Scotland's options post-independence

EDITORIAL

For one last time…

For those of you who missed my email in late September, this will be the final print edition of IFLR magazine. After nearly 40 years and hundreds of editions it is time to call it a day.

This wasn't an easy decision. IFLR magazine has been part of the furniture at Euromoney since 1982. Once a monthly journal, the magazine has evolved over time, changing to a bimonthly and later, a quarterly.

IFLR magazine was one of the first things I really noticed when I joined the company, something that young journalists aspired to be a part of. During my time, introductory editorials from Tom Young, Amélie Labbé and later, Lizzie Meager always set the tone for what would come in the issue and the biggest topics of the moment. Part of me knew that eventually it would be my responsibility to write that introductory message – but never did I expect to be writing this, the last.

This move may not come as a surprise. The decision to kill print has been taken frequently across the industry in recent years, from NME to the Weekly Standard to Teen Vogue, there is a long, long list of titles that have taken the decision to 'go digital'. When Institutional Investor, one of our publisher Euromoney's flagship titles, took the step last year, it seemed that the writing was very much on the wall.

The decision itself was made following extensive feedback from our subscribers. We regularly talk to our readers to help determine how best to improve our offering and ascertain subscriber needs. The IFLR team and I believe these changes will allow us to provide a better service to you. The pandemic has changed the way we work, and the feedback confirms that most subscribers are no longer receiving copies on desks, and no longer need them.

Our team wants to ensure that you receive the IFLR content you expect and that it reflects this new way of working. Without resorting to clichés, we believe a fully digital offering is the best way to achieve that.

We are also very conscious of global sustainability efforts. While it is only a small act, not printing thousands of copies every quarter to be distributed globally will ensure we maintain the very standards we promote on the website each and every week. More on that in Closing Conditions on page 80.

When the planning for this edition started, there was of course the option to issue a backward-looking magazine that summarised the last four decades of IFLR magazine and highlighted some of the best editions, covers and features. Perhaps this might have been the correct approach, but in the spirit of being a forward-looking, reactive publication that does not hold on to the past, we took a different path.

With that in mind, for this last ever IFLR cover story I took it upon myself to put together an article that couldn't be much more forward looking, an in-depth analysis into the annals of Scottish independence. Before the referendum, the concept of Brexit as it pertained to legal and financial journalism seemed so alien that the very thought of it seemed impossible. After it happened, the rush to cover the nitty gritty details started in earnest and has barely slowed some five years later. Who is to say if the same won't be said for Scottish independence in a decade's time?

Many of you may doubt that Scotland will ever separate from the United Kingdom, it may well never happen. But, to assume the status quo will remain in place when such a large portion of a population supports something is verging on arrogance. It may well happen, and this time – like so many times before – IFLR has done its homework. So, on page 10, we take a closer look at all the regulatory and legal implications that the financial markets of the UK and an independent Scotland would face in the run up to and after, a vote for independence.

Elsewhere in the issue are some old favourites. On page 4, our journalists give their opinions on the topics of the moment, we highlight all of the winners at the recent Africa Awards on page 6, and as ever we have included a litany of excellent contributed content, starting on page 18 with a close look into decentralised finance.

This change can only be for the better. IFLR has evolved. What we have become will be far brighter and far better for everyone, myself included.

So, without further ado and for one last time. Enjoy the issue.

John Crabb, Managing Editor
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PODCAST

IFLR Podcast: Hope Jarkoswki

In this edition, John Crabb speaks to the head of equities at the New York Stock Exchange about the state of the US capital markets, the IPO market, SPACs and the general regulatory landscape

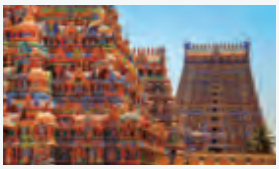
EMEA

Concerns with UK plans to diverge from EU GDPR

The British government recently announced plans to revamp its data rules, marking a significant point of divergence from the EU since Brexit

ASIA

Archaic laws stunt SPAC growth in India



Business friendly tax laws are necessary to prepare Indian startups as potential SPAC targets, if the country wants to attract the popular IPO route

EMEA

Digital euro enters the next phase

The project enters the next phase of its inception but questions surrounding regulation, design and use of distributed ledger technology remain murky

AMERICAS

End in sight for Puerto Rico's debt restructuring saga

The Caribbean island's sluggish economy is stunted by territorial debt, choked by population loss, and battered by natural disasters, but there may be brighter days ahead

DEAL

Thai Union's sustainability-linked bond explained

The first-of-its kind deal introduced step-up and step-down coupon rate features linked to sustainability targets

QUOTES OF THE MONTH

"So far, I have not seen evidence to suggest that banning payment for order flow is going to be beneficial to retail investors"

Hester Peirce, SEC Commissioner, discusses the PFOF debate

"This open access approach supports a vastly more inclusive type of financial innovation, but has raised concerns among policymakers that it could at some point give rise to an alternative financial system"

Lewis Cohen and Alex Lipton discuss the promise of DeFi on page 18

"What will be surprising to most observers is that the greatest number of notifications to CFIUS in 2019 and 2020 involved Japanese-sourced deals"

Harry Broadman, partner at Berkeley Research Groups, discusses the 2020 CFIUS report on page 28

"We cannot afford to have a split focus to investing or providing funding for a new sub asset class, any infrastructure that we're looking to finance or develop has to – nine times out of 10 – be sustainable"

Kome Johnson-Azuara, associate vice-president at the Africa Finance Corporation, stresses the importance of sustainability

AMERICAS

Time to shut revolving doors

The so-called "revolving door" between regulators and business has polarised critics and defenders. Former US financial regulators are not bound by the strictest rules for moving between government and private business, and this has presented a paradox — particularly for combating climate change — when former regulators have moved to lucrative private business positions at law firms and large financial firms.

The phenomenon has led to worries over regulatory capture and influence peddling from the private sector to favour light-touch regulation and decreased scrutiny for the finance industry.

Investor advocacy groups, including Better Markets, have criticised this revolving door. Dennis Kelleher, president and CEO of Better Markets, said one career move earlier this year was exemplary of an epidemic of "regulators selling out" to the highest bidder.

"Congress should outlaw it by prohibiting former regulators from working directly or indirectly for any entity within their jurisdiction while they were in government for not less than five years," he wrote in a statement.

While one-offs like this may be jarring and raise hackles of investor protection types, at the very least, the optics of that particular hire were awful: they smacked of a back-slapping boy's club financial in-crowd that has harmed the fortunes of both retail investors and Main Street.

A likely counterargument to bolstering rules is that this would limit choices for former regulators. It would. A former regulators' employment options would be circumscribed for five years, but not to an injurious degree, and they are not barred from business for life.

If the revolving door is so deleterious, shouldn't the financial system fall apart? Not exactly. Besides, that's an unnuanced argument and a low bar for doing anything.

Regulation lives in greys, it is not a matter of black and white. Besides, former regulators' options are not inherently limited by some faceless and malevolent force.

If one firm could not hire a former US regulator for a longer period, there could be good results, like others having a turn. That would likely bring in fresh thinking or individuals from historically underrepresented groups. Increased diversity and hires with different experiences make everyone think harder, and therefore make the nation better and more thoughtful on a myriad of critical issues.

Yet, the US economy remains the paragon for the world, capital markets are strong, and the sector contributes significant portions to the gross domestic product. We don't want to hamper it.

But in times of financial stress and economic downturns the spectre again is raised. Champions for greater regulation and stronger rules will note that systemic failures — most recently the 2008 great financial crisis — are worsened if not stem from inadequate transparency and oversight, possibly emanated from a too-chummy relationship and cross-pollination between regulators and business.

ASIA

China's bond defaults have come of age

Chinese corporate bond defaults hit a record high of RMB116 billion ($18 billion) in the first half of 2021 and are expected to rise in the months to come. Defaults are also getting bigger, with defaulters having RMB8.7 billion onshore bonds outstanding on average, according to Fitch. This is 1.6 times the size of defaults in 2020 and three times that of 2017. While these are worrying signals for investors in the Chinese bond market, there are also signs that regulations and infrastructure for market-oriented debt resolutions are developing, albeit slowly.

From property developer China Evergrande to China Huarong Asset Management, bond defaults, especially of state-owned enterprises, have caused jitters in the global market. Zombie companies and insolvent local government financial vehicles are common default candidates but the real estate sector could be hit hard.

All eyes are on Evergrande, which is sitting on a $300 billion mountain of liabilities, and whether the Chinese government will decide to bail out the debt-laden company. As China's state-owned banks are the biggest creditors of the company, they rank high on the liability waterfall and will be prioritised before private investors, including bondholders.

While the practice of government bailouts may have been frequent in the past, China is shifting gears towards more tolerance for defaults of unfit firms in an effort to push for market opening and discipline. State-owned enterprises have long been favoured by the government and benefited from implicit debt guarantees. By drawing a line between what is

systemic and what is not, the central government is injecting more credit risk into the financial system and pushing investors to think about their risk appetite, rather than relying on the government to bail out distressed borrowers. It is also sending a signal to companies that they can no longer rely on the government to help them out.

The momentous task the Chinese government now faces is to ensure that defaults happen in an orderly fashion in its de-risking campaign. A number of initiatives are being taken to clean up the bond market.

The primary focus is on cleaning up the rating agency sector. In August, five central government bodies, including the China Securities Regulatory Commission and the China Banking and Insurance Regulatory Commission, issued rules for rating companies detailing standards for disclosures, corporate governance, and business operations. They are required to be stringent about rating scores based on the probability of defaults and reduce the proportion of high-rated bonds, a practice that has been common for domestic rating agencies that want to attract potential clients.

Another priority is to develop the legal infrastructure for courts to deal with defaulters. Court restructurings of defaulters are beginning to take shape as the market starts to accept court-led workouts. However, legal precedents for bankruptcy proceedings are still new. For offshore bondholders, the process is slow and arduous. What will help in the future is streamlining of documentation, whether it is for transfer or liquidation, to ensure that investors can do repatriations. It remains a challenge for offshore bondholders to find recourse when they are structurally subordinated to onshore claimants and face challenges such as delaying tactics and lack of transparency in the legal process.

EMEA

Binance crackdown has wider implications

In recent months, cryptocurrency exchange Binance has faced increasing regulatory scrutiny worldwide. The company has even been forced to cease operations in the UK, Singapore, Australia and South Korea. The UK's watchdog, the Financial Conduct Authority (FCA), has said that Binance cannot be properly supervised and poses a significant risk to customers. Other countries have echoed the same criticisms.

While it may seem that Binance has been the key target for regulatory scrutiny, the company's struggles may signal wider regulatory concerns for crypto asset and crypto exchange firms. There seems to be a worldwide push from regulators demanding further transparency from crypto exchanges.

In South Korea, authorities raided the offices of Bithumb and Coinbit over allegations of fraud. Crypto scams have not only been rising in the country but elsewhere in the world, driving regulators to take on a microscopic view on crypto. Recent moves in China to ban cryptocurrency transactions altogether highlight how far some governments are willing to go.

AML concerns

It's not just regulators that have showed concern with Binance and crypto more generally, a number of large banks have revoked Binance's access and vowed to review their approach to crypto at large. Both regulators and banks have cited the risk of money laundering as a key reason for these actions.

The UK recently announced proposed changes to its anti-money laundering rules (AML), placing a key focus on cryptocurrencies. Among the key proposals is a requirement that any virtual asset transfer over $1,395 be accompanied by detailed personal information on the originator and beneficiary.

These increased regulations have spooked some crypto firms because it undermines the ease and unregulated nature of crypto exchanges themselves. Nevertheless, Binance's story is a warning to other crypto firms that their days operating in a regulation-free zone are nearly over.

Stifling innovation

While it's universally agreed that having robust anti-money laundering (AML) and countering terrorist financing (CTF) measures in place is essential, there's always been a key concern that too much regulation could stifle innovation. Nevertheless, with crypto the opposite could be true.

Businesses are found to be more willing to partake in business if they can enjoy the comfort of knowing there is a robust regulatory framework to cushion potential problems. "Clarity is key in driving innovation – if Her Majesty's Government sets out a clear framework it could actually encourage innovation and investment into the UK," said Chris Bostock, director of Deloitte's forum for tackling illicit finance.

Ultimately, the UK's AML/CTF framework is not intended to limit commercial growth. It's a mechanism that's intended to ensure safety and integrity within commercial transactions.

OFF THE

RECORD

"The UK could easily go to Iceland, Ireland, Cyprus or Malta and say, 'come and join us and we'll protect you', but if you're starting to arbitrage states like that it is completely the opposite discussion of what it's packaged up as being, which is Scottish independence"

London based private practice lawyer on Scotland joining the EU on page 10

"The Commission is very focused on consolidated tape, which will provide investors with more visibility on the performance of different trading mechanisms, thereby improving best execution and showing which kinds of trading infrastructure are optimal for them"

A source close to the European Commission told Practice Insight

"This is about evolution – not revolution. We played a central role in devising EU rules over the past decades. We have no intention of turning our back on those, or to engage in a race to the bottom"

UK Treasury official on post-Brexit divergence

"While this issue will not be completely unique to Asia-Pacific, it may be amplified here because of the prevalence of the use of US dollar in the international syndicated loans market"

International bank source discusses the use of SOFR outside of the US

All the winners from IFLR's Africa awards 2021

IFLR is delighted to announce the winning deals, teams, law firms and individuals for the second edition of its IFLR Africa Awards.

This announcement follows months of research by the team and careful deliberation by the editors and IFLR journalists that make up the internal judging panel.

The core objective of the awards is to recognise legal innovation in cross-border transactions. To be considered, all deals must have reached financial close between June 1 2020 and May 31 2021, as well as meet pre-defined criteria to be considered cross-border and jurisdictionally African.

The most significant theme running through the IFLR Africa Awards research this year was that of resilience. Legal innovation and cross-border deal making is invariably complex, but the global pandemic and associated knock-on effects fully tested the abilities and perseverance of all stakeholders. In the face of this adversity, law firms and practitioners getting deals done on the continent rose to the challenges admirably.

There was a raft of pioneering work analysed by our research team that reached across all areas of Africa, and the list of winners below reflects the innovative, cross-border legal advice that allowed the most transformative business transactions to reach completion.

The winners' award presentation, in which we reveal the winners and talk about some of the highlights from the research, can be viewed below.

To find out more about business development and marketing related to the awards, please contact: Liam Sharkey: lsharkey@iflr.com

On behalf of the research team, thank you to everyone who took the time to contribute through submissions and interviews, and congratulations to all the winners.

Regional awards

International law firm of the year
Clifford Chance

In-house team of the year
African Export-Import Bank (Afreximbank)

Legal network of the year
ALN

Deals of the year

Capital markets
Banque Ouest Africaine de Développement sustainability bond
Dechert
White & Case

Domestic
Nigerian Stock Exchange demutualization
Aluko & Oyebode

Loans
Trade and Development Bank pandemic relief loan
Clifford Chance
White & Case

M&A
Stripe / Paystack Payments
Aluko & Oyebode
Fenwick & West
Orrick Herrington & Sutcliffe
The New Practice

Private equity
Capitalworks / Peregrine
Bedell Cristin Partnership
BLC Robert & Associates
Cliffe Dekker Hofmeyr
Clifford Chance
Conyers Dill & Pearman
Webber Wentzel
Werksmans

Project finance
Beitbridge border post modernisation project
Allen & Overy
BLC Robert & Associates
Bowmans
DLA Piper Africa, Mauritius (Juristconsult Chambers)
DLA Piper Africa, Zimbabwe (Manokore Attorneys)
Eversheds Sutherland
Gill Goldlonton & Gerrans
Harneys
Herbert Smith Freehills
Werksmans

Restructuring
TAV Airports restructuring
Cabinet Donia Hedda-Ellouze Ellouze & Belajouza-Felli
Ciftci Law Firm
Clifford Chance
Meziou Knani & Khlif
NautaDutilh
Shearman & Sterling
Sibel Ertekin Law Office

Editor's choice impact award
African Vaccine Acquisition Trust (AVAT) Covid-19 vaccines
Appleby (Mauritius)
Slaughter and May

Teams of the year

Capital markets
White & Case

Loans
White & Case

M&A
Clifford Chance

Private equity
Clifford Chance

Project finance
Herbert Smith Freehills

Restructuring
Clifford Chance

National firm awards

Angola
ASP Advogados

Botswana
Bookbinder Business Law

Ethiopia
Aman Assefa & Associates Law

Ghana
JLD & MB Legal Consultancy

Kenya
Anjarwalla & Khanna

Mauritius
BLC Robert & Associates

Mozambique
CGA – Couto Graça & Associados

Morocco
Clifford Chance Morocco

Namibia
ENSafrica

Nigeria
Aluko & Oyebode

OHADA
Asafo & Co

Rwanda
ENSafrica

South Africa
Bowmans

Tanzania
ALN Tanzania|A&K Tanzania

Tunisia
Donia Hedda-Ellouze, Ellouze & Belajouza-Felli

Uganda
ALN Uganda MMAKS

Zambia
Bowmans

Zimbabwe
DLA Piper Africa, Zimbabwe (Manokore Attorneys)

Capital markets firm of the year: Nigeria
Aluko & Oyebode

Capital markets firm of the year: South Africa
ENSafrica

Loans firm of the year: Nigeria
Aluko & Oyebode

Loans firm of the year: South Africa
Allen & Overy

M&A firm of the year: Nigeria
Aluko & Oyebode

M&A firm of the year: South Africa
Webber Wentzel

Project finance firm of the year: Nigeria
Templars

Project finance firm of the year: South Africa
Bowmans

Individual Awards

Rising stars of the year award
Okechukwu Okoro – G Elias & Co
Tiwalola Osazuwa – Aelex

IFLR Women Dealmakers Hall of Fame
Brigette Baillie – Herbert Smith Freehills

In-House Market Maker
Magase Mogale – Africell

Lifetime achievement award
Iqbal Rajahbalee – BLC Robert & Associates

COVER STORY

Scottish independence: Brexit all over again?

For this edition of IFLR, Managing Editor John Crabb looks at the financial and regulatory implications that could arise from Scotland leaving the United Kingdom

By John Crabb

In 2014, the question of an independent Scotland was supposed to be put to rest for a generation. Those against edged out those in favour by 55.3% to 44.7% and the issue was deemed resolved: Scotland would remain a part of the UK, as it had been since 1707.

Except, just under two years later the terms upon which this vote had been made were drastically changed. When the Leave campaign voted to remove the UK from the European Union, the prospects for Scotland's future outside of the bloc did too.

In the five years since, there has been a growing dissent within much of Scotland and that which ought to have been put to bed, the question of independence, has been a constant point of contention.

Despite failing to win an outright majority in the Scottish parliamentary elections earlier this year, the ruling Scottish National Party (SNP) claims that there is a growing mandate for a second referendum, which they refer to as 'Indyref2', and continues to push the UK parliament in Westminster to grant it.

However, in an attempt to maintain the integrity of the union and keep Scotland united with the rest of the nation, and to avoid being the leader to 'lose Scotland', UK prime minister Boris Johnston has publicly quashed the idea and outright rejected this request. Yet, with a significant majority of the 'yes' voting Scottish public falling into younger age categories it seems likely that a second referendum will arise at some point. It is a question of 'when' and not 'if', suggest experts.

So, with the much-heralded COP26 event in Glasgow nearly upon us, which will turn the world's eyes momentarily onto Scotland, for this final edition of *IFLR* magazine we have decided to focus on the implications of Scottish independence for the financial markets, of course with a legal and regulatory twist, as we do best at *IFLR*.

Like Brexit before it, the financial implications of Scotland leaving the UK would be huge and would likely take years or even decades to iron out. Key debates would focus on how to break up the UK's existing debt implications fairly; what currency an

"It's only when you are de jure independent that – formally speaking – you can apply to accede to the EU"

– Andrew Wilson

independent Scotland would adopt; whether the new country would be granted membership into the EU and how long that might take; establishing a central bank, and the not-so tiny issue of what would happen to the established global asset management and banking institutions currently domiciled in Scotland but by not confined to its borders in terms of activities.

This is by no means exhaustive and does not even consider some of the other – hugely difficult – concerns such as establishing a border or how to handle trade with England (or the rest of the UK), currently Scotland's biggest trading partner.

The 28th State

Among the most prominent debates is whether an independent Scotland would be able to join the EU following its divorce from the UK. It has been touted as an obvious solution by the SNP and those in favour of independence, but is certainly not a simple proposition.

It is by no means a secret that one of the biggest roadblocks hindering the Scottish independence movement is the objections of Spain, the fourth-largest economy in the EU. The Spanish region of Catalunya has been debating independence for decades but is yet to be granted so much as a legitimate referendum of its own, despite numerous unofficial victories for the separatist agenda and a significant backing from its population. The Spanish government will not entertain the idea of an independent Catalunya and fervently opposes Scottish independence to avoid precedence.

This is a major issue for Scotland and its separatist movement.

EU membership would solve a lot of the issues that an independent Scotland might face. It would allow the country to adopt the euro, remove the need to rewrite an entire rulebook of civil laws and regulations, and generally ease the financial burdens that a fledgling country might face.

Were it not for Spain, there would be little to stop this from happening. Except, perhaps, from within England.

"It would not be easy at all, it would be a very serious thing indeed and I don't know how the UK would react - I suspect extremely strongly," one well known anti-independent voice tells IFLR.

"The UK could easily go to Iceland, Ireland, Cyprus or Malta and say, 'come and join us and we'll protect you', but if you're starting to arbitrage states like that, if you're having that sort of discussion it is completely the opposite discussion of what it's packaged up as being, which is Scottish independence."

The only way of making independence viable, they continue, is to have Scotland rejoin the EU, which he suggests would be deemed constitutional arbitrage.

If Scotland were unable to negotiate terms of joining the EU prior to leaving the UK, it would put the country into a transitionary period during which it would have to establish its own financial system independent of both the UK and the EU.

This is not necessarily a roadblock.

"It's only when you are *de jure* independent that – formally speaking – you can apply to accede to the European Union," says Andrew Wilson, former Member of the Scottish Parliament and shadow minister for finance and founding partner at Charlotte Street Partners. "Countries may be able to have informal talks in advance, and may be able to accelerate the process, but some academics say it could take up to five years."

Scotland would need to establish a financial policy position, deciding what happens prior to independence and what happens the day after. The first step would be to set up a central bank and a debt management office that mirror existing fiscal rules and regulations in the UK so as to avoid legal divergence and a potential meltdown.

Assuming the Scottish central bank would be the regulator of Scottish financial institutions, very quickly this would lead to significant balance sheet issues. "Most of the Scottish financial institutions that are off scale have already said that they will technically redomicile to London for the purposes of regulation for their overall business," adds Wilson, who adds that this would not lead to job losses for Scotland.

"If you are a banking group the size the former RBS group was or even NatWest now, the bulk of your assets (loans) and activities are outside Scotland and are regulated where they are focused, in this case London. The Scottish central bank would focus on the domestic Scottish activities of banks in Scotland."

It is hard to see how losing your biggest financial players would be good for a new country's financial system, but in reality the prospects of a financially independent Scotland – comprising just over 5 million people – would be nowhere near that of the super power that is London, and nor would it need to be.

Like the UK has in the years following Brexit, an independent Scotland would be able to build on the systems and regulations already in place. "There is a recognition that there would need to be a central bank and a financial regulator, the assumption is that they would build upon what is already there in terms of expertise," says Stephen Phillips, partner at CMS in Edinburgh. "For instance, the Financial Conduct Authority

(FCA) actually has quite a big establishment in Edinburgh.

In the early days, it would be very much the case of Scotland trying to mirror what the UK was doing and not trying to deviate too far away from that again.

"That will spill out if there is much more divergence between the UK and the EU because of Brexit. It would be an issue for an independent Scotland because there would be more of a pull towards Europe," he adds. "There would certainly be an attempt by Scotland to try to keep and keep as close as possible to the UK regulatory methods but at the same time it would probably to try to leverage off the fact that it would be seeking to join the EU, or at least have a closer relationship with Europe."

Scotland could look for market access, and perhaps even "act as a bridge between the two", he adds.

Banks planning to serve the Scottish market would also have to establish subsidiaries within the country to serve the Scottish market, but given that Scottish banks deposit ratios are healthy in terms of safety – which impacts regulation – excessive regulatory change would be unlikely.

"You wouldn't see change in regulatory standards at all, it would be in everyone's interest to keep things the same and to sort of grandfather the UK position into Scotland, providing stability for the financial sector through the transition period," adds Wilson.

In 2014, the financial situation in Scotland looked very different to how it does today. While it is important to note that RBS has already confirmed intentions to leave the country in the case of independence, following the bank's merger with NatWest it already moved a large part of its operations south of the border.

"The argument in 2014 was that the small Scottish economy could not withstand the burden of this financial instability, because the balance sheet was 15 times larger than the GDP of Scotland," says professor Emilios Avgouleas, chair of international banking law and finance at the University of Edinburgh's Law School. "Without this, financial stability is much, much less of a problem now than it was in 2014."

Despite London's dominance in the banking sector, the city of Edinburgh has an established financial services sector. The asset management sector, for instance, has seen some relocation of financial services activity, with large institutions such as Abrdn and Scottish Widows currently based there.

"If independence meant Scotland became a member state, then obviously financial institutions in Edinburgh would be able to passport again, rather than relying on equivalents, which would be hugely beneficial to Edinburgh's asset management cluster"

– Sarah Hall

Sarah Hall, professor of economic geography at the University of Nottingham, suggests that there would be significant benefits for the asset management industry, but it would not be an easy ask.

"If independence meant Scotland became a member state, then obviously financial institutions in Edinburgh would be able to passport again, rather than relying on equivalents, which would be hugely beneficial to Edinburgh's asset management cluster," she says. "The issue is in the process of joining the EU, the evidence suggests that that is a very long process."

While the end point of having single market access would be valuable to the industry, there would be a significant period of uncertainty while that was worked out.

Regarding the UK banking system, Nicholas Macpherson, Baron Macpherson of Earl's Court, and former permanent secretary to the Treasury from 2005 to 2016, does not think "Scotland gives a damn any more about banks because they are all in London anyway", but agrees that there are issues around the Edinburgh asset management industry and what happens to Standard Life, Abrdn, Baillie Gifford, etc. Most of their assets are not in Scotland, despite being headquartered there, but there would be issues.

"The big players might re-headquarter to London while having serious businesses in Scotland, just as Baillie Gifford have opened an office in Dublin to deal with aspects of leaving the EU – a lot of businesses would ride two horses," he says. "In the process, Scotland would lose out more than London has lost out in leaving the EU."

"At the moment, business regulation is effectively tied to EU regulation, and Scotland would be tied to that," he adds. "Obviously it would have to set up its own agency and depending on plans to join the EU it could actually tie its regulation to the UK's, but for Britain, 'taking back control' means it is about to go out on its own and carve out its own approach to regulation."

In the end, most regulatory issues will not be hugely problematic, Scotland would either choose to follow the British approach or to follow the EU approach. The EU sets its own regulatory parameters, and it will be up to an independent Scotland to interpret them in a way which it sees fit.

Currently, that would not require any work at all. Whether that changes would very much depend on how long independence would take and how much divergence there has been in the meantime between the UK and the EU.

The issue of money

One of the fundamental questions surrounding independence concerns is currency; namely, what currency an independent Scotland would use. There are three potential options: keep pound sterling, adopt the euro, or come up with an alternative.

Economics aside, each of these options comes with its own set of legal issues and contractual conundrums that make the question hard to answer without some form of pushback. In 2018, the Sustainable Growth Commission – convened by SNP leader Nicola Sturgeon and chaired by Andrew Wilson – recommended that an independent Scotland kept the pound sterling as its currency for a "possibly extended transition period".

"In the longer term, if it were in the rounded economic interests of Scotland to develop its currency arrangements Scotland would, of course, be able to introduce its own currency. The Commission recommends that such a future decision should be based on a formal governance process and criteria set out clearly in advance of voters making a decision on independence. Such an approach is an absolute necessity to maximise certainty and stability and to minimise risks," reads the report.

From a legal perspective, taking into account contracts within Scotland that reference the pound for example, this option would be significantly more straightforward than any other.

Scottish economist and Oxford fellow John Kay agrees that the status quo would be the best course of action and would likely cause the least problems.

"The financial issues that worry me seem to be greatly exaggerated, the currency issue for one is straightforward," he says. "The right thing to do is nothing."

"It might be that in due course trading patterns look different, it depends on what Scotland's relationship with the EU would be, but the idea that Scotland would simply rejoin the EU is naïve," he adds.

However, given the political gains that the independence movement has made in the aftermath of Brexit, it seems unlikely that a referendum would be fought on any grounds other than rejoining the EU as quickly as possible. This would be no easy task and would require significant economic change, including the act of joining the Economic and Monetary Union (EMU) and therefore adopting the euro.

"In the current world, an independent Scotland would make no sense whatsoever unless there is an arrangement with the EU that their membership would be fast tracked," adds Edinburgh Law School's Avgouleas. "Fast track membership for Scotland would mean that the country joins the euro."

"This would resolve the issue of bank regulator – it would have to be the ECB [European Central Bank]," he adds.

The conditions for becoming a member, referred to as the Copenhagen criteria, insist prospective countries have "the ability to take on and implement effectively the obligations of membership, including adherence to the aims of political, economic and monetary union". While it would not be the case that Scotland would be forced to join the euro immediately, all members that have joined the bloc since the Maastricht Treaty in 1992 are legally obliged to adopt the euro once they meet certain criteria.

Sweden, which joined in 1995, is required to join at some stage.

"Technically, if you want to join the EU, you're supposed to sign up to joining the euro," says Thomas Sampson, associate professor at the London School of Economics. "If the goal is to eventually rejoin the EU, then unless Scotland can negotiate a waiver – the EU does give waivers in certain circumstances – it would have to agree to work towards joining the euro."

The euro has evolved over the years and has become a very stable, major currency, which would offer its advantages. The downside would be that Scotland would become a very small part of the bigger European markets.

"The other difficulty that would arise if Scotland were to join the euro, or to create his own currency, would be the technical and legal difficulties of taking contracts that were originally written in pounds, and converting them into a new currency," adds Sampson. "This would be a huge undertaking. But it can be done."

"The difficulties involved in creating a new currency mean it is probably the riskiest option for Scotland. Investors and holders would be worried that the currency would lose value in the initial days and weeks of independence, or that there would be a run on the currency and Scottish people earning money in the new currency would end up much poorer than they previously were," he adds.

Some, however, do advocate for an independent Scotland to form its own currency. Lord Macpherson believes that despite the fact that Scotland spends more money relative to its tax base, the SNP could implement independence reasonably successfully, if it took tough decisions on tax and spending.

"The SNP would not say that ahead of independence, but I would try to encourage them to be fiscally careful so that Scotland doesn't stand out," he says. "It all relates to the currency issue and the fundamental lack of clarity around that."

He adds that he struggles to see the benefit for the rest of the UK to enter into a

"It might be that in due course trading patterns look different, it depends on what Scotland's relationship with the EU would be, but the idea that Scotland would simply rejoin the EU is naïve"

– John Kay

> *"There would certainly be an attempt by Scotland to try to keep and keep as close as possible to the UK regulatory methods but at the same time it would probably to try to leverage off the fact that it would be seeking to join the European Union"*
>
> – Stephen Phillips

monetary union with a country that is seeking to become more independent. "Scotland would have a choice, either try to peg the Scottish pound to sterling – which could leave you vulnerable to the speculative attacks – or to just make a virtue of necessity and float its own currency."

"A Scottish pound would probably depreciate in the short run but in the longer term if Scotland can establish credibility there is actually no reason why it should be weaker than sterling; it is similar to when Ireland stopped pegging the punt to sterling," he adds.

Made in Scotland

A further consideration would be how Scotland's corporates would react to this uncertainty. It is fair to say that if a referendum were to result in a positive vote for independence then many would question the value of relocating to England to avoid the stresses of a potential Brexit 2.0.

Kay, however, would turn that argument the other way. "Historically, one of the things Scotland has suffered from has been the migration of large corporates out of the country," he says. If you go back to the 1980s, he argues, there was a change to competition policies so that the planned takeover of RBS by HSBC was actually blocked on the correct grounds that it would damage the Scottish economy. After that, the UK competition policy was changed so that the regional issue was not grounds for blocking M&A. This allowed Irish giant Guinness to acquire the Distillers Company, arguably against Scottish interests.

"Independence might mean more of a chance in the future for homegrown Scottish corporates, but who knows, when Skyscanner left for example, they didn't go to London, they went to Beijing," says Kay.

The debate tends to focus on wider macroeconomic issues.

Of course, the impact would not just be felt by the larger corporates in the country, but also SMEs. Ross Brown, professor at St Andrews, believes that independence would affect change that could alter Scotland's economic growth in future years.

"Scotland would suddenly have quite a range of different policy levers to do things differently," he says. "Rejoining the European Union would be one such distinctive policy angle which would be very attractive for all of the small businesses that are screaming at the moment, they now have non-tariff barriers with the biggest single market which amounts to about 10% cost increase for SMEs."

A 10% increase could influence whether companies bother trading at all, or not, he argues. "Scotland could make a significant advance for the economy if it were to rejoin as a separate country, not just for companies in the country but for small companies in England which might consider relocation based on that decision," he adds. "Small businesses are mobile these days, a lot of firms can move easily. It could prove very attractive, not just for indigenous Scottish firms but for English ones."

UK debt share

One of the key economic implications of Scottish independence would revolve around the newly formed country's proportion of the UK's existing debt, and how that debt would be transferred – if at all – to the Scottish state.

At the end of 2020, the UK had general government gross debt of £1876.8 billion, which an independent Scotland would be proportionality responsible for. A key question would be formulating exactly how much of this total was Scotland's responsibility and how it would be serviced.

One solution to this problem would be for Scotland to pay an annual solidarity payment to the UK.

"This would be annual payment to service the agreed share of debt interest, so that that negotiation would need to weigh up both liabilities and assets which are currently on a report published by the UK government once a year, called Whole of Government Accounts," says Andrew Wilson. The last published balance sheet shows £4.6 trillion of liabilities, but this number will have increased significantly due to Covid-19.

According to the report of the Sustainable Growth Commission, "an agreement should be sought for a mechanism for Scotland to pay a reasonable share of the servicing of the net balance of UK debt and assets".

The Annual Solidarity Payment is modelled at around £5 billion including debt servicing contributions, 0.7% GNP contribution for foreign aid and a further £1 billion set aside for other shared services, continued the report.

"The calculation would tell us a legacy sum of money that Scotland would agree to service, which would be very important to begin with," adds Wilson. "Over time, the legacy sum of that would be eroded and refinanced, and run down."

Tartan bonds

An alternative to this would be for Scotland to transfer and take on a calculated proportion of the UK debt directly. This would bring a whole host of legal issues and concerns, not the least with the calculation of that number.

"The essential issue is that because the UK government has issued debt to finance budget deficit and spending – some of which it can reasonably argue has taken place in Scotland – a newly independent Scotland should assume its fair share of the debt," says Neil Shearing, chief economist at Capital Economics. "The question is where to draw that line: is it a share of GDP, a share by population, or by government spending. Either way, it is going to be a mess really."

"There are no provisions in bond issues for this sort of event, it is not like UK government bonds have clauses that say what is going to happen in the event of an independent Scotland," he adds.

What an independent Scotland's currency would look like is a key economic concern that has been richly debated in the years leading up to and following the 2014 referendum. The ultimate decision would also have a significant bearing on the outcome of the shared national debt.

If – as is widely suggested – the country were to use a pegged version of pound sterling, it would mean there was significantly less risk for the holders of the debt that was transferred to the Scottish sovereign.

"Of course, you would still have to take on the debt, but it would mean less exchange rate risk," says LSE's Sampson.

"It would be subject to negotiation, but if Scotland was still using the pound there would be no risk," he adds. "Suppose you use a new currency and set it up so that one Scottish pound is worth one British pound, if afterwards that is not what the market thinks it was and the Scottish pound were to depreciate, then things would look very suddenly in terms of the value of that debt."

This issue was also central in 2014, with the Scottish government suggesting that it would continue to use the pound as a pegged currency. At the time there was some suggestion that Scotland would renege on its share of the national debt if it was not given access to the pound sterling by Westminster.

"They're still proposing that on some basis, at least until there is an introduction of a new currency," says Owen Kelly, deputy director of the Edinburgh Futures Institute and one time CEO of the Scottish Financial Enterprise, the representative body for Scotland's financial services industry.

"As part of that argument, there was a slightly silly suggestion that Scotland would refuse to pay its share of any legacy debt, unless the UK government allowed Scotland to use sterling on a dollarised basis," he adds. "This could be a point of political contention, there might be an attempt to use it as a bargaining chip once you got into the business of negotiating the terms of the separation."

Setting a precedent

Were Scotland to begin the process of preparing for independence, it would of course not be the first time that a country has seceded nor the first time that national debt be divided in such a manner.

Lee Buchheit, sovereign debt restructuring veteran and honorary professor at Edinburgh University, told IFLR that the public international law when a constituent of a state secedes or leaves to join another state – as happened in 1846, when Texas joined the United States – the rule is that debts incurred by the previously unified state have to be allocated between the two newly formed countries.

"There is no hard and fast formula for doing that," he says. "The one thing that's clear is that as your debt was incurred, let's say to build a hydroelectric dam in the seceding province, then that debt stays with them, but the debt incurred for general governmental purposes has to be allocated between them."

Buchheit says that when Yugoslavia broke up, this issue was not handled particularly well, and that the handful of emergent countries are still quarrelling.

"As it relates to UK guilds, the UK such as it might exist after Scotland left, would remain wholly responsible," he adds. "The UK would negotiate with Scotland for what in legal terms is called a contribution, or they could say that something like 70% of the guild is now the responsibility of the UK and 30% is Scotland's."

The Sustainable Growth Commission and its Annual Solidarity Payment suggests the second approach.

"I would be astonished if they deviated from that if there is another referendum," says Buchheit. "The history of these referenda around leaving is not particularly good in terms of debt."

Speculation

Of course, all of the aforementioned arguments amount to no more than speculation. The UK remains intact and Scotland remains a constituent member of that, regardless of what the pro-independence population think. The current UK government appears very unwilling to grant a second referendum, and the lack of the clear mandate in the national elections came as a blow to the SNP's arguments.

That being said, many of the arguments used in 2014 to advocate for unity appear to have dispersed, and the population of voters who would now vote differently has, without doubt, grown. Empty supermarket shelves and growing despair at the way the incumbent government in Westminster is handling the transition away from the EU and the Covid-19 crisis, with the interweaving problems that brings, is politically and socially pushing Scotland away from its southern neighbours.

For now, the status quo remains intact, but in the years to come the pressure for change is only going to grow.

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DeFi: a pathway forward

Alex Lipton co-founder of **Sila**, and **Lewis Cohen**, co-founder of **DLx Law**, write about the promise of decentralised finance and how it intersects with traditional finance

Decentralised finance (DeFi) has seen remarkable growth over the last 18 months and has quickly established itself as one of the first true "killer apps" for smart contract networks like Ethereum, Cardano, Polkadot, and Solana. DeFi allows parties to create precisely tailored and highly complex economic arrangements that execute automatically without the need to rely on a central intermediary or other trusted party. Even in its current early stages, DeFi raises the promise of a more decentralised and resilient financial system capable of embracing both established players and nascent market entrants.

The value of assets deployed in DeFi, barely $1 billion in June 2020, grew to over $80 billion at the end of August 2021. DeFi takes many forms, including secured lending, asset trading, and a wide variety of derivative transactions, all occurring almost instantaneously, and all recorded on the ledger of a public blockchain network. Not surprisingly, most, if not all, of the activity in DeFi to date has concentrated on the use of natively digital assets, represented by a plethora of blockchain-based tokens and "stablecoins" – digital assets pegged with various degrees of reliability to a fiat currency (almost always the US dollar); however, proponents are increasingly looking at incorporating real world assets, such as real estate, intellectual property rights, traditional equity, and other fiat currencies, thus dramatically expanding DeFi's importance.

The absence of traditional intermediaries also means that anyone with the know-how and a wallet full of digital assets can directly access DeFi protocols without undergoing any prior know-your-customer (KYC) or anti-money laundering (AML) checks, or sanctions compliance. While this open access approach supports a vastly more inclusive type of financial innovation, it has raised concerns among policymakers that it could at some point give rise to an alternative financial system, one that allows illicit actors and

those who run afoul of governments in developed nations to transact without the scrutiny and oversight provided by the current system of regulated financial intermediaries.

The Financial Action Task Force (FATF) Draft Guidance, issued in March of this year, suggested that parties directing the creation, development and/or deployment of DeFi protocol software — but who do not act as intermediaries controlling customer funds — should nevertheless be considered "virtual asset service providers" (VASPs), and should be held responsible for complying with relevant AML/KYC obligations. If this approach was widely adopted, DeFi protocol developers would be treated like banks, money transmitters, and other financial institutions that do control customer funds. Even though there is much more room for automation in the KYC/AML process, enforcing these obligations invariably comes down to numerous human judgment calls, something which banks, with their large compliance departments, have learned to manage. Attempting to impose such an across-the-board KYC/AML requirement at the DeFi protocol layer or on entities with no control over customer funds and no means to comply as a practical matter simply would not work and would swiftly drive this activity into a gray market with even less visibility for regulators than they have today.

We believe that a vibrant and diverse DeFi ecosystem is essential to the promise of "Web 3.0" – a more decentralised and democratised internet and the foundation of a more open and inclusive society. At the same time, we also acknowledge that the concerns raised by FATF in the Draft Guidance need to be taken seriously. Whether these concerns can be addressed without stifling the remarkable level of innovation occurring in the DeFi space is far from certain, though.

A potential solution begins by looking at decentralised exchanges (DEXes), those protocols (that is, software-based platforms running on blockchain-based networks) that utilise various permutations of automated market making (AMM) by freely participating third-party liquidity providers in order to facilitate efficient and trustless exchanges of digital assets by users. DEXes effectively underlie all other DeFi activity. Recently, the company that developed Uniswap, one of the world's most popular DEXes, announced that it would remove certain tokens from its company-controlled web-based user interface (UI) to the protocol. (These tokens may still be accessed and traded using the Uniswap protocol through third-party UIs or by directly accessing the protocol software.)

"This open access approach supports a vastly more inclusive type of financial innovation, but has raised concerns among policymakers that it could at some point give rise to an alternative financial system"

The Uniswap announcement generated intense introspection in the DeFi community about the nuanced relationship between the traditional corporate entities that control popular DEX and other DeFi UIs and the underlying permissionless protocol software itself. But the debate the announcement engendered also points toward a way forward.

Incentivise permissioned automated finance

Rather than attempting to impose regulatory obligations on either the protocol software (impossible) or on all UI providers (impractical, as alternative UIs can be created cheaply and anonymously), we believe that the focus of regulators should instead turn toward finding ways, both formal, through rule-making, and informal, through the regular flow of supervisory dialogue, of incentivising the development and operation of permissioned access points (UIs) to the many protocols developed for use in DeFi. These alternative platforms, which might more properly be known as automated finance, rather than decentralised finance, could be operated by both traditional financial services businesses and new market entrants. They would provide the benefits of access to the same innovative DeFi protocol software on the same public blockchain networks, but would have UIs operated by identifiable entities willing to take on some or all of the responsibilities of being a VASP and of evaluating the underlying protocol software being accessed by users.

This automated finance approach would allow commercial users of the digital asset ecosystem desiring or required to transact only with others who are known to have also met industry-standard KYC/AML and sanctions compliance checks in a relevant jurisdiction to do so. Of course, others preferring to exchange digital assets in a permissioned environment using DEX protocol software could also use these access points and their associated pools of underlying assets. How the permissioning is accomplished would be open to the market and could feature the use of "zero knowledge proofs" and separate layers of activity, among other techniques, to enhance privacy and reduce vulnerable data "honeypots". Work would also need to be done to facilitate integration of these automated finance platforms with "DEX aggregators" – separate front-end UIs that originate most digital asset trading volume at this point and allow those interested in trading digital assets to quickly identify the best DEX to which to route a trade, depending on the user's priorities (*e.g.*, lowest spread, least price slippage, etc.).

Benefits of a compromise position

Such an approach would require compromise on the part of both regulators and industry. We understand that simply accepting the idea of permissioned access to DEX protocol software is contrary to the core tenets of many developers, entrepreneurs, and users in the DeFi sector and inevitably means that, at least in the early days of automated finance, there will be far fewer liquidity providers who support the exchange of pairs of digital assets in that environment as well as an overall smaller number of pairs of assets to trade there. Even over the long term, permissioned actors will inevitably also be more selective as to the asset pairs for which they provide AMM liquidity. The remarkable network effects that have quickly developed around existing fully open DEXes through innovations like liquidity mining would need to be rebuilt as liquidity is rebalanced between permissioned access and non-permissioned access asset pairs. Business models would also need to develop for arbitrageurs who can operate in both permissioned and non-permissioned pools to

keep asset prices broadly uniform across marketplaces.

We also understand that a significant part of the current appeal of DeFi is its composability – complex arrangements that can be quickly constructed by combining the use of distinct lending, exchange, and other DeFi protocols into a single transaction (these arrangements are sometimes referred to as building with money Legos). At best, it will take automated financetime to be established across the full range of protocols used in DeFi, initially limiting composability; at worst, corresponding permissioned environments for some DeFi protocols may never be developed, excluding these tools from use in composing transactions for users of automated finance.

In fact, some may question why public infrastructure (such as the Ethereum network) would even be used for automated finance, when plenty of consensus protocols designed for permissioned networks (like Hyperledger's Fabric) already exist. Herein lies a key observation: while the levels of interest in DeFi in the legacy financial system is unprecedented, after more than five years of trials by many disparate groups (and outside of some important specialised exceptions), the demand to participate in the day-to-day operation of permissioned "layer 1" blockchain protocols ranges from tepid to non-existent. Moving the economic burdens and benefits of participating in the core tasks required to maintain and secure the blockchain network itself to a group of open and self-selecting "validators", allows the public good of the network to exist, without any single participant required to take responsibility for the network or the other validators who from time to time are securing in it.

At the same time, by encouraging the development of automated finance, regulators would need to fundamentally re-think their approach as well, signaling to commercial users, investment funds, financial institutions, and other regulated entities that, with other appropriate precautions, they may begin to utilise AMM protocols and other of the underlying innovative tools developed through the growth of DeFi on public blockchain infrastructure without potentially violating AML/KYC or sanctions regulations applicable to them. As a result, the utilisation of these platforms (and their associated liquidity) should increase significantly and similarly permissioned access to lending and other protocols developed by the DeFi community may expand, thus spurring further growth and innovation in the DeFi sector while substantially enhancing transparency and regulatory visibility into the activity, relative to traditional markets.

Because all activity on these protocols (whether or not through permissioned access) occurs and is recorded on public blockchain networks, the level and detail of real-time monitoring to which regulators will have access will provide a huge improvement over the current system that consists solely of aggregated and delayed reporting by centralised financial intermediaries. In addition, with much activity occurring in permissioned environments, regulators will be able to work more efficiently with blockchain analytics providers to detect the true bad actors operating on non-permissioned networks. Consumer protection advocates should also be pleased, as the presence of an active automated finance sector running in parallel with peer-to-peer use of DeFi protocols by non-regulated entities will put a meaningful check on the power currently exercised by a handful of giant centralised financial institutions and should dramatically reduce costs to consumers and increase product choice, much as the switch to VoIP (voice over internet protocol) infrastructure 20 or so years ago did for telephone service. In addition, where user access to automated finance platforms is provided by regulated financial market participants, there will exist opportunities to integrate traditional services, such as insured fiat currency deposit accounts, with new uses for customer digital asset portfolios (such as lending against a basket of non-fungible tokens (NFTs) owned by a customer).

Moreover, by abandoning the idea of an outright prohibition on the use of DEXes and other true DeFi protocols that provide permissionless access to all users, regulators would be acknowledging the reality that, once written, the protocol software for virtually all DeFi applications will be available from public repositories, and that access points (and associated liquidity pools) for these protocols can be created by anonymous developers and maintained on decentralised storage platforms like Arweave, Swarm and IPFS.

Nor is this a new phenomenon for regulators, who have managed the dual system of account relationships with banks and other regulated entities that are subject to KYC/AML and the fluid and non-transparent use of physical cash. Further, attempting to do otherwise would give privacy tech a huge shot in the arm, igniting an arms race of cryptography and, likely, further obfuscating most if not all DeFi activity. Despite the sound-bite appeal of mandating across-the-board KYC for all DeFi, as with the handling of physical cash, attempting to prevent both illicit actors as well as those many other users with perfectly appropriate and legally supportable reasons to prefer true privacy in their financial dealings in digital assets from interacting with the smart contracts developed for use in DeFi needs to be recognised as an undesirable, functionally impossible, and ultimately counterproductive, mission.

What the future may hold

It is critical that regulation in Web 3.0 should be applied functionally to users of DeFi services, not to the protocol software or its developers, or to those operating access points. An intermediary-based compliance mindset served us well for the 70-plus years since World War II but will be an abject failure if applied to DeFi. DeFi presents a once in a lifetime opportunity to rethink our financial infrastructure from the ground up.

A two-tier system of open access through non-permissioned portals (or direct access to the underlying smart contracts for users who are not subject to mandatory KYC/AML obligations and who are comfortable using decentralised peer-to-peer systems), on the one hand, and, on the other, permissioned portals for institutions, enterprises, and others required to comply with KYC/AML obligations due to their existing regulatory status or otherwise seeking to conduct significant transactions in a managed environment, could create a viable pathway forward. This side-by-side development of automated finance and decentralised finance would support the growth of DeFi as we know it today while allowing many more to benefit from its innovations. At the same time, such an approach would still give regulators the opportunity to protect the next generation of financial infrastructure from those seeking to exploit these developments for unlawful or illicit ends.

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Switzerland paves the way for tokenisation of securities and introduces new DLT trading platforms

Stefan Kramer and Sandrine Chabbey of Homburger present two new concepts introduced in Swiss law to address the potentialities of distributed ledge technology (DLT): (1) the new ledger-based securities and (2) the DLT trading facility.

Discussions surrounding the new distributed ledger technology (DLT) and its legal implications have generated important debates in the last years. In this context, notably in order to address some of the more controversial issues, Switzerland recently updated its legal framework to address the challenges and opportunities of DLT and the blockchain.

While many of these changes deserve close attention, this article focusses on two developments which offer important opportunities for innovation: the introduction of a new category of negotiable securities conceptualised to facilitate the tokenisation of rights and obligations as well as the introduction of a new type of licensed trading platform for DLT-based products.

New ledger-based securities

While discussions surrounding the tokenisation of rights is neither new, nor exclusive to Switzerland, the recent legislative update introduced a new type of negotiable securities conceptualised to allow the electronic registration of rights, for instance on the blockchain, with similar functionalities and the same level of protection as traditional securities.

The new ledger-based securities are defined as rights which, in accordance with an agreement between the parties, are registered in a suitable register and may be exercised and/or transferred to others only via such register. In order to be considered as "suitable", a register must in particular fulfil the following conditions:

1. It shall use technological processes to give creditors, but not obligors, power of disposal over their rights;
2. Its integrity shall be secured through adequate technical and organisational measures to protect it from unauthorised modifications;

1 MINUTE READ

This articles presents two new concepts introduced in Swiss law as part of the lawmaker's efforts to better address the potentialities of distributed ledger technology (DLT) under Swiss law: (1) the new concept of ledger-based securities which allows for the tokenised of securities or other rights on the blockchain or other DLT-based ledger with similar functionalities as other securities; and (2) the DLT trading facility, a new licensed financial market infrastructure enabling the trading of tokenised securities and other DLT-based assets.

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"The intended purpose of these new securities is primarily to allow the issuance and transfer of rights directly on the blockchain or other similar DLT-based registers"

3. The content of the rights, the functioning of the registration and the registration agreement must be recorded in the register or otherwise linked to it; and
4. Creditors must be able to view relevant information and entries, and check the integrity of their contents without the intervention of a third party.

While these requirements are technology-neutral, the intended purpose of these new securities is primarily to allow the issuance and transfer of rights directly on the blockchain or other similar DLT-based registers. In other words, the introduction of ledger-based securities zanchors in the law allow the possibility to issue rights, such as company shares, directly as tokens whose ownership and transfer directly affect those of the underlying rights.

The general and principle-based nature of these requirements however, means that any type of token and/or register may be eligible for the issuance of ledger-based securities, as long as it fulfills those requirements. This provides the new legislation with a certain level of flexibility which may allow it to adapt to potential new developments in DLT technologies and related products. Since their purpose is to represent rights and obligations however, it should be noted that pure cryptocurrencies, which do not have underlying claims, are ill-fitted for this purpose and would generally not qualify.

In summary, with the introduction of the new ledger-based securities, Swiss law aims at offering a tailor-made solution to enable the (direct) tokenisation of rights and obligations on the blockchain and aims to pave the way for innovative business models.

New DLT trading facilities

Next to traditional financial market infrastructures, such as stock exchanges and multilateral trading facilities, the Swiss lawmaker has introduced a new type of regulated platform, the DLT trading facility. As its name indicates, such facilities have a focus on dealing in DLT-based products, such as the new ledger-based securities outlined above, but also digital assets which do not qualify as securities under Swiss law, such as cryptocurrencies.

Essentially, DLT trading facilities are modelled after traditional multilateral trading facilities and subject to similar rules and requirements. An interesting feature of the new regime however is that a single license may suffice to offer not only multilateral trading services, but also some post-trading services, such as the clearing and settlement of trades as well as custody services.

Furthermore, while participants in traditional trading venues are usually limited to financial institutions, DLT trading facilities may accept a broad range of members, including in particular unregulated corporate entities and individuals, hence allowing for their direct participation without the need to resort to a qualified bank or securities dealer as is the case for traditional trading platforms.

As their name indicates, the central attribute of DLT trading facilities is that it deals in DLT-based securities and related products. The exact types of products accepted by a specific facility is determined in an internal regulation, whose content must be approved by the Swiss Financial Market Supervisory Authority (FINMA).

"A flurry of new service providers promising to assist companies through such a transitions have made their debut on the market"

Interestingly, limitations as to the type of tokens which may be admitted are not defined in the law, but only in implementing regulations and provides FINMA with an important degree of flexibility. This set up makes the regulation more adaptable to innovation and new trends. We note in particular that, under the current regulations, DLT trading facilities may generally not accept securities or other DLT-based products that significantly complicate the implementation of anti-money laundering regulation or undermine the stability and integrity of the financial system, as well as some types of derivatives.

Another factor which may be of interest to prospective market participants is that small undertakings may benefit from a lighter regulatory regime, to take into account the limited risks associated with the limited size of their operations.

In order to qualify as a 'small' DLT trading facility, one must in particular ensure that its activity stays below the following thresholds:

1. Annual trading volume of CHF250 million ($272 million);
2. assets under custody of CHF100 million; and
3. annual settlement volume of CHF250 million.

While not revolutionary in its set up, this new category of licensed financial market infrastructure aims at providing the market with a new regulatory category, whose functionalities are better suited to meet the specific requirements of the trading and settlement of digital tokens, with the hope that it may offer new opportunities to service providers and investors alike.

First experiences and outlook

While the new provisions discussed in this article entered into force in the last months, market participants have started drawing on their potentials and they have already inspired new ventures.

Since the entry into force of provisions governing the new ledger-based securities on February 1 2021, several companies reportedly started tokenising their shares. At the same time, a flurry of new service providers promising to assist companies through such a transitions have made their debut on the market. In parallel, the Geneva-based Capital Markets and Technology Association (CMTA) is expected to publish an updated version of its standard documentation on the tokenisation of shares in line with the new law in the upcoming weeks. The availability of such standards should make it easier for further companies to register their shares on the blockchain. Still largely untapped, the potential use of the new securities to tokenise other types of financial instruments, such as bonds, structure products or derivative products, offers interesting possibilities.

Developments may also be noted in relation to trading platform for DLT-based securities. The Swiss platforms Taurus SA for instance, obtained a license to operate as securities firm earlier this year, which allowed them to launch TDX, a multilateral trading facility for digital assets, in the spring. In early September 2021, SIX Digital Exchange AG was granted the first license to operate a central securities depository for securities based on DLT-technology, while its affiliate, SDX Trading AG, was approved as the first stock exchange for digital tokens. Also, recently, the Berner Kantonalbank, announced the upcoming launch of SME|X, its own platform for the trading of tokenised assets.

Overall, while it is still too early to fully assess the Swiss lawmaker's attempt to adapt the legal framework to the challenges of DLT-technologies, it is generating keen interest from market participants and academics alike. As more projects are likely to come into fruition in the coming months, we can expect that the provisions set out in the articles will continue to generate important discussions.

A guide to cross-border financing in Switzerland

Daniel Hayek and **Mark Meili** of **Prager Dreifuss** look at the rules, practicalities and latest developments in a friendly, but recently more challenging environment for cross-border financing

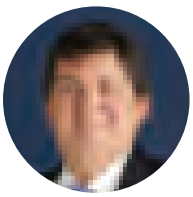
Switzerland is home to approximately 250 banks with an aggregate balance sheet of about CHF3.47 trillion ($3.76 trillion). Consequently, the Swiss cross-border financing market is mature and well-developed.

Local banks such as Credit Suisse, UBS and the Zurich Cantonal Bank (ZKB) are the dominant lenders when it comes to cross-border financing, but international banks are also active in the Swiss market. This is because the headquarters of large international groups are located in Switzerland and also because borrowers frequently have Swiss affiliates that grant security.

Since the global financial crisis, banks in Switzerland have become stricter with regard to providing loans to companies. This trend is reinforced by Basel III legislation, which requires banks to hold more equity. Notably, it is becoming harder for small- and mid-sized companies that do not have an investment grade rating to refinance and renegotiate existing debt structures.

As a result, many companies are turning to alternative lenders such as funds, pension funds, insurance companies and family offices which are willing to take more risk. To support the additional financing needs created by the negative impacts of Covid-19, the Swiss government has so far supported businesses with around CHF40 billion. In addition, it established a liquidity support scheme for small and mid-sized Swiss companies under which Swiss banks granted loans in a total volume of CHF17.11 billion which were guaranteed by the federal government.

Over the last decade, the ratio of Swiss bank non-performing loans (NPLs) to total gross loans has continuously fallen from 1.3% in 2005 to 0.6% in 2019, which is low in comparison to other jurisdictions and equals the all-time low for Switzerland from 2017 (which was also 0.6%). Because of the negative effects of the Covid-19 crisis, the number may soon get worse. However, under usual



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Daniel has acted for major US and German banks in acquisition finance transactions and in the recovery of distressed debt. In these fields, he has also represented clients in court and before arbitration tribunals.

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circumstances NPLs are not a very topical issue. A reason for the typically low ratio may be that NPLs suggest that obligors are facing liquidity problems. A liquidity problem is a major issue for Swiss directors.

The board of a Swiss obligor has to convene an extraordinary shareholder's meeting and propose restructuring measures if half of the company's share capital and legal reserves are no longer covered by its assets. In the event that the balance sheet of a Swiss obligor shows negative equity, the board of directors must notify the court. This usually leads to bankruptcy. If the board fails to observe its obligations, the individual directors may incur personal liability. It goes without saying that the board will try to find a commercial solution with the existing lenders or try to raise additional capital from alternative sources to avoid such a situation.

Switzerland provides the legal certainty to resolve any disputes relating to large-scale financial transactions. However, borrowers and lenders tend to find amicable solutions rather than resorting to litigation.

As regards trends in the market, the negative impacts of Covid-19 on the financial situation of many companies has created additional financing needs. In particular, many companies have accumulated a lot of debt over the past year and require additional funding.

Financing structures

Recent notable transactions in the market include a multi-billion euro financing of a large-scale infrastructure project. The most interesting aspect of this transaction was that the lenders were European energy companies that did not have a banking licence. There were no bank lenders involved, even though banks may provide financing at a later stage of the project.

This raises some difficult questions in relation to the '10/20 Non-Bank Rule', which limits the number of potential non-bank lenders in a financing transaction (further details below). Finding a solution to the allocation of 'slots' for lenders that do not have a banking licence, thereby allowing them to provide mezzanine, bridge or funding gap capital, as well as to the transfer of loan shares to non-banks, is challenging. The composition of the lenders made this transaction quite unique. We do not expect that its structure will influence the Swiss market standard.

Syndicated secured loan facilities are probably the most frequent type of cross-border financing transaction in the market and it appears that this will not change in the near future.

Legislation and policy

There is no specific legislation and there are no specific regulatory bodies that exclusively or predominantly govern cross-border financing in Switzerland. However, it goes without saying that the Swiss Financial Market Supervisory Authority (FINMA) is relevant when it comes to the regulation of domestic (bank) lenders and that the Swiss Federal Tax Administration (SFTA) is relevant in relation to ancillary tax issues.

Swiss headquartered groups looking to raise capital via the international debt capital or bank debt markets may face Swiss withholding tax (WHT) if the issuer or borrower is a non-Swiss group member and where the structure requires guarantee support from the Swiss parent company. If there is backflow to Switzerland, a 35% WHT rate applies on the interest payments, unless the maximum backflow is capped at the equity amount of the non-Swiss issuer. On February 5 2019, the SFTA published an important clarification that introduced two exceptions to the backflow rule, which may also be combined.

Under the equity exception, it is now possible for a non-Swiss issuer with a parent guarantee from its Swiss headquarters to grant a loan back to the Swiss company sourced from the funds raised on the international capital market, whereby the up-stream loan will not exceed the aggregate

> ***"The WHT reform is subject to an optional referendum, entry into force before January 1 2024 is unlikely"***

equity of all non-Swiss subsidiaries. In case the shareholding is less than 100% in the non-Swiss subsidiary, the equity amount is reduced accordingly.

Under the intragroup funding exception, it is now possible for a non-Swiss issuer, which holds a parent guarantee from the Swiss headquarters, to grant a loan back to the Swiss company sourced from the funds raised on the international capital market whereby the up-stream loan shall not exceed the aggregate amount of all intragroup loans granted by Swiss group members to non-Swiss group companies.

The SFTA requires an upfront tax ruling if a Swiss headquartered group wants to benefit from the new exceptions. The new regime is likely to increase the ability of Swiss groups to raise funds outside of Switzerland and use such funds in Switzerland.

Meanwhile, the abolishment of the 10/20 Non-Bank Rule has been widely discussed and may be achieved by a tax reform initiated by the Swiss Federal Council aimed at strengthening the debt market in Switzerland. The dispatch by the Swiss Federal Council on the reform of the WHT was published in April 2021. According to the dispatch, interest paid to investors outside of Switzerland will no longer be subject to Swiss WHT. For the 10/20 Non-Bank Rule, this means that re-characterising a loan as a bond (which is dependent on the number of creditors involved that are not banks) will no longer have any implications for Swiss WHT on interest.

The WHT reform is subject to an optional referendum. Entry into force before January 1 2024 is unlikely.

In a nutshell, the 10/20 Non-Bank Rule states that interest payments are subject to 35% WHT rate, if the number of lenders without a banking licence exceeds 10, under a single debt instrument, or 20, under all debt instruments of the Swiss borrower taken together. Under certain circumstances, interest payments guaranteed by a Swiss guarantor may be subject to WHT as well. The limitation of syndication to non-bank lenders due to the 10/20 Non-Bank Rule is a viable solution to avoid or mitigate the consequences of this rule. However, such an approach may not be satisfying in larger syndicated finance transactions or if the involvement of lenders without banking licence is a necessity. In such cases, funds are often raised by a foreign parent company, with the Swiss entity acting solely as guarantor and security provider.

If this structure is properly planned and implemented, the applicable upstream and cross-stream limitations (see below) could be reduced to minimum; but it would be preferable if the lenders had unlimited claims against the Swiss entity and the transfer of loan shares to non-banks was not restricted. Therefore, the abolishment of the 10/20 Non-Bank Rule be most welcomed by borrowers and lenders. As a positive side effect, the volume of loans made available to Swiss borrowers could increase substantially.

Market norms

As mentioned above, the 10/20 Non-Bank Rule and the applicable up- and cross-stream limitations on guarantees (see below) may have a significant impact on the structuring of a deal. This is frequently underestimated by foreign lenders who are not familiar with the Swiss market.

Indeed, the most frequently asked questions about the market concern the potential structure of the transaction in the light of the 10/20 Non-Bank Rule, the applicable up- and cross-stream limitations and the resulting tax consequences. Not all foreign lenders are aware of the significance of these issues.

To a lesser extent, lenders also want to know which asset classes can be taken as security and what documentation or formalities are required to create, perfect and maintain such security.

As for the security regime, security can be taken over all classes of assets a lender would usually expect, such as shares, bank accounts, receivables, insurance policies, real property and intellectual property.

In order to perfect and maintain a pledge over shares (or other movable objects), the security trustee needs to be in physical possession of the pledged movable objects during the security period (*Faustpfandprinzip*).

As a consequence of this requirement, security over plants, machinery, equipment or inventory is possible, but is usually not taken. There are also some limitations to security taken over real estate that serves primarily as living accommodation, and there are certain formalities that must be observed. However, the quality and value of the security is usually worth the extra effort.

In principle, floating charges are not available in Switzerland. However, there is the option to grant security over a value quota of an intermediated securities account. Therefore, it is possible to create Swiss security over intermediated securities that is, to a certain extent, similar to a floating charge. It should be noted that there are several ways to create security interest over intermediated securities.

Solutions exist to avoid or at least mitigate the impact of any of the particular demands that the Swiss marketplaces on lenders and borrowers. The best approach for a lender that is not familiar with the Swiss jurisdiction is to engage a specialised law firm before agreeing to a financing structure that could be either difficult or impossible to implement.

Practical considerations

A key consideration for most cross-border financings should be downstream, upstream and cross-stream guarantees. In Switzerland, downstream guarantees are not subject to restrictions or limitations, but upstream and cross-stream guarantee payments are considered to be constructive dividends and are, as a result, limited to the profits and reserves freely available for distribution in the guarantor's balance sheet. Consequently, the respective rules for distribution of dividends must be observed. This includes the preparation of an up-to-date balance sheet by the guarantor and the approval of the resulting distribution by a shareholders' meeting.

In order to maximise the assets available for distribution, the finance documents should contain Swiss guarantor limitation language to that effect. It is also standard to combine a guarantee with a pledge over the shares in the Swiss guarantor.

"The 10/20 Non-Bank Rule has been identified as an obstacle for cross-border financings connected to Switzerland"

It should also be noted that the proceeds from upstream and cross-stream guarantees are subject to a 35% WHT. In recent years, it has become standard practice for the SFTA to request that any Swiss company providing a guarantee to its parent company receive appropriate remuneration for the guarantee: a guarantee fee.

In the context of a bankruptcy or restructuring, the enforceability of any contract may be limited under the rules of the Swiss Debt Enforcement and Bankruptcy Act. In particular, the following transactions may be fully or partially voidable:

- Transactions carried out during the year prior to the bankruptcy or insolvency decree, in which the Swiss security grantor accepted to receive no consideration at all or a consideration out of proportion to its own performance.
- Certain financially inadequate transactions, if carried out during the year prior to the bankruptcy or insolvency decree and if the Swiss security grantor was at the time of the transaction already over-indebted. However, the transaction is not voided if the recipient proves to have been unaware of the security grantor's over-indebtedness.
- All transactions which the Swiss security grantor carried out during the five years prior to the bankruptcy or insolvency decree with the apparent intention of disadvantaging its creditors, or of favouring certain creditors to the disadvantage of others.

Another major insolvency related issue that should be addressed in the finance documents is the allocation of proceeds between the different classes of lenders. Frequently, there is a foreign law-governed intercreditor agreement that provides for a certain waterfall, but that does not necessarily take into account Swiss insolvency law.

In particular, subordination of claims can lead to issues and delays in relation to the enforcement of security in Swiss insolvency proceedings, if it has not been properly addressed in the intercreditor agreement, the security documents and other ancillary documentation.

As for other practical considerations, there are no foreign debt quotas which would have to be observed in connection with a cross-border financing. There are also no rules that would require any specific monitoring of offshore financing to domestic entities, subject to the applicable money laundering legislation and sanction regimes.

Looking ahead

The 10/20 Non-Bank Rule has been identified as an obstacle for cross-border financings connected to Switzerland. The rule may in the future no longer be relevant as the WHT on interest on bonds and bond-like instruments will likely be abolished. However, this change of the Swiss WHT regime is not expected to become effective before January 1 2024.

Further, the negative financial effects of Covid-19 on many businesses in Switzerland continue and create additional financing needs. Large companies with solid prospects should be able to obtain new financing from banks or alternative lenders. However, for smaller companies the situation may be more difficult and it may prove challenging for them to access liquidity in the current market situation and they may have to rely on additional public financial support.

CFIUS 2020 Annual Report reveals a maturing agency with increased agility

In his latest quarterly IFLR National Security Column, Berkeley Research Group's Harry Broadman argues that CFIUS's 2020 Annual Report reflects how the US is taking a "whole-of-government" approach to regulating national security risks of inbound foreign direct investment

Marking the 45th year since its establishment with the publication of its 2020 Annual Report to Congress, the Committee on Foreign Investment in the United States (CFIUS) evinces a mature and agile governmental agency. It is setting the world's standard for balancing openness to cross-border capital flows and mitigating risks arising from foreign direct investment from states whose objectives or conduct are deemed to undermine US. national security.

Indeed, the latest report's data reveal the impact of the "whole-of-government" approach the US is taking on CFIUS's operations and decisions as a direct result of the nearly unanimous passage by the legislative branch of the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) and the subsequent implementing regulations developed by the CFIUS agencies in the two years following FIRRMA's enactment.

These data also illustrate how foreign investors from the countries in the crosshairs of FIRRMA and CFIUS have adjusted their expectations about the prospects of being able to consummate direct investments in the US unless they and their home governments reform certain practices seen as posing risks to US national security.

Origins of CFIUS and its Annual Reports

It will surely come as a surprise to the uninitiated that CFIUS's origins trace back to a 1975 executive order of President Gerald Ford mandating an assessment of how certain foreign investments could undermine US national security.

The subsequent passage of the "Exon-Florio Amendment" in the Omnibus Trade Act of 1988 gave CFIUS the authority to require modifications of or even block of such transactions. At that time the perceived major threat to US national security stemmed from the

technological superiority of Japan – not that of China. It was a concern I recall well from my role working on the 1988 law as a Senate Committee professional staff member.

It was the passage of the Foreign Investment and National Security Act of 2007 (FINSA) that required CFIUS to transmit annual reports to Congress, which received classified versions while unclassified reports were made public.

The drive for, and impact of, FIRRMA

Over its multi-decade lifespan, CFIUS's evolution has not been without teething problems. This has been punctuated by the extant technological rivalry to which the US (and other advanced democracies) have become increasingly exposed due to the rise of China – now the world's second-largest economy and one whose underlying fabric is fundamentally characterised by state-dominated enterprises and financial institutions, including those without *de jure* state-ownership.

Recurring teething problems are, of course, to be expected from regulatory regimes such as that executed by CFIUS in as much as they need to align with the dynamics of the global economy. The enactment of FIRRMA, however, provides substantial footing to guide such changes.

Prior to FIRRMA, parties generally submitted notifications of proposed transactions involving a controlling interest by foreigners to CFIUS on a voluntary basis. Under FIRRMA, apart from certain transactions required to file with CFIUS, CFIUS must complete its review of notified transactions within 45 days (15 days longer than before), and if it deems necessary, CFIUS can undertake a formal investigation that could extend the review by an additional 45 days (the same duration in existence prior to FIRRMA).

Importantly, however, FIRRMA also provides for a party to make a declaration, which is a briefer form of a notification. CFIUS must respond to such declarations within a 30-day assessment period.

It should be noted that both pre- and post-FIRRMA, CFIUS has possessed the authority to review both pending or already completed (i.e., non-notified) transactions unilaterally. The outcome of a CFIUS review may be (i) completion, where no action is taken (tantamount to a no-objection); (ii) suspension or prohibition, generally requiring presidential action; (iii) implementation by the parties of specific CFIUS-defined mitigation measures; or (iv) the parties' transaction is subject to third-party monitoring.

Transactions for which CFIUS has concluded all actions receive a safe harbor, which means absent certain exceptional circumstances, CFIUS (or the president) will not subject such a transaction to review again.

One of the more important changes induced by FIRRMA is that CFIUS will review certain investments and real estate deals where foreigners only have a non-controlling interest. Moreover, FIRRMA and its implementing regulations stipulate transactions involving specific critical technologies and other sectors will be subject to more intensive assessments and possibly prohibitions.

> *"FIRRMA and its implementing regulations stipulate transactions involving specific critical technologies and other sectors will be subject to more intensive assessment or possibly prohibitions"*

Overview of key data included in CFIUS's public 2020 Annual Report

The statistics presented by CFIUS in its unclassified report for calendar year 2020 provide a historical and contemporary snapshot of its activities. The focus here is on some of the key findings drawn from that report illustrating the impact FIRRMA has been having on the scope and nature of CFIUS' administrative operations and its decisions.

At the same time, both the enactment of FIRRMA, and CFIUS's resulting actions, are likely to affect how certain foreign investors in specific sectors are navigating changes in the US regulatory regime governing inbound foreign investment. The data in the report for 2020 yield some insights along those lines – although since many variables are at play, it is difficult to draw hard and fast conclusions on cause and effect in this regard.

Decrease in formal notifications and increase in declarations

Formal notifications submitted to CFIUS for covered transactions between 2018 and 2020 decreased from 229 to 187 – an 18% decline; at the same time, the number of declarations (the new, abbreviated notification option under FIRRMA) over the same period increased from 20 to 126 – almost a sixfold rise.

Moreover, of the 126 filed declarations in 2020, CFIUS completed its review for 81 (64%); it requested formal notifications for 28 (22%); it was unable to complete its review for 16 (13%); and one transaction (one percent) was withdrawn.

All other things equal, this points to parties availing themselves of the new, more efficient review route offered by CFIUS.

Examination of non-notified transactions

At the same time, CFIUS has stepped up its scrutiny of non-notified transactions, that is, past deals for which the parties did not file with CFIUS.

The intelligence process pursued by CFIUS in this regard includes securing referrals from a wide range of sources: "executive branch agencies; tips from the public; media reports; commercial databases and Congressional notifications."

Critically, the number of non-notified transactions reviewed by CFIUS was substantial in 2020: 117. (This compares to 231 transactions for which CFIUS received notifications.) Of the 117, CFIUS requested formal notification for 17 transactions (15%).

The message CFIUS is trying to send through its aggressive pursuit of non-notified transactions and the need for *ex ante* compliance with FIRRMA is clear: companies face the risk of being forced to unwind their transactions – the costs of which can be substantial, both to the firms themselves and their shareholders.

"What will be surprising to most observers is that the greatest number of notifications to CFIUS in 2019 and 2020 involved Japanese-sourced deals"

Decrease in reviews of China-related transactions

CFIUS reviews of China-related transactions have continued their decline in the aftermath of FIRRMA and of past CFIUS decisions of Chinese sourced investments – think *TikTok; Broadcom / Qualcomm; Ant Group / MoneyGram; Canyon Bridge / Lattice;* and *Beijing Kunlun / Grindr.* The data in the 2020 Annual Report make this clear: whereas CFIUS reviews of China-sourced deals accounted for 25% of total CFIUS notifications in 2017, in 2020 such transactions represented just only nine percent of notifications.

However, these data in and of themselves do not disentangle the extent to which the fall off observed in CFIUS reviews of Chinese deals is the result of US parties being more cautious about engaging with Chinese counterparts; Chinese investors, themselves, pulling back, being less willing to engage with the US; both sides being more selective in the types of investments they are willing to entertain in order to reduce the perception that US national security risks are being heightened; or a general retrenchment in Sino-US investment due to macro factors arising from political economy tensions between Beijing and Washington DC.

What will be surprising to most observers is that the greatest number of notifications to CFIUS in 2019 and 2020 involved Japanese-sourced deals. Indeed, apart from China and Japan, the capital-source countries with the highest incidences of transactions reviewed by CFIUS over 2018-2020 are Canada, the UK, Germany, France and Australia.

Moreover, the data in the report indicate that for 2020 the capital-source countries with the largest number of notified transactions in CFIUS-specified critical technologies sectors were Japan, Sweden, and Canada. China ranks seventh, with just over a quarter of Japan's amount of such deals. While these data do seem to suggest greater risk aversion or selectivity on the part of potential Chinese and US partners' willingness to engage in certain transactions as result of FIRRMA and CFIUS per se, it is too difficult to draw such a conclusion based on this evidence alone.

Withdrawal of transactions

The same conclusion about parties climbing the CFIUS learning curve also might be discerned from the report's data on the number of transactions withdrawn as a result of the CFIUS review process. Whereas as in 2017 and 2018, approximately 30% of transactions were withdrawn, in 2019 and 2020, such withdrawals were 13% and 16%, respectively, about only half as much.

While it might be presumed that in the wake of FIRRMA, US technology and other sensitive sectors would be targeted less frequently by foreign investors than has been the case, such an assumption is not borne out by the data in CFIUS's 2020 Annual Report. The greatest number of declarations filed with CFIUS in 2020 involved transactions in: (i) electrical power generation, transmission, and distribution; (ii) computer systems designs and related services; (iii) software publishing; (iv) aerospace products and parts manufacturing; (v) semiconductors and other electronic component manufacturing; and (vi) computer and peripheral equipment manufacturing.

Conclusion

The match between a veteran agency and an ambitious young statute is not always an easy one to make in Washington DC. In the case of CFIUS and FIRRMA, however, it appears that, to date, there has been a smooth integration. Of course, as is Congress's want, amendments to FIRRMA are already being discussed, especially in light of the currently ruptured relationship between Beijing and Washington DC. Before such action is taken, both the legislative and executive branches would do well to dispassionately assess why and how any contemplated changes would enhance both the global competitiveness and national security of the US.

Harry Broadman
Berkeley Research Group

CORPORATE
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Merger control overview: what governments are concerned about

David Smith of **Vinson & Elkins** in Washington DC discusses the concerns of different regulators across the world and when filings might be required

In much of the world, mergers, acquisitions, and joint ventures are subject to suspensory merger control regimes, meaning an antitrust regulator must review such deals before they can close. The EU, US, Canada, Russia, Saudi Arabia, and many other jurisdictions have such requirements: from roughly a dozen such regulatory regimes 30 years ago, there are now well over 100 separate merger control systems.

Though each regulatory regime differs, they share a common general purpose: to provide governments prior notice of M&A activity that may harm competition or consumers and allow the government a chance to block or seek modifications to transactions.

Therefore, these laws usually require pre-closing notification for deals above a specified turnover, asset or deal value, or other thresholds. Notification requirements are uneven across jurisdictions and sometimes do not require the target company in a transaction to have any revenue in the relevant jurisdiction to trigger a filing. Similarly, required waiting periods vary widely, from statutory review periods of approximately one month to mandatory standstills of four months or more.

In the vast majority of jurisdictions, the filing requirement does not depend on any competitive nexus between the transaction parties. For example, parties in two completely different industries frequently need to notify transactions, despite there being no reasonable way competition or consumers could be harmed by the transaction. As a result, the vast majority of deals notified – upwards of 90% in most jurisdictions – do not face significant antitrust regulatory impact other than delay.

Given that most jurisdictions employ filing thresholds based on the parties' worldwide or in-jurisdiction turnover or assets, larger entities are much more likely to generate filings than smaller ones. Energy firms are disproportionately affected because of their large size, both in terms of needing

"Dealmakers should always consider whether a deal – if notifications are required at all – will be cleared quickly or whether it might face a long antitrust investigation"

to notify the regulator of transactions and in facing substantive investigations. (Because many jurisdictions impose substantial fines for companies that close a deal without notification and clearance, or that prematurely integrate their businesses before obtaining clearance, it is important for companies considering significant M&A projects or joint ventures to consult antitrust counsel well in advance of signing.)

Dealmakers should always consider whether a deal – if notifications are required at all – will be cleared quickly or whether it might face a long antitrust investigation. To assess whether an investigation is warranted, authorities typically focus on how much a deal increases concentration in a properly defined market, and whether there exists "merger specific harm". "Harm" in this context usually means negative effect on price, quantity, or quality, and "merger specific" means caused by the transaction, and only by the transaction.

Generally, the larger the parties relative to competitors and the more closely they compete, the more likely it is that they will encounter an in-depth merger control investigation. But this is not necessarily the case: even small transactions or those in which the parties are not competitors can face regulatory resistance in certain circumstances.

Antitrust authorities most commonly assert three categories of harm: unilateral price effects (ability of the merged entity to raise price by itself); co-ordinated price effects (ability of the merged entity to raise price in concert or in parallel with rivals, owing to a reduction in overall marketplace competition as the result of the merger); and vertical foreclosure (ability of the merged firm to burden or exclude rivals, to the ultimate detriment of customers, because rivals no longer have access to key products or services that the merged firm will control).

In addition, the tendency of a merger to eliminate a "maverick" — a company that is disruptive as to price or technology — can be a particularly damning allegation. Because the energy industry — and especially renewables — often involves innovators and mavericks, dealmakers should be keen to demonstrate that a merger will improve, not curb, the competitive spirit of the businesses involved.

Special cases for energy

Apart from the sheer size of many participants, the energy industry often features ownership or control structures that can lead to complicated issues in merger control. A prime example of this is the creation of joint ventures, which can face an astoundingly varied thicket of rules, depending on their specific structure. Some jurisdictions, such as the US, feature relatively simple filing requirements with respect to joint ventures. But the situation is much more complicated in several other major jurisdictions, including the EU and China.

It is relatively common in the energy industry, and especially in developing new or risky projects in renewables, for two or more companies to combine forces when making new investments. When two or more entities have "decisive influence" — each having the ability to make or block major strategic decisions such as management appointments, annual budgets, or business plans — over a combined entity, many jurisdictions treat the parent companies as having joint control over the venture. In such situations, it is the turnover of the parent companies, rather than the joint venture, that often becomes determinative for merger control purposes.

Odd outcomes can result. For example, a Canadian and a Brazilian company could enter into a transaction resulting in joint control of a large solar energy company in Mexico. Such a transaction might logically be expected to potentially trigger a filing in Mexico. But, if the parent companies also generate significant turnover around the world, it could also result in numerous other filings — including with the European Commission (EC) and in China — depending on the precise commercial nature of the joint venture and the places the parents generate turnover.

The larger and more widespread the turnover of the parents, the more significant this risk. Given the size of energy companies and their propensity for joint investments, the merger control implications of these structures should be closely scrutinised when they are proposed.

Special cases for renewables

Apart from joint ventures, which are a problem common to the whole energy industry, renewables transactions can present certain issues of their own for merger control. For example, biomass power generation frequently involves feedstock in one country being shipped to a second via a vessel flagged in a third. This can present issues in terms of properly allotting turnover generated to the correct jurisdiction. While this issue crosses industry lines, the multinational nature of many renewables participants means that allocation of customer revenue to the correct jurisdiction is often more challenging than in other industries.

Similarly, many renewables projects involve significant subsidies from governments, whether as construction funding or as operating subsidies. Accurately accounting for such flows can have a substantial impact on the exposure of such companies and their transactions to international merger control.

Filing: what issues does it present for a transaction?

Aside from the obvious risk of a regulatory authority blocking or requiring that a transaction be modified, the merger control filing process introduces timing and cost implications.

For example, a filing in China with no significant competitive issues can take up to 120 days to clear (although a simplified procedure is available for some of the least-sensitive transaction types). This can be contrasted with jurisdictions such as the US or the EU, where the initial review phase allows most transactions to clear in approximately one month.

"Apart from the sheer size of many participants, the energy industry often features ownership or control structures that can lead to complicated issues in merger control"

Many major transactions require multiple international filings, all of which need to clear regulatory review before the transaction can close. Therefore, as a practical matter, closing timing is often driven by merger control filings with the longest timelines: as can be seen by the previous example, planning can be materially affected by filings in long-review jurisdictions such as China or Saudi Arabia, when compared with deals with no filings or those only in places with more expedited review periods.

Unfortunately, this timing can be uncertain. Many regulators, such as the EC, encourage or require pre-notification contacts with the regulator to confirm that draft filings can be accepted. As the length of such contacts can vary, planning a precise filing date can be challenging and the time required for filing preparation can be extended. In other relatively common filing jurisdictions for energy transactions – such as Nigeria – a regulator-issued request for information stops the review clock, functionally extending the timeline until the parties respond. On the other hand, some regulators regularly clear transactions well in advance of their statutory deadlines, occasionally allowing parties to make up for lost time.

Preparation and submission of filings also introduces a cost burden to notifying parties. While some regimes do not feature filing fees, others — such as the US and the multinational COMESA regime in Africa — can require fees of well over $100,000 per filing. Many other regimes require smaller payments. These costs are on top of legal fees for filing analysis and preparation.

Parties must also be mindful of rules against premature integration of business operations or of the buyer controlling aspects of the target business before closing. Closing or establishing control before clearance is known as "gun jumping" and is subject to substantial fines under most merger control laws, even where a deal has no competition problems.

Generally, parties are not permitted to begin integrating their business, but they may plan for such integration. Such planning can be particularly important in many energy businesses, where smooth continuity of operations across closing is an imperative for safety reasons. As such, a careful understanding of each jurisdiction's restrictions around gun jumping is important for transaction parties so that the deal can proceed as efficiently as possible without running afoul of gun-jumping rules.

Related fields: national security and foreign investment laws

Competition regulations are no longer the only pre-notification requirements in certain jurisdictions. In recent years, foreign investment regulations have increasingly required pre-notification of transactions in a small but growing number of countries.

Countries with such regulations include the US, China, Russia, Australia, and a growing number of EU Member States. Foreign investors acquiring assets in jurisdictions with foreign investment regulations must also be mindful of these regulations, which can require filings in parallel with competition-centred merger control processes.

While country-specific laws vary, many focus on a core set of sensitive industries in which governments wish to scrutinise foreign investors before permitting them to exercise any control over these critical technologies or assets. Unsurprisingly, energy and petrochemicals assets can be viewed as sensitive in some foreign investment review regimes (and therefore require filings). When required, these processes often require extended filings and reviews that may extend beyond the review timeline for competition filings.

The proliferation and complexity of pre-merger review laws adds a layer of complexity and delay largely absent in decades past. As this complexity continues to increase and disproportionately affect energy industry participants, those companies should be especially mindful of multi-jurisdictional filing requirements early in the transaction-planning process.

David Smith
Vinson & Elkins

CORPORATE INSOLVENCY & RESTRUCTURING REPORT 2021

IFLR has partnered with market-leading lawyers from Denmark, Germany, Luxembourg, Mexico, Poland, Russia and Switzerland to provide a snapshot of how Covid-19 continues to have an impact on the global restructuring and insolvency space.

The chapters provide an overview of each country's restructuring and insolvency framework, consider the processes available for debtors and creditors, and assess the impact for cross-border businesses.

The authors study how national governments and companies have responded to the economic crisis caused by the pandemic, and how such decisions have influenced the perceptions of key stakeholders. In addition, the authors discuss plans of enhancing market sustainability and make predictions based on their market's restructuring and insolvency trends.

With considerable global developments in this space over the last twelve months, we hope that you enjoy hearing from the experts leading the response in IFLR's special report.

The gradual coming of age of Swiss distressed M&A

Christoph Vonlanthen and Olivier Hari of Schellenberg Wittmer explore how positive procedural changes in Switzerland have improved bankruptcy-related scenarios for businesses and creditors

In 2014, Swiss bankruptcy law was updated to improve the ability of companies to restructure. These revisions expanded the toolbox available to distressed M&A practitioners and generated helpful case law.

In light of these recent developments, this article gives a snapshot of key considerations in the structuring of the sale and acquisition of distressed assets in Switzerland.

Schellenberg Wittmer

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Out-of-court transactions

As a company teeters on the verge of financial distress, it may envisage the disposal of assets to raise cash and forestall bankruptcy. Yet, such out-of-court transactions by a company in distress are inherently risky for the seller's directors and the purchaser alike.

Typical structure

In scenarios where it is not the target that is put up for sale in a share deal with all liabilities attaching to the business, the transaction will be structured as an asset deal.

An asset deal enables the purchaser to pick the assets and contracts that it wishes to acquire. The purchaser may also assume specified liabilities.

A variant of an asset deal is the 'hive-down' in which the assets, liabilities and contracts to be taken over are first dropped down into a newly formed subsidiary. The seller then transfers the shares in the subsidiary to the purchaser.

Risk of challenge

Whether structured as a straight asset deal or a hive-down, an out-of-court asset deal by a distressed seller exposes the purchaser to the risk of challenge.

Specifically, if the seller were to become bankrupt during the 12-month period following the asset sale, the transaction could be avoided if it was made at an undervalue.

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In addition, a 'credit bid', i.e. a sale in which a purchaser-creditor uses a claim as consideration to purchase assets from the seller-debtor, would be subject to challenge in a subsequent bankruptcy happening within a 12-month period if the transaction occurred while the seller-debtor was over-levered.

The recovery or hardening period is extended to five years if the asset sale occurred with the actual intent (recognisable by the purchaser) to harm the seller's creditors or favour certain creditors of the seller over others.

If the risk crystallises and the transaction is avoided, the bankruptcy estate will be restored in its ownership of the assets previously divested while the buyer's claim to recover the purchase price would be classified as an unsecured (pre-petition) claim in the bankruptcy – an exceedingly unfavourable outcome for the purchaser.

Purchaser's additional risks

While the purchaser will seek to cherry pick the assets, liabilities and contracts, Switzerland has its own version of 'transfer of an undertaking regulation' or TUPE. These rules provide that if the asset sale comes down to the transfer of a business or part thereof, employment contracts and related claims will automatically transfer to the purchaser, unless the employee objects to the transfer. This may in effect defeat the purposes of an asset sale.

In addition, there may be little credit behind post-closing claims for breaches of representations and warranties or indemnity claims. Accordingly, the purchaser often will need to look for an escrow, a holdback or warranty and indemnity (W&I) insurance.

Key risks for the seller's board of directors and management

In a distressed asset sale, the directors and management of the seller must ensure they satisfy their fiduciary duties or else be exposed to personal liability claims in a potential subsequent bankruptcy.

Specifically, the board must act to obtain the best available price. In this connection, the board must design a reasonable sale process, which will usually involve an active market check. The board must also seek specialist advice, a key underpinning to the board's acting reasonably in the circumstances.

Time pressure

Intense time pressure is part and parcel of out-of-court distressed transactions. This is not only a business imperative to raise cash and maintain the company's standing with clients and suppliers. Key parties in interest, such as the seller's board, management and auditors, will also want a transaction to happen in a short timeframe as they may otherwise be duty bound to notify the bankruptcy court (or be personally liable for 'wrongful trading').

A corollary is that the risk of a transaction at an undervalue or engaging the liability of the seller's board and management is heightened.

Mitigation strategies

Depending on the circumstances, the parties may turn to a number of mitigation strategies:

- First, the purchaser will be well advised to due diligence the financial condition of the seller. It may be, for example, that while a group is distressed, the particular entity selling the assets is healthier with the result that the risk of bankruptcy and challenge may be remote.
- For the board to protect itself against liability claims (and to defeat a claw-back

"While the purchaser will seek to cherry pick the assets, liabilities and contracts, Switzerland has its own version of 'transfer of an undertaking regulation' or TUPE"

action as well), it is often critical that there be a record of arm's length disposition process conducted in good faith with the assistance of experienced advisors and resulting in reasonable terms.

- The seller's board should seek a fairness opinion from a financial advisor for additional comfort.
- The seller's board should, as usual, create contemporaneous records of the various steps undertaken in the disposition process.
- The purchaser-creditor should avoid structuring the transaction in the form of a credit bid.

Alternatively, where the risks to the parties remain substantial, they may turn to in-court transactions.

In-court transactions

Switzerland has its own version of 'Chapter 11-type' restructurings. These proceedings can serve to transfer assets or a business to a purchaser and proceed with the orderly liquidation of the seller under a plan of reorganisation approved by the creditors and the court.

In addition, a solid framework has emerged for 'Section 363' type court-approved asset sales.

These court-approved sales have been the subject of recent case law and are discussed below.

Nuts and bolts of a Swiss restructuring

Companies can restructure pursuant to a plan of reorganisation with the usual checks and balances: the creditors will vote on the plan and the bankruptcy court must confirm it. These proceedings, commonly referred to as 'composition proceedings', exist alongside the traditional bankruptcy route aiming to liquidate the company.

Composition proceedings are initiated at the request of the company or a creditor eligible to file for bankruptcy. If the bankruptcy court approves the request, it will grant an interim stay or moratorium protecting the company from enforcement actions by its creditors.

If, during the interim moratorium, the bankruptcy court concludes that there are prospects for a restructuring or court-approval of a composition, it will then approve a definitive moratorium.

Importantly, during the interim and definitive moratorium, the company and its board and management typically keep control of the business and the assets, usually under the supervision of a court-appointed 'trustee'.

However, the company cannot dispose of its fixed assets or the entire business without the approval of the bankruptcy court or, if set up by the court when approving the definitive moratorium or later, the creditors' committee. This important provision is the underpinning for court-approved asset sales.

Key steps of a court-approved asset sale in Switzerland

Court-approved asset sales, while often labelled 'pre-packaged deals', in fact have features of a US style Section 363 sale.

A typical template for such an asset sale is as follows:

- The seller markets the assets pursuant to a reasonable process designed by the board with the help of its advisers.
- The seller negotiates an asset sale agreement with the selected bidder and simultaneously prepare its filing for composition proceedings.
- The asset sale agreement is conditional upon, among other things, the court granting an interim moratorium and approving the asset sale.
- The seller files for composition.
- Unless there is obviously no prospect for a restructuring or court approval, the bankruptcy court approves the interim moratorium. It also adopts measures intended to protect the assets of the company (essentially, the appointment of the trustee).

Determination by the court

The court, when requested to approve the asset sale, will establish whether:

"Important procedural issues have recently been litigated up to the Swiss Supreme Court, giving a firm foundation to the authority of the bankruptcy courts to approve asset sales during the interim moratorium when time is of the essence in a 'melting ice cube' scenario"

- There is urgency in completing the asset sale (e.g. to settle suppliers or wages and to maintain goodwill);
- There has been a robust market check designed and implemented with the assistance of specialist advisors to elicit the highest bid (i.e. ensuring that all interested parties have been allowed to bid). A public auction however is not required. The court will be particularly sensitive to any indication that the bidder is closely related to the seller or that the parties may have colluded; and
- The liquidation proceeds in a bankruptcy would likely be lower (e.g. in consequence of a loss of goodwill) with the result that the asset sale is in the best interests of the creditors.

If the bankruptcy court is satisfied that all conditions are met and the transaction is in the best interests of the creditors, the court may approve the sale.

The sale can then be effected as a straight asset sale or a hive-down.

Upsides of an in-court transaction

Court-approved asset sales have many upsides:

- The decision to approve the interim moratorium is not appealable (although it cannot be excluded that the decision be null and void – a very high bar, such as where the bankruptcy court does not have jurisdiction over the matter).
- Creditors do not have a right to be heard or to participate in the approval process of the bankruptcy court. In addition, creditors do not have standing to appeal from the decision of the bankruptcy court approving an asset sale, although it cannot be excluded that the court's decision be null and void (a high bar).
- The court-approved asset sale cannot be challenged by way of a claw-back action even if the composition proceedings were to fail and the seller were to be liquidated in traditional bankruptcy proceedings.
- Special rules apply to the transfer of employment contracts: they only transfer to the purchaser if that has been agreed by the purchaser. A transfer of assets however will still require the seller to inform the works' council or, if there is not any works' council, the employees themselves ahead of any transfer of a business. If measures affecting the employees are envisaged, the works' council or the employees must be consulted before the measures are implemented.
- While the overall timeframe will depend on a number of variables, including the size and complexity of the assets, since the creditors do not need to be consulted, a court-approved asset sale can be completed relatively rapidly. In a recent case, the bankruptcy court approved the interim moratorium within two days. The asset sale was approved six days later by the court.
- Unlike Section 363 sales in the US, the sale process can be kept relatively confidential in an effort to manage the business's clients and suppliers. Both the interim moratorium and the asset sale approval will not be made public if applicable conditions are met.

A firm foundation

Bankruptcy courts have approved asset sales within short timeframes with an eye on preserving the goodwill of businesses and maximising recovery for creditors. Important procedural issues have recently been litigated up to the Swiss Supreme Court, giving a firm foundation to the authority of the bankruptcy courts to approve asset sales during the interim moratorium when time is of the essence in a 'melting ice cube' scenario. These developments have greatly expanded the ability of companies to restructure quickly in order to salvage viable businesses alongside out-of-court transactions and Chapter 11-type composition proceedings.

Denmark

Kristian Gustav Andersson and Anne Hansen-Nord, Lundgrens Law Firm

The Danish Bankruptcy Act contains procedural as well as substantive provisions in relation to formal insolvency proceedings.

The formal reconstruction process is often criticised for being both expensive and troublesome. However, the changes proposed by the Danish Bankruptcy Council to the rules on restructuring may alleviate these issues. The proposed changes got implemented in a legislative proposal and enacted on March 23 2021. The purpose of the legislative amendments is to improve the chances for companies that are viable but have temporary financial difficulties resulting in continuation instead of being declared bankrupt to limit financial losses and prevent job losses.

It is expected that the amendments will increase the incentive to undergo restructuring. Among other things, the proposal suggests that the requirement for compulsory security in any subsequent bankruptcy proceeding is removed and that employees' guarantee fund coverage must take effect at the very beginning of the reconstruction proceedings. The amendment to the Bankruptcy Act seems to be especially welcome as the recent Covid-19 crisis has affected the cash flow in otherwise well-run companies.

The Danish Bankruptcy Act distinguishes between bankruptcy, formal reconstruction, and rescheduling of debt. Bankruptcy and formal restructuring proceedings are available for legal entities as well as individuals, while debt rescheduling on its own is only obtainable by individuals. Insolvency proceedings under the Danish Bankruptcy Act can be launched only once a company is insolvent. A company is insolvent when it cannot fulfil its obligations as they fall due, and when this inability to pay is not temporary.

Instead of initiating a formal restructuring process, an insolvent company may seek to enter into an arrangement with its creditors, and in this way obtain a percentage reduction of the debt, a lapse of the claims, a postponement

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of the payments or a combination of all of these, via an informal restructuring process. It is important that certain creditors are not given preferential treatment at the expense of other creditors, as this may result in legal liability for the management.

Directors' duties

The management of a distressed company is not automatically liable if insolvency proceedings are initiated against the company. The management is only liable, if it has failed to comply with its managerial duties or if the management have violated legal regulations.

The management is obligated to ensure that the company's capital reserves are sufficient to fulfil its present and future obligations as they fall due. If the capital reserves are not sufficient, the management must restore the reserves or file for insolvency proceedings.

However, it is important to note that management often is tasked with complex decisions. Consequently, Danish law operates with the so-called 'business judgment rule'. This legal principal is a presumption of innocence if management has acted in good faith and with care, and the management reasonably believed the actions taken were in the best interest of the company.

Formal filing

The formal filing and issue of a bankruptcy or restructuring order has several impacts on the creditors. The creditors are subject to limitations concerning proceedings taken by creditors individually, as the creditors cannot seek satisfaction in the debtor's assets. Therefore, execution or attachment may not be levied against property comprised by the estate.

The trustee can decide to maintain contracts that have not yet been fulfilled, unless this is contrary to the very nature of the contract. In restructuring proceedings, the trustee can additionally decide to maintain a contract that has been terminated within the last four weeks leading up to the initiation of the restructuring, provided that the contractual party has not yet acted upon the termination. If a contract is maintained, all claims arising out if it will be elevated in the estate's priority of claims. If the contract is not maintained, the contractual party may terminate the contract and file its claim.

Priority, dissenters and asset sales

The order of the priority of claims is in general as follows:

- Costs of the estate administration (pre-preferential claims)
- Claims in relation to previous restructuring or liquidation processes (preferential claims)
- Claims from the debtor's employees (preferential claims)
- Certain tax claims (preferential claims)
- Any remaining claims, including invoice claims (ordinary claims)
- Claims of interest, fines, gifts etc. (deferred claims)

Creditors with valid and enforceable security do not form part of the ranking. However, if the security does not fully cover a creditor's claim, they are viewed as an unsecured creditor in relation to the unsecured part of their claim. Post-petition debt or costs incurred by the estate will be considered pre-preferential debt, which will be covered at the same level as costs of the estate administration.

During bankruptcy proceedings, the trustee is responsible for handling the sale of assets. The trustee can carry out the sale as a sale of the individual items or as a sale of the business or of separate branches. The trustee must manage the interests of the estate to the widest extent possible, must manage the sale in such a way that the outcome for the bankruptcy estate and its creditors becomes as favourable as possible.

During a formal restructuring process, the appointed trustee must consent to the selling of the debtor's assets, if the sale significantly impacts the restructuring. Furthermore, a business transfer must be carried out in accordance with a ratified

restructuring proposal. Hence, a sale of the business or of one or more of the branches must be approved by the creditors for the restructuring proposal to be valid. The legislative change from March 2021 allows a new form of business transfer called a 'fast-track business transfer'.

The fast-track procedure involves a business transfer, which can take place with the consent of the appointed trustee, provided that a majority of the voting creditors have no objections. Creditors have five business days to file objections. This fast-track business transfer can only be completed before the passing of a restructuring plan. Thereafter, business transfers can only be carried out after the previously applicable rules, where the final restructuring proposal is adopted unless a majority of the creditors participating in the vote, vote against it. Votes are cast in proportion to the amounts of the claims. The compulsory composition will typically include all creditors. This means that creditors may be forced to accept undesirable terms and be crammed down in accordance with an approved restructuring proposal.

A formal restructuring must contain at least a compulsory composition or business transfer. The compulsory composition may take the form of a lapse of the claims or a percentage reduction of these, it may also entail a postponement of payments.

All sectors and industries are subject to the same insolvency and restructuring regime. However, a restructuring containing a business transfer may be subject to approval from the competition authorities if the transfer triggers the merger rules.

Challenging the debtor's transactions

Transactions carried out in the period leading up to an insolvency proceeding may be null and void. Claw-back actions can be initiated by the trustee during bankruptcy proceedings or compulsory composition proceedings that are approved in a formal restructuring. Distinction is made between so-called 'subjective' and 'objective' clawback action rules. Under the objective rules, some transactions carried out may be challenged, irrespective of knowledge of the debtor's insolvency or fraudulent intent. Transactions such as granting of security in respect of old debt and gifts can be challenged after the objective rules, depending on the circumstances.

"The Danish Bankruptcy Act distinguishes between bankruptcy, formal reconstruction, and rescheduling of debt"

Under the general subjective rules, a transaction can be challenged if it fraudulently favours one creditor over another, where the debtor's property is withheld from serving the creditors, or where the debtor's debts are increased to the detriment of other creditors. However, a transaction can only be voided if the debtor had already become insolvent due to the transaction and the favoured party knew or should have known of the insolvency and the circumstances causing the transaction to be fraudulent.

Crossing-borders

Petitions for restructuring or insolvency proceedings can only be filed in Denmark if the debtor is engaged in commercial activity domiciled in Denmark or is otherwise subject to the jurisdiction of Denmark. Proceedings cannot be opened in respect of a foreign debtor that does not meet neither of these two requirements.

Danish legal advice on handling of any Danish assets comprised by foreign proceedings will often be relevant for foreign debtors. Additionally, some foreign insolvency or restructuring proceedings receive recognition in Denmark pursuant to Nordic and EU rules. The EU enacted a directive on restructuring and insolvency in 2019 which will be implemented in Danish law in 2022. The main purpose of the directive is the introduction of preventive restructuring frameworks which should, above all, enable debtors to restructure effectively at an early stage and to avoid insolvency, thus limiting the unnecessary liquidation of viable enterprises.

Generally, Danish assets held by a foreign debtor would be handled alongside any other asset within the debtor's restructuring process. Transfer of certain assets such as shares, and real estate must be recorded in accordance with Danish law to have priority over third party transferees acting in good faith. Any creditor rights in Danish assets must be handled in accordance with Danish law, meaning a sale of Danish real property must respect the rights of pledgees and mortgagees as set out in Danish law.

Covid-19

It is important that businesses negatively affected by Covid-19 have a clear overview of their financial situation, including outstanding debts, the most critical contracts and general liquidity needs. This will help a business to address the situation in an effective manner.

A knowledge of relevant government aid packages and a general proactiveness in respect of debtors is likely to increase a company's chances of reaching an instalment agreement with creditors, if necessary.

Furthermore, a continuous assessment of the financial situation will guide management as to the tipping point of the financial situation. This is important, as management may be held liable to pay damages to creditors if they should have realised that there was no reasonable prospect that the company would be able to survive – management must commence insolvency proceedings once it establishes that the point of no return has been reached. Continuous assessment can also help management assess what urgent steps or more long-term changes need to be made. It is also generally beneficial for a company to be transparent with its key stakeholders and creditors.

Beyond the short-term consequences of the Covid-19 crisis, creditors and other stakeholders are now looking into its long-term consequences. The crisis has also

"Many businesses find that the formal restructuring scheme – similar to a US Chapter 11 bankruptcy – is too formal in the sense that the procedures hinder in particular a transfer of the business"

meant an increased focus on *force majeure* clauses as many deliveries have proven difficult.

Various aid packages for businesses have been introduced by the Danish government to help mitigate the negative economic effects of Covid-19. Although the Covid-19 restrictions have been in place for a long time, they have not led to an increase in the number of restructurings initiated. The reason for this is undoubtedly the aid packages, which have given companies compensation for fixed costs, subsidies for wages and extended the deadline for settlement of VAT and tax, etc.

The aid packages are not endless, and when they cease a number of companies will most likely be pressured on their liquidity. The number of distressed companies will therefore presumably increase when Covid-19 aid packages is no longer available and when the companies must start repaying the deferred VAT and tax liabilities.

Finally, on July 3 2020, the Danish Bankruptcy Council proposed a series of changes to the rules on restructuring, some directly due to Covid-19. The suggestions became a legislative proposal and came into force on March 29 2021. Overall, the amendment to the law aims to make the restructuring rules more flexible and less costly, including mitigating the economic consequences of Covid-19.

The amendments can be summarised as follows:

- There is no requirement to appoint a restructuring accountant on commencement of the restructuring proceedings;
- Four to eight weeks controlled 'time out' will be introduced to explore the possibilities of a restructuring;
- The company will not automatically be subject to bankruptcy proceedings if a restructuring plan is not adopted during the time out;
- No obligatory security is required for subsequent bankruptcy proceedings; and
- Coverage from the Employees' Guarantee Fund will be available as soon as restructuring proceedings are initiated.

It is expected that in the wake of the pandemic, there will be a wave of insolvency, which is why the rapid introduction of new restructuring rules hopefully can avert some future bankruptcies.

Looking ahead

Many businesses find that the formal restructuring scheme – similar to a US Chapter 11 bankruptcy – is too formal in the sense that the procedures hinder in particular a transfer of the business. Also, the procedural scheme makes it an expensive process. A business with its main assets pledged to a bank or another creditor, will have to turn to a third party financing to finance its operations during the reconstruction process. These issues could to some extent be alleviated by the changes to the restructuring scheme recently enacted. It is expected that the rules will be amended again in the near future as a result of the implementation of the EU directive.

As a result of Covid-19, in addition to short- and long-term liquidity, creditors are now also looking into a debtors' adaptability and ability to cut expenses on short notice while still maintaining a running business.

Expectedly there will be an increase in the number of distressed M&A transactions in the wake of Covid-19. Hopefully, the new set of restructuring rules will increase the appeal of the restructuring institute to distressed companies resulting in fewer bankruptcies.

Germany

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The booming German credit and capital markets came to a sudden halt when Germany went into a general lockdown in March 2020. Corporates, sponsors and investors immediately switched their focus from new money and repricing deals to protecting their businesses and investments. Many businesses, fearing impending draw-stops and credit crunches, utilised their existing credit lines in full while at the same time trying to access the newly-established German state-aid schemes.

German state-aid: KfW loans

German state-aid regimes were enacted by the government to provide liquidity to Covid-19-affected businesses. Such businesses were offered subsidised loans through the German state-owned bank KfW, predominately through two KfW programmes.

First, the expanded entrepreneurial loan programme No. 037 which provides for a back-to-back (re-)financing of commercial banks by KfW. Under this programme, KfW takes up to 80% of the credit risk of the extended loan.

Second, the newly established KfW programme No. 855 for direct participations in syndicated facilities which provides for KfW to become a lender of record alongside commercial banks in syndicated facilities. The commercial banks have to take at least 20% of the credit risk in such syndicated facilities. KfW's special Covid-19 programme for subsidised loans runs until year-end 2021.

German state-aid: Economic Stabilisation Fund

In addition, the Economic Stabilisation Fund was established which provides financial support to businesses in all sectors of the economy (other than the financial sector) by means of federal guarantees for borrowed capital and/or recapitalisation measures. Such recapitalisation measures

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range from equity injections through silent partnerships to subordinated loans.

These state-aid programmes remain available until year-end 2021, although the demand has significantly decreased following the reinvigoration of the financial markets and the general economy.

German state-aid: other subsidies

Apart from the financing support through KfW and the Economic Stabilisation Fund, direct, non-repayable subsidies were made available for businesses affected by the lockdowns in November and December 2020 under the so-called November and December support programmes and also for other business under the so-called bridge support programmes.

In addition, the access for businesses to the federal short-term working benefits programme, to compensate employees of businesses for the loss in wages resulting from down periods, was facilitated.

Actions taken by the legislator: short term

With a view to avoiding insolvencies of companies who became distressed due to the Covid-19 pandemic, the German legislator comprehensively modified the German insolvency regime with retroactive effect as of March 1 2020. These modifications addressed nearly all insolvency-related obligations and restrictions which typically apply to insolvent companies, their directors and their creditors, including a suspension of directors' insolvency filing duties. The modified regime expired at the end of April 2021, i.e. the 'normal' regime is fully applicable again.

The state-aid programmes, which in aggregate had an initial volume of €1,100 billion (approximately $1.285 billion), and the suspension of the insolvency-related restrictions have provided substantive relief to distressed companies. Actual insolvencies were few and far between and, mostly, hit companies which had financial difficulties already pre-Covid-19. According to the German Federal Statistical Office, corporate insolvencies in 2020 were around 16% lower than in 2019. In the first half of 2021, corporate insolvencies were around 18% lower than in the first half of 2020 and around 23% lower than in the first half of 2019.

Actions taken by the legislator: long term

Recognising the need for a pre-insolvency restructuring regime in light of the economic distortions caused by the Covid-19 pandemic, the German legislator has introduced the long-awaited new German restructuring scheme at the beginning of January 2021.

The availability of this new German scheme closes the gap between fully consensual out-of-court restructurings and

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in-court restructurings by providing a pre-insolvency restructuring instrument which allows for a cram-down of creditors and/or shareholders. In practice, the mere possibility to outvote or cram-down hold-out stakeholders often enables a fully consensual restructuring.

Framework

For non-consensual restructurings, two restructuring instruments are generally available in Germany. First, the new German restructuring scheme, a pre-insolvency restructuring regime aiming at a sustainable restructuring of the debtor by means of a restructuring plan to be adopted by the affected stakeholders. Second, insolvency proceedings as a comprehensive in-court restructuring (or liquidation) regime.

In addition, German law governed bonds can also be restructured pursuant to the German Bond Act by means of a bondholder vote without any court involvement. The German Bond Act allows for a holistic restructuring of the bonds, including, for example, haircuts, maturity extensions, debt-to-equity swaps and the acceptance of exchange offers, with a qualified majority of 75% of the voting bondholders.

Apart from a temporary modification of the insolvency regime for businesses hit by the devastating floods in Germany in July 2021, there are currently no legislative projects aiming at an amendment of the restructuring regime for businesses.

On a European level, the EU initiative for increasing convergence of national corporate (non-bank) insolvency laws in order to encourage cross-border investment is ongoing as part of the general effort to strengthen the EU Capital Market Union. The public consultation process has been finished in March 2021 and the adoption by the European Commission is planned for the second quarter of 2022. The effects for Germany are currently difficult to predict as Germany already has, as a consequence of various reforms, a rather sophisticated and efficient insolvency and restructuring regime.

Processes and procedures

Directors' duties under German law

Directors of entities with limited liability, i.e. entities without at least one individual as directly or indirectly personally liable shareholder, are subject to certain specific statutory duties in a 'crisis' situation of such entities.

A 'crisis' generally means a situation where the entity experiences commercial and/or financial distress to an extent that it could possibly result in an insolvency or otherwise endanger its corporate existence. Typical symptoms of a crisis are a decrease of earnings before interest, taxes, depreciation, and amortisation (EBITDA) and equity, accompanied by an increase of financing costs and net leverage ratio (i.e. the ratio of total net debt to EBITDA).

It should be noted that the omnipresent 'cov-lite' term loans or incurrence-based high yield bonds typically do not provide for a trigger enabling lenders or investors to act in the event of such deterioration of the borrower's financial situation, which *vice versa* may eliminate the need of the borrower to react to the situation early on. Hence, the visibility of, and the reaction to, the crisis may be delayed.

Statutory directors' duties, however, continue to apply and are often exacerbated due to the crisis situation. E.g. the duties of directors in a crisis situation comprise an intensified monitoring obligation with a specific focus on the financial status of the company (in particular, its liquidity) and an obligation to closely coordinate with the other corporate bodies, in particular the supervisory board.

If the crisis is aggravated, directors may be required to file for insolvency. The German Insolvency Code imposes an obligation on directors to file for insolvency in the event of 'illiquidity' or 'over-indebtedness'. In the event of an 'imminent illiquidity', i.e. if it is not more likely than

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not that the debtor will be able to honour all of its payment obligations which become due and payable from time-to-time within the applicable forecast period of generally 24 months, directors may, but are not required to, file for insolvency. Any insolvency filing solely on the basis of imminent illiquidity generally requires shareholder approval.

Illiquidity is generally presumed if a debtor ceases to make payments when due. Irrespective of a cessation of payments, the state of illiquidity is generally attained if the debtor cannot pay its creditors within a three weeks' timeframe and this affects more than 10% of the outstanding payment obligations.

Over-indebtedness occurs if the debtor's assets at liquidation values are insufficient to cover its liabilities and, in addition, it is not more likely than not that the debtor will be able to honour all of its payment obligations which become due and payable from time to time within the applicable forecast period of generally 12 months.

Each director must file for insolvency proceedings without undue delay and in no case later than three weeks after the occurrence of illiquidity and six weeks after the occurrence of over-indebtedness. Directors are only allowed to wait for the full three or six weeks, as applicable, if there is a realistic chance of a sustainable improvement of the financial situation of the company which eliminates the insolvency reason.

Further, no payments may be made by the directors following the occurrence of an illiquidity or over-indebtedness unless the relevant payment is reconcilable with the diligence of a prudent businessman. Payments made to existing creditors which have already discharged their obligations for delivery etc. *vis-à-vis* the company are generally irreconcilable with the diligence of a prudent businessman.

Lastly, it should be noted that there is generally no 'shift of directors' duties' in Germany. The management generally owes its duties to the company and its shareholders until the occurrence of actual insolvency (i.e. illiquidity or over-indebtedness). However, such shift of directors' duties does occur following the entry of the debtor into the new German restructuring scheme proceedings (see below).

German restructuring scheme proceedings

Both, the new German restructuring scheme and insolvency proceedings are available to all debtors whose centre of main interests (COMI) is located in Germany irrespective of the debtor's legal form. Certain specific rules apply to insolvencies of financial institutions which are precluded from German scheme proceedings.

The new German restructuring scheme is available to debtors which are in the state of imminent illiquidity without yet being insolvent. The institution of insolvency proceedings requires that the debtor has entered the state of imminent illiquidity, illiquidity or over-indebtedness (see *Directors' duties under German law* above).

Both processes provide for the option of staying any enforcement action of secured or unsecured creditors with a view to preserving the opportunity for a continuation of the business operations. Ipso-facto clauses, i.e. termination clauses which are triggered by the commencement of German scheme proceedings or insolvency proceedings, are null and void, although other termination rights, including upon default of the debtor, remain unaffected.

The new German restructuring scheme is a debtor-initiated process. Only the debtor is entitled to propose the restructuring plan and to submit it for adoption by its affected creditors and/or shareholders. A pre-packed solution is, however, possible. Court-involvement is not necessarily required. However, especially for more complex, controversial or cross-border restructurings, debtors will require the involvement of the competent restructuring court to cram-down dissenting stakeholders.

Creditors and, if their rights are affected, shareholders have to be allocated into different classes. An adoption of the restructuring plan requires its acceptance by each class with a majority of 75% of the voting rights. A cross-class cram-down is possible if, essentially, the crammed-down creditors are not worse off compared to their position in the absence of the restructuring plan and such creditors participate appropriately in the value allocated by the restructuring plan to the stakeholders. This generally requires compliance with the so-called 'absolute priority rule'.

This rule in principle provides that no stakeholder ranking junior to the crammed-

down class may be awarded any economic value by the restructuring plan unless such economic value compensates a corresponding contribution by the subordinated stakeholder into the debtor's estate.

Insolvency proceedings

On the other hand, insolvency proceedings are always an in-court process and in practice often aim at a liquidation of the debtor's assets rather than a restructuring. Insolvency proceedings, however, do provide several different possibilities to restructure the debtor. A debtor can be restructured in insolvency proceedings by means of an insolvency plan (including a debtor-in-possession administration) or by way of a transfer of assets of the debtor (so-called 'restructuring by transfer').

In insolvency plan proceedings, similar to the German scheme, the creditors and, if their rights are affected, the shareholders have to be allocated to classes. The adoption of the insolvency plan requires acceptance by each class with a simple majority of participating class members by headcount and claim value with the option for a cross-class cram-down if, essentially, the crammed-down creditors are not worse off compared to a regular liquidation of the insolvency estate and such creditors appropriately participate in the value distributed by the insolvency plan to the stakeholders (which requires compliance with the absolute priority rule). The insolvency court has to sanction the insolvency plan before it becomes effective.

In regular insolvency proceedings, the insolvency administrator usually pursues a restructuring through the sale of the business of the insolvent debtor, typically by means of an auction process. The sale as such is implemented through an asset deal. This allows the insolvency administrator to comprehensively reorganise the debtor and its assets and liabilities by transferring the 'good', i.e. valuable and competitive, part of the business of the debtor to the purchaser and leave the 'bad' part of the business (and the corresponding liabilities) behind in the insolvency estate.

In insolvency proceedings of larger companies, a creditors' committee regularly has to be established. It comprises representatives of secured creditors, large claims creditors, small claims creditors such as suppliers, the Federal Employment Agency and, if pension obligations are affected, the German Pension Insurance Fund. The creditors' committee represents the interests of the creditors as a whole and has to monitor the insolvency administrator.

No group restructuring or insolvency concept and no consolidation

Under German law, there is no group restructuring or insolvency concept, i.e. despite the economic ties between various entities within one group of companies, there will be one separate insolvency or restructuring proceeding for each of the entities. Each of these proceedings is legally independent from all other insolvency or restructuring proceedings (if any) within the group.

In particular, there is no consolidation of assets and liabilities of a group of companies in the event of insolvency and no pooling of claims among the respective entities of a group. However, the German Insolvency Code contains provisions to facilitate the coordination of and cooperation between insolvency proceedings of group companies.

Clawback

Under the German Insolvency Code, the insolvency administrator may challenge transactions, performances or other acts that are deemed detrimental to insolvency creditors and which were effected prior to the opening of formal insolvency proceedings during applicable avoidance periods.

Generally, if transactions, performances or other acts are successfully challenged by the insolvency administrator, any amounts or other benefits derived from such challenged transaction, performance or act will have to be returned to the insolvency estate. The administrator's right to void transactions can, depending on the circumstances, extend to transactions having occurred up to 10 years prior to the filing for the commencement of insolvency proceedings.

Cross-border cases

As regards the recognition of insolvency proceedings, German insolvency proceedings are to be recognised by the EU member states under the European Insolvency Regulation. As regards non-member states, recognition has to be awarded under the individual national recognition regimes. Generally, also due to the harmonisation of the recognition regimes on the basis of the UNCITRAL Model Law on Cross-Border Insolvency (1997), German proceedings should be recognised if the debtor has its COMI in Germany. The same principles apply *vice versa* to the recognition of foreign proceedings in Germany.

Recognition of pre-insolvency restructuring proceedings such as the German scheme should, as regards EU member states, be awarded under the so-called Brussels 1a Regulation, the pre-Brexit approach for the recognition of English law schemes of arrangements. From July 2022 onwards, German scheme proceedings can also be conducted as public proceedings, having the effect that the venue, hearing dates and court decisions will be announced. In this case, the German scheme proceedings will be eligible for recognition under the EU Insolvency Regulation.

Looking ahead

Looking ahead, the following main trends are likely materialise: More restructuring cases and potentially more insolvency cases should evolve in the mid-term once the relief granted by Covid-19-related state-aid programmes abates. Long-term structural trends, such as digitisation and structural transformation of certain sectors, e.g. automotive, energy and high street retail, will keep putting pressure on businesses. Moreover, businesses which are not able to meet the now ubiquitous environmental, social and governance (ESG) criteria of commercial banks and institutional investors should increasingly face difficulties in accessing equity and debt financing sources.

Furthermore, it is expected that the new German scheme should become the instrument of choice for financial restructurings of debtors with a diversified capital structure, in particular if the debtor is financed through *Schuldschein* loans or various bilateral credit agreements due to the possibility to cram-down passive or hold-out creditors. Lastly, with the implementation of the EU preventive restructuring framework in the various EU members states, such as the German scheme, the English law scheme of arrangement may become less attractive for non-UK domiciled companies. This trend towards a certain re-nationalisation of restructurings is aggravated by the legal uncertainties around cross-border recognition of English schemes of arrangement and the overall tendency of current jurisprudence to take a more critical view on COMI shifts.

Luxembourg

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As with the rest of the world, the Covid-19 pandemic has been affecting the operation of companies registered in Luxembourg in multiple ways. With new challenges lying ahead, and the health and economic crisis dragging on for much longer than what was expected in spring 2020, Luxembourg has adopted a pragmatic and flexible approach to support the local economic stakeholders and limit their prospects of facing insolvency. The efficacy of the numerous aids, guarantees, moratoria and other measures implemented and constantly reviewed by Luxembourg is demonstrated by the fact that there has not been a dramatic increase of businesses filing for bankruptcy so far.

In practice, businesses which were directly impacted by the various restrictions imposed by the Luxembourg government assessed whether they were eligible to benefit from the various state aids and measures offered by the state and whether this would be sufficient to keep them afloat until full resumption of their economic activities would be permitted. Aside from resorting to this safety net, the initiatives taken by businesses are manifold. Where possible, existing contracts with various stakeholders have been renegotiated or terminated. *Force majeure* and material adverse change (MAC) clauses have been invoked to suspend existing contracts.

Further to the relative success of the vaccination campaign and the full reopening of businesses, some state aids terminated, and businesses regained more control over their destiny, which underlines the importance of efficient management and the anticipation of economic challenges. In contrast to most European countries, which imposed full lockdown for several months, Luxembourg emphasised the importance of preventative measures to combat Covid-19 (for instance, by implementing extensive large scale testing) and allowed for some businesses (such as shops) to remain open

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almost all throughout the second half of 2020 and 2021, which mitigated the negative impact of the pandemic in specific sectors.

Basic framework

The most commonly initiated insolvency proceeding in Luxembourg is a bankruptcy proceeding, which aims to realise a debtor's assets and distribute the proceeds to the creditors in accordance with the order of priority as defined by law.

Where the two cumulative conditions for bankruptcy are not met yet – namely, cessation of payment and impairment of creditworthiness – a debtor, which must qualify as a merchant (*commerçant*) or be a commercial company, may apply for one of the three available alternative insolvency proceedings. Depending on the severity of the financial difficulties, these are: the suspension of payments (*sursis de paiement*); controlled management (*gestion contrôlée*); or scheme of composition with creditors (*concordat préventif de faillite*).

In practice, the benefits of alternative insolvency proceedings are rarely granted by courts as the applicable legal conditions are seldom fulfilled. This generally leaves judges with little option but to conclude that the applying company is bankrupt. Initiatives such as the bill of law No. 6539 on the preservation of companies and the modernisation of bankruptcy law (Insolvency Bill) and Directive (EU) 2019/1023 of June 20 2019 (Directive (EU) 2019/1023) are expected to endow Luxembourg with more flexible and effective reorganisation tools. However, the likely timing for the adoption of these new rules remains uncertain and the deadline for implementation of Directive (EU) 2019/1023 (which was July 17 2021) has passed.

Until these impending reforms are enacted, a more consensual approach, based on dialogue between a debtor and its creditors, should be sought to implement contractual debt restructurings where there are reasonable prospects of salvaging a distressed undertaking; however, if both the conditions of bankruptcy are met, a debtor is obliged to file for bankruptcy after expiry of the moratorium granted until December 31 2021 by the Luxembourg legislator as part of the Covid-19 measures.

This market dynamic means that the majority of published insolvency judgments in Luxembourg relate to bankruptcies. Since the Luxembourg private law system derives from both French and Belgian law, Luxembourg judges tend to refer to case law in these countries. International contractual restructurings also give rise to very few court cases in Luxembourg, moreover with legal issues at stake often relating to the enforcement of security interests governed by the law of August 5 2005 on financial collateral arrangements, as amended (the 2005 Law).

Bankruptcy proceedings are governed by Articles 437 ff. of the Luxembourg Commercial Code.

"Luxembourg offers three alternative insolvency proceedings"

The Luxembourg court must declare a debtor bankrupt if it is a merchant (*commerçant*) or a commercial company and the two following cumulative conditions are met: the debtor has ceased to make payments and its creditworthiness is impaired.

The court then proceeds with the appointment of one or several trustees in bankruptcy (*curateurs*) whose office is carried out under the review of a designated supervising judge. The trustee in bankruptcy must represent the interests of the insolvent estate as well as those of the creditors. Its mission is defined by law and consists, among other things, in: (i) initiating claw-back actions and actions for avoidance; (ii) realising the assets of the debtor; (iii) verifying the existence and extent of the claims against the insolvent estate; and (iv) proceeding with the distribution of the assets of the bankrupt according to the priority rules defined by law.

Bankruptcy proceedings commence either once a debtor files for bankruptcy – a debtor must do so within one month after the date of cessation of payments; after the presentation of a petition for bankruptcy by one or several creditors; or *ex officio* by the court, upon request from the Luxembourg State Prosecutor office. The company's management is deprived of managing the debtor's assets once bankruptcy proceedings have commenced.

When the debtor's situation is not yet irremediably compromised, it can turn to one of the three alternative insolvency proceedings, depending on the severity of his financial situation. However, as mentioned above, while these legal procedures exist on paper, they are rarely used in practice owing to the relatively stringent thresholds imposed by the conditions to which they are subject. Further, failure of any of the three alternative insolvency proceedings will almost invariably lead to bankruptcy.

Alternative options

Luxembourg offers three alternative insolvency proceedings.

The first is the suspension of payments (*sursis de paiement*), whereby the court orders suspension of payments of a distressed debtor for a limited period. The benefit of such a measure is reserved to a debtor that is forced to temporarily cease payments due to an unforeseen event and which presents sound evidence of its financial capacity to meet its liabilities in future. This procedure, which does not apply to certain debts and preferential claims, requires the approval of a majority in number of creditors that together represent 75% of outstanding unsecured debts.

The second is controlled management (*gestion contrôlée*), which aims at either reorganising the business of the debtor or realising its assets under the supervision of the court and of court-appointed commissioners. This procedure is available to debtors that (i) act in good faith and (ii) have lost their creditworthiness or are experiencing difficulties in fulfilling their payment obligations but do not meet the cumulative conditions for bankruptcy. If the debtor passes the preliminary steps of the procedure, court-appointed commissioners are entrusted with the preparation of a reorganisation plan or, as the case may be, an asset distribution plan. The plan is in turn submitted to the creditors. If a majority in number of all creditors representing more than 50% of the debtor's liabilities so consent, the plan will be presented to the court for final approval.

The third is a scheme of composition with creditors (*concordat préventif de faillite*), which aims at finding an agreement between a debtor and its creditors in a last-ditch attempt to avoid a declaration of bankruptcy. Unlike the two other proceedings, a scheme of composition is only available to the debtor that already meets the two cumulative conditions for bankruptcy (is virtually bankrupt). The agreement between the debtor and the creditors must be approved by a majority in number of the creditors representing 75% of the debtor's unsecured liabilities. Thereafter, if the court ratifies it, the arrangement will be binding on all unsecured creditors and those secured creditors who waived their rights of priority to become parties thereto.

There are no group-specific insolvency procedures under domestic law. However, Regulation (EU) 2015/848 of May 20 2015 on insolvency proceedings, as amended (Insolvency Regulation) contains a number of rules on the cooperation and communication between insolvency practitioners acting for insolvent entities of the same group.

Directors' duties

Directors of a company facing financial difficulties should be wary of not committing any actions for which they may potentially be held liable (criminally, contractually and/or in tort), should the company be declared bankrupt. In particular, directors should file for bankruptcy within the one-month deadline starting on the date of cessation of payments, as soon as the two cumulative conditions for bankruptcy are met (account being taken of any extension of the deadline owing to Covid-19, as briefly mentioned above and highlighted below). In addition, they should refrain from performing any acts which would be void or voidable further to the exercise by the trustee in bankruptcy of any clawback action or action for avoidance.

Formal filing

Commencement of a bankruptcy entails immediate suspension of all individual enforcement actions which creditors have initiated against the debtor. A similar suspension applies when a court has approved the opening of the initial phase of the procedure for controlled management (with the appointment of a judge to investigate the debtor's state of affairs) or the conclusion of a scheme of composition with creditors (but in the latter case, only *vis-à-*

vis the unsecured creditors and preferential or secured creditors who have foregone their preferential right or security to cast a vote regarding the approval of the scheme). In the event of a suspension of payments procedure, the court can grant a temporary stay during the investigation phase.

As a matter of principle, any contracts in existence at the date of the bankruptcy, other than staff employment contracts, will remain in force, unless: (i) they are declared null and void by a court further to the exercise of a claw-back action/action for avoidance by the trustee in bankruptcy; or (ii) they contain an automatic termination clause in the event of insolvency of one of the parties. Nevertheless, the trustee in bankruptcy may exercise a cherry-picking right and elect to terminate the contracts that he considers as unprofitable for the bankrupt.

Priority, dissenters, asset sales and clawbacks

The order of priority of creditors in the distribution of a bankrupt entity's assets is defined by law and cannot be varied by the trustee in bankruptcy or by the court.

The claims of secured creditors will be satisfied with the proceeds resulting from the sale of the assets, which were the subject-matter of the security interest. If funds obtained from the sale are insufficient, the unsatisfied part of the claim will rank equally and compete with those of unsecured creditors. In addition, collateral subject to the 2005 Law remain enforceable according to their terms despite the existence of insolvency proceedings. The same observation can be made in relation to mortgages over the bankrupt's assets.

The order of priority for other creditors is as follows:

- Claims incurred as a result of the bankruptcy, which arose after the bankruptcy commences (*créances de la masse*), including judicial expenses, and fees and expenses of the trustee in bankruptcy, debts to the treasury (for example, corporate taxes, income tax, etc.), and salary debts;
- Preferential claims (for example, certain employee claims, claims secured by a security interest other than financial collateral or a mortgage);
- Ordinary unsecured creditors (which can include claims arising from unsubordinated shareholder loans); and
- Subordinated claims.

If the funds are insufficient to satisfy all claims in full, they will be distributed *pari passu* (namely, on a pro rata basis). Any funds remaining after satisfaction of all claims, are distributed among the shareholders of the bankrupt company.

Luxembourg bankruptcy rules do not allow creditors to be crammed down, since the entitlement of creditors over the assets of the bankrupt is strictly regulated by law. As far as alternative proceedings are concerned, court-approved reorganisation plans, liquidation plans and arrangements are binding on all creditors that are required to comply with these instruments by effect of law, even if they voted against their implementation.

Luxembourg insolvency law does not provide for an accelerated or otherwise preferential form of asset sale. Pursuant to the Luxembourg Commercial Code, the sale of a bankrupt's assets is performed by the bankruptcy receiver with the prior consent of the delegated judge, or as the case may be, the competent court.

When exercising any claw-back action or action for avoidance which is prescribed by law, the trustee in bankruptcy can request the court to nullify agreements or actions which are void or voidable pursuant to Articles 445 to 448 of the Luxembourg Commercial Code. Accordingly, pursuant to Article 445, specific actions shall be null and void if they took place during the hardening period (i.e. a maximum period of six months prior to the date of the bankruptcy judgement) or 10 days preceding such period (such as any disposals of assets without consideration, or any payments of debts which have not fallen due). Moreover, by virtue of Article 448, all acts and payments made at any time by the bankrupt to defraud its creditors may be declared null and void, if the trustee in bankruptcy can establish complicity of a third party (who can be a creditor) as well as the reality of prejudice caused to the (other) creditors.

However, it is worth noting that some contracts, such as those subject to the 2005 Law or the law of July 10 2020 on professional payment guarantees (the PPG Law) are bankruptcy remote.

Some regulated entities in Luxembourg (such as credit institutions and insurance undertakings) are subject to special insolvency and restructuring regimes and are therefore not subject to the ordinary insolvency proceedings existing in Luxembourg. Nevertheless, the applicable laws can authorise the competent court to apply the rules of bankruptcy or as the case may be, only the rules on liquidation of bankruptcy to the winding-up of the regulated entity.

As a matter of principle, governmental or regulatory institutions do not have a say on the manner in which insolvency proceedings are conducted, since oversight of these procedures lies with the judicial courts. However, special powers are vested in Luxembourg regulators in relation to winding-up or reorganisation of certain regulated entities.

Crossing-borders

Luxembourg law does not contain specific provisions regulating cross-border aspects of insolvency cases.

Nevertheless, the Insolvency Regulation, according to which principal insolvency proceedings must be opened in the EU member state where the debtor's centre of main interests (COMI) is situated, allows for secondary insolvency proceedings to be commenced in any other EU member state where the debtor has an establishment. The effects of these secondary proceedings are limited to the territory of that member state and do not have to be liquidation proceedings.

The Insolvency Regulation also creates obligations of exchange of information and cooperation between (i) the insolvency practitioners in the main and secondary insolvency proceedings and (ii) the courts having ordered, or having to decide on, the commencement of such proceedings. The Insolvency Regulation also authorises the opening of group coordination proceedings for insolvent entities belonging to the same group, for which a coordinator is appointed.

The advantage of the Insolvency Regulation is that it allows automatic recognition and enforceability of judicial insolvency decisions in the other EU member states. In contrast, while the existence of non-EU insolvency decisions is generally recognised in Luxembourg, any related enforcement actions be taken in Luxembourg (for example, in relation to assets of the foreign bankrupt) are subject to the prior obtaining of the exequatur of the foreign decision.

If the COMI of a foreign debtor is located in Luxembourg, Luxembourg insolvency law should apply. By effect of Insolvency Regulation, main insolvency proceedings may be commenced in Luxembourg.

Covid-19

Creditors have generally taken a pragmatic approach towards their professional debtors. For instance, rather than enforcing claims immediately, they have granted moratoria or consented to renegotiate debts where the debtor's financial situation was not impaired before the outbreak of Covid-19 and showed prospects of improvement upon resumption of economic activities.

Six Luxembourg banks also committed to offer a six-month moratorium on the repayment of loans granted before April 18 2020 to small and mid-size enterprises (SMEs), self-employed and liberal professionals, provided they met certain conditions. The moratoria, which totalled approximately 4.5 billion as at the end of 2020, had to take effect before June 30 2020 and gave several businesses a lifeline. Some landlords also renounced the payment of some rents in order to help their commercial tenants to get back on track.

In order to support companies and individuals impacted by Covid-19, Luxembourg quickly adopted a 'stabilisation package' in March 2020, which comprises various laws and regulations. These measures are reviewed regularly in light of the situation in order to ensure that they are adequate and consistent with the evolution of the pandemic.

While some initiatives have been discontinued after businesses were allowed to reopen and vaccination programme ramped up, other regimes were prolonged or adapted to support certain economic sectors. Among those are repayable state aid owing to temporary financial difficulties linked to the Covid-19 crisis, which can be requested until November 1 2021. Moreover, the state-guarantee scheme for 85% of the total amount of eligible loans granted by participating Luxembourg banks has been periodically extended and is currently due to run until December 30 2021. The Luxembourg government reported that for the time being, no state guarantee had to be enforced and that the scheme was relatively little used owing to the efficacy of the other public measures offered by the state.

Another important measure concerning Luxembourg insolvency laws is the suspension of the mandatory one-month deadline, imposed on merchants and directors of commercial companies to file for bankruptcy, which is available until December 31 2021.

Finally, a Covid-19 working scheme (*chômage partiel*) for staff was implemented and maintained until June 30 2021. The scheme allowed undertakings to take employees concerned off the payroll. Alongside this measure was the introduction of two new mutually exclusive state aids for specific sectors, namely (i) an aid for 'costs not covered' (i.e. costs other those covered by the Covid-19 working scheme, other non-repayable state aids and insurance indemnities), which is currently covers the period ending on October 31 2021, and (ii) a recovery aid (*aide de relance*), which could be granted for the period running up to June 30 2021.

As a general note, businesses should be performing a review of their existing contracts to ensure that any *force majeure* clause expressly encompasses epidemics such as Covid-19. In addition, MAC clauses should now be more systematically inserted in contracts and cover sanitary crises in order to allow parties to vary or terminate their contractual obligations, since there is no end in sight yet to the Covid-19 crisis on a worldwide scale.

To date, there have been no permanent legislative changes concerning insolvency and restructuring which are directly linked to the Covid-19 crisis. However, the pandemic has hastened the passing of some laws which facilitate the granting of credit in Luxembourg. These include the PPG Law, which creates a new type of personal guarantee. A key feature of this guarantee is that it remains valid despite the existence of domestic or foreign insolvency proceedings or reorganisation proceedings over the guaranteed debtor.

Luxembourg has yet to transpose Directive (EU) 2019/1023, which aims to improve the effectiveness of different national regulations on preventive restructuring, insolvency and debt remission. Another pending reform is the Insolvency Bill, which is inspired by Belgian business insolvency legislation and prioritises (where practicable) the preservation/reorganisation of a debtor's business, rather than its winding-up.

Looking ahead

Although the latest figures show concrete signs of V-shaped recovery of the Luxembourg economy and the state revenues are higher for the first half of 2021 than in the corresponding periods in 2020 and 2019, the number of bankruptcies and judicial liquidations ordered by Luxembourg courts has slightly increased between January and June 2021 in comparison to the first six months of 2019 and 2020. It remains to be seen whether or not this trend in the opening of bankruptcy cases in Luxembourg will be confirmed in the second half of 2021, with state aids being progressively phased out as the health situation gradually normalises.

Although the economic challenges caused by the Covid-19 pandemic have been somewhat kept under control thanks to the measures taken by Luxembourg, this unprecedented crisis has highlighted the importance to go ahead with the modernisation of insolvency law. This area of law has generally been seen as rather lagging behind, when compared with Luxembourg business and finance laws, which are generally known for their innovative features and the flexibility they provide to businesses and investors. The introduction of new legal tools would also give formal support to the insolvency practitioners who generally keep on exploring new ways to help companies become solvent again.

Another trend that has been observed in court decisions published over the past decades and which may become more popular after the suspension of the obligation to file for bankruptcy expires, is the shifting of COMI by Luxembourg entities to other jurisdictions whose insolvency systems afford more flexibility to salvage businesses.

The Luxembourg market is also expected to experience a surge in out-of-court debt restructuring deals and the restructuring of international groups will be granted by courts located in jurisdictions offering efficient mechanisms to avoid bankruptcy/winding-up. More often than not, these transactions will involve the enforcement of financial collateral governed by the 2005 Law as it is common for cross-border groups to include Luxembourg companies in their corporate structure. In addition, the use of financial collateral arrangements, coupled with the recent creation of a new type of flexible guarantee under the PPG Law, could also have a positive effect on the granting of credit to businesses, since these efficient tools allow lenders to somehow limit the credit risk to which they are exposed.

Mexico

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Throughout 2020 and 2021, Mexico, like many other countries, has faced the consequences related to the health and economic impact derived from the global Covid-19 pandemic.

This pandemic exacerbated an already weak economic situation in Mexico causing an important economic contraction. Going into 2020, Mexico was already in a recession, due in part to falling investments resulting from political uncertainty and fiscal tightening.

Even as economies reopen – regardless of their size, and whether in the formal or informal sector –the recovery of most businesses and industries´ remains uncertain.

The government had earlier announced extended nationwide lockdowns and restrictions on non-essential economic activities. Businesses, among many other issues, faced a decrease in income and, in many cases, the need to continue incurring in fixed costs, which made them struggle financially and to default their credit payments and commercial obligations.

Courts were closed for almost three months and, currently, the operation of federal courts, regarding insolvency proceedings, still suffer many deficiencies due to the pandemic restrictions.

Unlike some other countries, which had quickly responded by enacting emergency legislation and implementing measures concerning restructurings, rights of creditors and insolvency proceedings, Mexico did not implement or modify its insolvency laws during the period.

On top of this, while many economies relied on government support which provided a significant relief to businesses (loan guarantees and wage subsidies for workers, tax stimulus and moratoria), this was not the case of Mexico. There has been very limited government support for the private sector. It is reported that Mexico has only spent around 0.7% of GDP on tackling this crisis, and mainly providing loans to low income households, compared to, for

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Alejandro has more than 30 years of experience advising and representing clients in the practices of cross-border insolvency and restructurings (out-of-court and in-court – concursos mercantiles), finance, refinancing and corporate reorganisations, as well as in the purchase and sale of assets in special situations and distress. Throughout his vast experience, he has represented clients from various industries, both nationally and internationally, domestic and foreign companies, public and private, as well as several ad-hoc committees of international bondholders and noteholders issued abroad by Mexican issuers.

Alejandro is a graduate of the Panamerican University and has completed further postgraduate qualifications at Harvard University. He is also a certified mediator by the Mexican Institute of Mediation, and was a professor at the Ibero-American University.

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example, an 8% of GDP in Brazil and an average of 4% in emerging markets.

It is unquestionable that the current worldwide health emergency, and its serious effects on the Mexican economy, will force businesses in various sectors and industries to evaluate their financial liquidity and define plans to avoid insolvency or even bankruptcy.

The effects of this pandemic, which are expected to be felt for at least an extended period of months (or even years), require that companies look for alternative sources of income and liquidity, organisational reorganisations and negotiation with their creditors, out-of-court and in-court.

These turbulent times have led and will continue to lead to a waterfall of restructurings and workouts in various industries. Companies will need to identify inefficiencies, suspend non-essential operations, optimise activities, and negotiate amendments to their business plans and contractual terms considering the current scenario.

Corporate reorganisations and out-of-court restructurings to stabilise business operations should be definitely considered before deciding for an in-court insolvency or liquidation proceeding of any business. However, when this is not possible, the restructuring and insolvency proceeding, known as *concurso*, which is the only formal insolvency procedure available in Mexico, will be the alternative for both debtors and creditors.

In the coming months and years, insolvency lawyers will be focusing on mitigating the impact of the global pandemic on companies' operations, finances and disputes. Experts will have to provide, more than ever, creative and agile strategies to adopt responsive actions to present and future threats that this pandemic could generate in different areas.

Framework

The Concursos Law provides for a single insolvency proceeding known as *concurso mercantil* (conciliation/restructuring or insolvency/bankruptcy procedure). The applicable laws to restructurings and insolvency proceedings are mainly the Concursos Law, the General Law on Business Organisations, the Law of Credit Institutions, and the Law of Insurance and Bonds Institutions.

A debtor may consider a corporate reorganisation and out-of-court restructuring to stabilise business operations before deciding for an in-court insolvency or liquidation proceeding of any business.

Many restructuring proceedings in Mexico begin as informal and/or consensual efforts. Ending in a judicial proceeding would depend on the various circumstances around the negotiations and status of the debtor. The possibility of aligning interests and positions of different creditors is essential as well as the ability to reach a

reorganisation agreement. It is likely that if, sophisticated creditors (banks, funds) are involved – which occurs in major restructurings – they will try to be co-operative to reach a reorganisation agreement that may serve to restructure the debtor out-of-court or prepare it for pre-pack, in-court proceedings – a more expeditious procedure than a regular proceeding.

"Many restructuring proceedings in Mexico begin as informal and/or consensual efforts"

Processes and procedures

The debtor itself, any creditor, the district attorney, a judge, and tax authorities in their capacity as creditors, may file insolvency claims. With the petition filed by creditors or authority (involuntary) or the insolvency petition filed by the company (voluntary), as the case may be, a guaranty or bond must be posted to secure the examiner's fee payment.

Debtors which are part of the same corporate group may simultaneously request the joint judicial *concurso* declaration, without need of estate consolidation. For the joint *concurso* procedure it is enough that one of the parties of the group is under the assumptions of insolvency under the Concursos Law, and that such condition places one or more of the parties forming the corporate group under the same situation.

Creditors of debtors that are part of a group that meet the assumptions described above may claim the joint judicial *concurso* procedure. The joint judicial *concurso* procedure can be cumulative with other *concurso* procedures.

Formal filing

All creditors of the debtor, whether domestic or foreign, shall have access to the *concurso* procedure, and shall collect in equal proportion (according to the class) from the assets located within the territorial jurisdiction of the court.

The general rule is that contracts must be honoured by the debtor, unless the conciliator rejects the contract. Even if the debtor or its management remains in control of its business, the conciliator is entitled to accept or reject executory contracts, incur new indebtedness, substitute collateral and sell assets outside the regular course of business.

With some exceptions, any contractual stipulation, which – due to the filing of a voluntary petition for *concurso* or the issuance of the declaration of insolvency – sets modifications that worsen the contract terms for the debtor, shall be deemed as not included.

In most cases, it is unlikely that a successful out-of-court restructuring may be reached over the dissent of a minority of creditors. An express procedure for cramming down creditors that do not approve proposals approved within these procedures, as permitted under other foreign jurisdictions, is not expressly contemplated by the Concursos Law. However, when an in-court restructuring agreement is reached by more than 50% in a *concurso* proceeding the conditions of unsecured creditors are uniformed.

There are various legal actions available to creditors prior to a formal insolvency proceeding to recover on a defaulted loan or obligation of a debtor. The action proceedings (foreclosure, attachment, temporary restraining orders, preliminary discovery or pre-filing motions, etc) would vary depending on the type of agreement, source of the action to be followed (civil, mercantile, ordinary, special), whether collateral was granted, whether promissory notes were issued, type of collateral, etc.

Creditors are entitled to challenge resolutions issued within a *concurso* proceeding. Although the proceeding will not be suspended, such actions may certainly disrupt or delay the process.

It is important to bear in mind that following the *concurso* judgment and even in the preliminary stage of *visita*, the court (based on its own opinion or the examiner's recommendation) may issue restriction orders on the debtor's business operations, including a prohibition to make any due payments of existing obligations or disposing of any property.

Distressed assets and businesses

During insolvency proceedings, the sale of assets to protect the ongoing concern of the debtor shall be subject to the conciliator or intervenor's approval. The purchaser will acquire good title as long as the sale is conducted in the same terms as a public auction. The receiver shall follow the rules of publicity and operability to guaranty the transparency of a sale procedure.

The directors of a company that has not been declared insolvent by a competent court may not be liable for continuing to operate a company under financial distress. However, the transactions related to the collection of a creditor's rights could be subject to review when the company is declared insolvent.

In the event that the company is declared insolvent, directors engaging in any malicious act or conduct that causes the non-performance of the company's payment obligations might be liable to civil actions or even criminal liability, if those acts are proven to be fraudulent.

The Concursos Law provides for events during which a director or managing officer will become liable to the debtor, for the benefit of the estate of the company in a *concurso* procedure, for any damages and losses of anticipated earnings caused by any unlawful decision they had made, provided they cause damage to the estate of the debtor which led to the insolvency situation of the company. This is regardless of any liability incurred by the director or managing officer under any other law.

Unless good faith and compliance with the duties of care and loyalty can be evidenced members of the board of directors, as well as relevant employees, of the debtor shall be liable for damages and losses.

Furthermore, as the company is a legal entity, criminal liability might be pursued against the members of its board of directors, administrators, managers or liquidators who were the authors of, or participated in any criminal offence.

"Various amendments and new rules and regulations are required at various levels: The Ministry of Finance, the Mexican Securities and Exchange Commission and the IFECOM"

An express procedure for cramming down creditors that do not approve proposals approved within these procedures, as permitted under other foreign jurisdictions, is not expressly contemplated by the Concursos Law. However, when an in-court restructuring agreement is reached by more than 50% in a *concurso* proceeding the conditions of unsecured creditors are uniformed.

Pursuant to the Concursos Law, some transactions may be invalidated if entered into during the period starting on the day which is 270 calendar days prior to the declaration of insolvency by a competent court. Such period can be extended up to three years under some situations regulated by law and would be doubled for intercompany transactions.

Creditors are also entitled to challenge resolutions issued within a *concurso* proceeding. Although the proceeding will not be suspended, such actions may certainly disrupt or delay the process.

Protection for post-petition credit

The existing Concursos Law classifies creditors into the following categories or classes (and with the following rankings or preferences):

- First priority claims against the 'estate' of the debtor (*créditos contra la masa*), which includes:
- Special labour claims under Section XXIII, Chapter A, of Article 123 of the Constitution, and applicable regulations;
- Debt incurred for the management of the estate of the debtor with the authorisation of the conciliator or the receiver, as the case may be, or those contracted directly by the conciliator;
- Debt incurred to cover ordinary expenses for the safety and protection of the estate; and
- Debt incurred from the judicial or extra-judicial acts for the benefit of the estate; provided, however, that under Article 225 of the Concursos Law against the secured creditors, with mortgages or pledges, or creditors with special privilege, the preference or privilege of the claims against the estate would not apply, except for the following claims: the special labour claims referred in subsection (a) above, the litigation expenses incurred for the defense or recovery of the goods or assets subject to the security interest of the secured claims or over those assets related to the 'special privilege', and the expenses necessary for the repair, conservation and sale of those assets;
- Singularly privileged creditors;
- Secured creditors (with mortgages and pledges over assets of the debtor) and tax claims secured with a security in rem (up to the value of such guaranty) are paid first with proceeds from the sale of mortgaged or pledged items; if the items have a value or a price in excess of the debt, any such excess or remaining value is directed to cover subsequent debt payments to other creditors; if the price does not cover the debt, mortgage or pledge, the corresponding creditor may participate, pro rata, as a common or unsecured creditor, to collect the remaining amount);
- Other tax claims and labour claims;
- Creditors with a special privilege (i.e. those with a guaranty trust)
- Unsecured creditors; and
- Subordinated creditors (inter-company claims).

Special provisions govern the reorganisation of public service companies, credit institutions and bonded warehouses. These procedures shall be subject to the Concursos Law and to the specific applicable laws, regulations, and concession titles, as the case may be. The agencies responsible for

overseeing such public service companies have the right to commence a case and direct the *Instituto Federal de Especialistas de Concursos Mercantiles* (the Federal Institute of Experts in Insolvency Proceedings – IFECOM) to appoint the specialists ordinarily appointed at its discretion

Crossing-borders

According to the Concursos Law, a foreign proceeding is as a collective or universal proceeding, whether judicial or administrative, including provisional proceedings, in a foreign state pursuant to a law governing bankruptcy, liquidation, or insolvency matters of the debtor.

The Concursos Law recognises foreign proceedings in bankruptcy, insolvency and reorganisation matters, and it recognises foreign representatives appointed through a recognition request. In this regard, the Concursos Law recognises foreign proceedings when legally held in a foreign country in accordance with bankruptcy or insolvency laws applicable to the debtor due to its activities, the location of assets or other similar causes.

Pursuant to the Concursos Law, the following are the alternatives under which a Mexican court can recognise a foreign bankruptcy procedure:

- As a principal procedure, when the foreign procedure is brought to a court with jurisdiction in the place where the business has its main place of interests; or
- As a non-principal procedure, when the foreign procedure is brought to a court with jurisdiction in the place where the business has an establishment. The main difference between the two is in the direct effect of such recognition over the business's assets located in Mexico.

If a foreign bankruptcy procedure is recognised as a principal procedure then any and all foreclosure over the business's assets, and any and all rights to transfer or grant any lien over business' assets, shall be suspended.

A Mexican court shall recognise the foreign bankruptcy procedure as a non-principal procedure if the debtor has a permanent place of business outside Mexican territory, but not as a principal foreign bankruptcy procedure.

Upon the recognition of a foreign procedure, the foreign representative will be able to ask the receiver, conciliator or examiner, to entrust, through a foreign representative, the distribution of all the business' assets located in Mexican territory. The Mexican court must make sure that the creditors' interests domiciled in Mexico are sufficiently protected so that it may decree the injunctions briefed above.

The foreign representative has the power and capacity to ask that the examiner, the conciliator or the receiver initiates the recovery of assets actions for the recovery of assets that belong to the entirety of a property, and of nullity acts concerning the defrauding of creditors. The authorisation of the foreign representative to take part in the procedures promoted against the businessman that are in the proceedings and that have a patrimonial content can take place.

The injunctions that may arise from the recognition of a foreign bankruptcy procedure under a *concurso* procedure depend on the procedural phase, namely as from the filing of the recognition request throughout the corresponding resolution, and as from the issuance of the recognition resolution.

Therefore, and provided that the above-mentioned is followed, if a company organised under the laws of Mexico entered into extraterritorial bankruptcy or insolvency proceedings then those proceedings would be recognised within Mexican jurisdiction.

With respect to the insolvency matters, the international documents that served as basis for the current provisions of the Concursos Law are the 'Model Law for Cross Border Insolvency' of the UNIDROIT and the 'Effective Insolvency Systems' of the World Bank.

Looking ahead

Mexican companies and creditors have always faced uncertainty in their local insolvency and restructure proceedings. Some serious disadvantages are that local courts are not educated and specialised on these matters. There is no certainty on the admission of the petition, timing of the proceeding or courts decisions. The courts' discretion and contradictions in precedents make the process unpredictable.

Likewise, the preliminary *visita* (inspection) stage is not expedite and in many cases, it only deteriorates the economic situation of the distressed companies. Appeals and *amparos* (constitutional remedy) are available and frequently used by the parties delaying the process. On the other hand, pre-packed reorganisation proceedings are available and have proven successful outcomes for many debtors and participating creditors.

In Mexico, due to the health emergency that begun mid-March 2020, the federal courts were initially closed and afterwards the operation of federal courts were limited to 'urgent cases'. The courts refused initially to hear insolvency cases by rejecting petitions and filings, as well as the reorganisation process of on-going *concursos* were delayed, which caused negative impact on debtors and stakeholders in delaying filings or outcomes of reorganisations.

An initiative to modify the Concurso Law was published in the Senate Gazette in April 2020, and it intended to include an 'Emergency Regime' to serve as a tool in assisting debtors in having an expedite access to courts in an unforeseen circumstance, *force majeure* or emergency declaration, health contingency or natural disaster. This Emergency Regime provided a 'fast-track' proceeding to allow debtors to have rapid access to debtor-in-possession (DIP) financing, automatic-stay, other measures to preserve the on-going concern, and be able to emerge through a summarised procedure. To date, this initiative has not been approved and the road ahead may be a long one.

However, amendments of this nature are undoubtedly necessary to provide legal certainty and some relief to businesses and an environment to thrive and survive exceptional times and will certainly affect all areas of society and doing business.

These modifications alone will not be enough if additional changes in the insolvency and restructuring Mexican legislation are not made. Various amendments and new rules and regulations are required at various levels: The Ministry of Finance, the Mexican Securities and Exchange Commission and the IFECOM.

Ideally, specialised courts should be created given the particular and complicated nature of insolvency proceedings and the significant increase in the filing of these measures. The judicial power should receive constant training and education on insolvency and bankruptcy matters so they are prepared to assist companies in distress and maintain their existence to avoid that a generalised default in its payment obligations, put at risk their viability and that of those with whom it makes business.

Moreover, the insolvency sector should be strengthened by increasing the number of courts and courts' capacity as well as the implementation of technology to have full electronic access to the docket, filing of motions and even including virtual hearings.

Poland

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The Covid-19 pandemic has undoubtedly changed the rules of doing business. Businesses had to adapt to the new reality practically overnight. Numerous restrictions on the freedom of business activity caused financial problems for entire industries and sectors of the economy.

In Poland, as in many other countries, in order to limit the economic and social effects of Covid-19, businesses received financial aid from the state budget, which was aimed at maintaining jobs and preventing a wave of bankruptcies.

In addition, a new solution has been introduced into the restructuring law to make it easier for debtors in financial difficulty to complete the restructuring process quickly.

As it turned out, this solution has changed restructuring practice in Poland.

Changes to the restructuring law

In June 2020, one of the anti-crisis shields introduced a separate restructuring procedure (the so-called 'simplified restructuring proceedings'). This change enabled the debtor to initiate and conduct restructuring proceedings practically without court review. This procedure was deformalised to the maximum extent possible.

To commence the proceedings, it is enough for the debtor to announce the opening of restructuring proceedings in *Monitor Sądowy i Gospodarczy*. From this date onwards, the debtor is protected against enforcement by all creditors. As of this date too, it is prohibited to terminate any contracts considered key for the debtor, such as leasing, loan, rental or lease agreements.

Suspension of all enforcement proceedings and the possibility of terminating contracts remain in place for four months from the date of the announcement of the opening of restructuring proceedings.

It is the legislator's intention that within this period the debtor should conclude agreements with creditors and file

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an application with the court for approval of the arrangement.

The simplified restructuring proceedings have transferred control over the course of the procedure entirely to the debtor, who will be left with both his own management over the enterprise and the right to select a restructuring advisor of his choice who will support and, according to the legislator's intention, control the course of the restructuring procedure.

The position of creditors and their impact on the opening and course of restructuring proceedings have been marginalised. Even in a situation where creditors are not interested in the arrangement, on the basis of his own individual decision the debtor may open the restructuring proceedings and block any actions by the creditors. Considering that the role of the court is confined to possible approval of the arrangement at the final stage of the restructuring proceedings, control over the proceedings rests entirely with the debtor.

Given that simplified arrangement proceedings are designed so favourably for the debtor, it is not surprising that they are currently the most popular restructuring method and accounted for about two thirds of all restructuring proceedings in Poland in 2020, while in 2021 this proportion has already reached 80%.

These proceedings were introduced as a temporary measure. Initially, debtors could avail of this option until June 30 2021. In a situation that saw the greatest economic difficulties related to the pandemic, it was possible to justify such privileging of the debtor.

Nevertheless, as often happens in life, makeshift solutions turn out to be quite permanent. Now, the effective period of the act has been extended until November 30 2021, and from December 2021, the main assumptions will be permanently implemented into the restructuring law.

Effects of public aid granted to businesses

A somewhat surprising effect of the public aid granted to businesses during the Covid-19 pandemic in Poland was the drop in the number of bankruptcies in 2020.

As statistics show, this is a regular pattern not only in Poland but also in other European countries. The drop in the number of bankruptcies is mostly attributed to the huge financial support provided by the governments to counter the economic effects of Covid-19. However, in many cases, following the absorption of public aid due to the changes in the manner of conducting business activity (which are often of a permanent nature), some entities will not regain their financial balance and will go bankrupt. Due to the pandemic, customer preferences have changed. Therefore, some businesses will not be able to adapt and will declare bankruptcy or require restructuring.

Therefore, it seems that in Poland, the statistics on the number of new bankruptcies and restructuring procedures will continue to grow, which seems to be reflected in the statistics for the first half of 2021, according to which the number of bankruptcies is indeed growing.

The increase in the number of bankruptcies will be a result not only of the depletion of funds from direct public aid for businesses, but will also result from the increase in the tax burden of economic activity, which will most likely occur at the beginning of 2022. Tax increases for businesses are part of the new government program, the so-called 'Polish order'.

Hence, the number of bankruptcy and restructuring cases will grow, but this increase will be spread out over time.

The specific character of the Polish situation as regards combating the Covid-19 pandemic was the introduction by the Polish government of restrictions on business activity by means of regulations, i.e. legal acts of a relatively low rank within the Polish legal system. This practice – criticised already at the time the regulations were issued – seems to have been unlawful in the light of court judgments currently being issued in Poland. It follows from these judgments that restrictions on conducting business activity should be introduced only by means of a statute. The current line of jurisprudence, unless it changes, will have huge implications for the legal situation in Poland because entire industries closed or otherwise affected by the lockdown will be able to take legal action to claim damages from the Polish state.

Legal framework of restructuring

In Poland, restructuring law – as a separate area of law – has only relatively recently been individually regulated in an autonomous legal act. The Restructuring Law was passed in 2015, and the act itself entered into force at the beginning of 2016.

Admittedly, it had been possible before for a debtor to conclude an arrangement with creditors, but only as part of the bankruptcy procedure in accordance with the Bankruptcy Law. In practice, the provisions concerning the possibility of concluding an arrangement under bankruptcy proceedings did not meet the parties' expectations because by the time the

"A somewhat surprising effect of the public aid granted to businesses during the Covid-19 pandemic in Poland was the drop in the number of bankruptcies in 2020"

conditions for declaring bankruptcy were met, it was usually too late to initiate the arrangement procedure and for the enterprise to recover from the crisis.

With the introduction of the Restructuring Law in Poland, the previous systemic assumptions have been changed. Under the new regulations, a change has occurred regarding the principle that in bankruptcy or restructuring proceedings the interests of the creditors are to be secured first, and only afterwards are the debtor's interests considered.

This change in priorities is becoming clearer with each new amendment to the restructuring law in Poland such as the above-mentioned regulation on simplified restructuring proceedings.

The shift from the principle of creditor protection to the principle of debtor protection is, in a way, the result of the implementation of EU law (the so-called 'second chance directive'). Choosing primacy of debtor protection over the creditor's interests has significant social and economic consequences. Cheap and quick debt relief procedures change ethical attitudes in business, promoting irresponsibility and gambling-like approaches.

Despite these reservations, the doctrine of so-called 'second chance' or 'new beginning' is becoming well-established both in European and Polish law. Without denying the need to introduce regulations to protect debtors and allow them to return to the market, this process should not be carried out at the expense of the legitimate interests of creditors. Meanwhile, bankruptcy has become one of the strategies for dealing with financial problems.

Legislators both in Poland and in other parts of Europe seem to ignore the negative impact of excessively liberal regulations on ethical attitudes in business. They seem to focus on arguments related to alleged job protection, as though only debtors – but not creditors – were creating jobs.

This attitude of moral hazard was aptly summed up by Alan Greenspan, the former president of the US Central Bank, who pointed out that "the number of bankruptcies is growing because Americans have lost their sense of shame".

Types and course of restructuring in Poland

In principle, Polish law distinguishes four types of restructuring proceedings:

1) Arrangement approval proceedings;
2) Fast-track arrangement proceedings;
3) Ordinary proceedings; and
4) Remedial ('sanation') proceedings.

According to the legislator, the introduction of four types of proceedings was designed to ensure a choice of the form of restructuring that would be best for a specific business. Nevertheless, it causes unnecessary complications in the restructuring processes, all the more that the rules for all of these proceedings are basically the same.

In all cases:

- The proceedings cover all debt which arose before the opening of the restructuring proceedings;
- The debtor is obliged to pay – on an ongoing basis – any debts that arise after the opening of the proceedings;
- After the proceedings have been opened, the restructuring plan and arrangement proposals are prepared;
- Creditors vote on the arrangement, which is then approved by the court; and
- Approval of the arrangement is followed by the implementation phase.

In the first three cases, only the debtor may file an application and initiate restructuring proceedings, and the rule is to preserve his management rights. Only in the case of remedial proceedings is it possible for creditors to submit an application. Additionally, in remedial proceedings, the rule is that the debtor is deprived of the management on his entire property. Remedial proceedings are intended for the 'most severe cases' in which deep restructuring is needed, including the sale of part of the debtor's assets.

On the debtor's part, the opening of the restructuring proceedings results in a prohibition on paying back the debts covered by the arrangement (i.e. those that arose before the opening of the restructuring proceedings) and in enforcement immunity protecting the debtor's assets. Pending enforcement proceedings are suspended by operation of the law. Creditors cannot initiate new enforcement proceedings against the debtor's assets. At the debtor's request, the court may revoke divestments of the debtor's assets made by the creditors.

The restructuring process is aimed, in principle, at preserving the debtor's property, not at selling it. The restructuring law provides for the procedure of selling the debtor's assets with the consent of the judge-commissioner only in the case of recovery proceedings. This sale has the effect of an enforcement sale and causes the security on the debtor's property to lapse.

Pre-pack

However, if the debtor's restructuring is to involve the sale of the debtor's enterprise, the provisions of bankruptcy law – which allow for the so-called 'pre-pack' – can be applied. To this end, the debtor or any of his creditors may apply to the court for an approval of the terms of sale of the debtor's enterprise (or its organised part) to a designated buyer.

The application for approval of the terms of sale should be accompanied by a proof of payment of the tender guarantee in the amount of one tenth of the offered price and an estimate of the value of the enterprise (or its organised part) prepared by a person entered on the list of court experts. The court accepts the application for approval of the terms of sale if the price is higher than the amount obtainable in bankruptcy proceedings, less the costs of the proceedings and other liabilities of the bankruptcy estate that would have been incurred in such liquidation.

Liability of management board members for the company's obligations

Pursuant to Polish law, management board members are required to file a bankruptcy petition with the court no later than 30 days from the date on which the grounds for declaration of bankruptcy occurred.

There are two prerequisites for bankruptcy: failure to settle due liabilities for at least three months, or when the value of liabilities is higher than the value of the debtor's assets. Members of the management board are liable to creditors for damage caused as a result of a failure to submit the application within the above-mentioned period, unless they are not guilty of failure to submit the application or if, within 30 days of the date when the prerequisites for bankruptcy are met, restructuring proceedings were opened against the debtor or an arrangement was approved in the arrangement approval procedure.

If the members of the company's management board fail to file a bankruptcy petition within the above-mentioned period they are liable with their personal property for the company's obligations towards creditors, as well as for public law obligations.

Liability of creditors

In order to prevent creditors from submitting unjustified bankruptcy petitions, a regulation has been introduced that allows such a creditor to be charged with the costs of the proceedings, and the court may order such a creditor to issue a public statement with appropriate content and in an appropriate form. Additionally, the debtor may pursue claims for damages from the creditor.

Protection of the bankruptcy estate

In order to protect the bankruptcy estate and prevent negative actions by the debtor

"The lack of uniform jurisprudence may become a problem in the development of restructuring in Poland"

"The role of simplified restructuring as the fastest and most informal form of restructuring will continue to grow"

(such as paying off only selected creditors), Polish law provides that legal actions performed by the debtor within a year before the filing date of the bankruptcy petition through which it disposes of its assets are deemed ineffective if they were made free of charge or for a fee, but where the value of the debtor's services significantly exceeded the value of the benefit received by it. Similarly, all legal actions taken by the debtor within the six months before the bankruptcy petition filing date involving the debtor's family or related entities are deemed ineffective.

It is also possible for the remuneration of the managerial staff or key employees of the debtor to be deemed ineffective if they are not justified by the amount of their actual work. Similarly, it is possible for securities established on the debtor's assets within six months before the date the bankruptcy petition is filed to be deemed ineffective.

Financing of restructuring proceedings

In practically all restructuring proceedings, to be implemented effectively it is necessary to provide an external source of financing, which is when an entity is already experiencing financial difficulties.

In order to make it easier to find potential financing, Polish restructuring law provides for privileges for entities that will assume the risk of granting financing during the restructuring process. Such an entity may be granted more favourable terms of repayment of its debt than other creditors, and it is also possible to establish security for such financing on the debtor's assets during the restructuring proceedings.

In the event of a failure of the restructuring proceedings and debtor's declaration of bankruptcy, such debts are satisfied in a higher category of satisfaction than the debtor's other receivables.

Separate procedures

Separate proceedings are provided concerning developers and bond issuers. In the case of developers, the introduction of a separate procedure results from the legislator's intention to secure the interests of one group of the developer's clients, namely natural persons who have concluded agreements with the developer concerning building and transfer of the ownership of residential premises.

In the case of bond issuers, the justification for a separate regulation is the need to ensure the protection of bondholders, as well as to ensure their uniform representation because of the fact that bond issues are often dispersed and targeted at an undefined group of entities. As regards bankruptcy proceedings, there are separate proceedings for banks and consumers, i.e. natural persons acting outside the scope of an economic activity.

Cross-border regulations

As regards bankruptcy and cross-border restructuring, the provisions of Polish law are compatible with Regulation (EU) 2015/848 of the European Parliament and of the Council of May 20 2015, according to which Polish courts have exclusive jurisdiction over restructuring cases in which the debtor's principle place of business is located in the Republic of Poland.

Polish courts also have jurisdiction if the debtor conducts business in the Republic of Poland or has a place of residence, registered office, or property in the country. Creditors who have their place of residence or registered office abroad enjoy the same rights in restructuring or bankruptcy proceedings as creditors whose place of residence or registered office is located in Poland. The opening of restructuring proceedings abroad does not preclude the opening of such proceedings in Poland if an entity has its branch in the country.

Therefore, there are no obstacles to opening bankruptcy proceedings in Poland against a foreign debtor if any of its assets are located in Poland. In the event of a declaration of bankruptcy of a foreign debtor which has its assets in Poland, it is also possible to recognise a bankruptcy decision issued by a foreign court. The result of such recognition will be a declaration of bankruptcy with regard to assets located in Poland.

A look to the future

It seems that the role of the restructuring law will increase due to the increasingly liberal approach of the legislator to the so-called 'second chance'. Other effects will be an increase in the number of restructuring proceedings, as well as the removal of the social odium from an entity that does not pay debts.

The role of simplified restructuring as the fastest and most informal form of restructuring will continue to grow. The lack of uniform jurisprudence may become a problem in the development of restructuring in Poland. Restructuring proceedings are conducted in district courts, which are the lowest courts in the hierarchy of courts in Poland. Appeals against their decisions are processed by regional courts. Due to the exclusion of the possibility of submitting cassation appeals to the Supreme Court at the level of regional courts (of which there are 46 in Poland), different judgments are made with reference to the same legal issues, which causes considerable legal uncertainty.

It is also probable that in the near future, the number of bankruptcies will increase due to the expiry of the aid programmes for businesses that were launched during the pandemic. In addition, the likelihood of this scenario is supported by the significant state indebtedness as a result of Covid-19 and, consequently, an increase in taxes, whether direct or indirect.

Russia

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Covid-19 has led to negative consequences for most sectors of the economy in many countries around the world and Russia is no exception. The introduction of a high alert regime in the spring of 2020 actually stopped or complicated the activities of most companies.

Considering this, it is important for creditors to control the financial and general economic situation of their large debtors during the coronavirus pandemic, in order to:

- Monitor their financial state;
- Collect information about the transactions performed; and
- File suits for the collection of large debts without waiting for the end of the moratorium on initiation of bankruptcy proceedings.

As for managers of companies and beneficiaries, who are under huge pressure of possible subsidiary liability due to current court practice, it could be beneficial to have documents confirming specific causes of financial difficulties of the company (independently or with the involvement of specialists), to prepare written plans for overcoming crisis situations, to coordinate actions with the shareholders, and to implement other measures securing their finances in case of company insolvency.

The more high-quality documents that confirm the good faith and reasonableness of management decisions (for both the debtor and creditors), the better chances that the manager and/or beneficiary has to protect their interests and to avoid subsidiary liability in the event of company bankruptcy.

Impact of Covid-19

As one of the support measures during the pandemic, the Russian government announced from April 4 2020, a moratorium on the initiation of bankruptcy proceedings for companies acting in the most affected industries (the

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moratorium was in effect until January 7 2021). The moratorium covered companies in particularly affected areas of activity, including tourism and transport, backbone organisations and strategic enterprises.

While the moratorium was imposed, the courts had to return applications for declaring the debtor bankrupt. Meanwhile, a number of restrictions were imposed on such debtors, the most important of which are as follows:

- The withdrawal of members and shareholders from the company, redemption by the debtor of placed shares were not allowed;
- The debtor's obligations could not be terminated by offset, if this violates the order of satisfaction of creditors' claims;
- Payment of dividends or income by shares, as well as distribution of profits between the participants of the debtor were not allowed;
- Penalties and other financial sanctions for non-fulfilment of monetary obligations and mandatory payments were not charged;
- Foreclosing on the pledged property both in a judicial and extrajudicial procedure was not allowed; and
- The enforcement proceedings were suspended.

Additionally, special rules were implemented for preventing the withdrawal of assets from companies that fell under the moratorium. Particularly, if within three months after the end of the moratorium, a bankruptcy case is initiated against the company, all its transactions related to the transfer of property and the assumption of obligations committed during the period of the moratorium will be declared null and void.

As practice has shown, on the one hand, the imposed moratorium helped maintain financial stability for companies most affected by the crisis. On the other hand, since no one cancelled debts on taxes, rent or salaries from companies, they continued to accumulate debts.

Legislative reform

Russian bankruptcy law is going through a number of changes. The most significant changes were introduced on December 5 2019 by the Ministry of Economic Development. The introduced bill aimed to solve such problems of Russian bankruptcy such as the absence of working procedures for restoring the solvency of companies, the lack of independence of an arbitration manager from the debtor and creditors, and from being a sophisticated mechanism for selling assets of a bankrupt company at auction.

The bill proposes a list of measures, including abolishing three bankruptcy procedures (supervision, financial recovery and external management) and introducing rehabilitation (which has been successfully applied since 2015 in the bankruptcy of citizens) instead of them.

Another important and controversial novelty is the new procedure for appointing an arbitration manager – randomly based on

ranking. The key performance indicators for getting a higher ranking are creditors' repayment rates and property sale prices. However, these factors are often beyond the control of arbitration managers, especially given that most debtors go into bankruptcy without assets. On the other hand, it is still unclear whether the competence, conscientiousness and other factors are deeply connected with the personality of an arbitration manager that will be included in factors influencing their rank position or not.

Another controversial and debated novel is the ability of arbitration managers to consider the validity of the creditor's claims and to establish them in the debtor's register outside of the court procedure. The possibility of ensuring independence and impartiality in their assessment of claims is highly questionable. In practice, it is possible to 'duplicate' the process of establishing creditors' claims, when first they are considered by the arbitration manager, and then by the court based on the incoming statements about the unfoundedness of the decision of the arbitration manager.

The new edition of the bill No. 1172553-7, based on proposals of the Ministry of Economic Development, was presented in March 2020. It caused a lot of controversy among the state authorities and the legal community. Therefore, it is not clear whether it will be accepted by the parliament and what changes will be implemented on this way.

Framework

One of the most sensitive issues, which raises many disputes, is a broad interpretation of the 'persons controlling the debtor' for the purpose of subsidiary responsibility. According to the renewed chapter of the Federal Law on Insolvency (Bankruptcy) , any natural person or legal entity that could give orders to the debtor or could determine actions of the debtor in another way within three years before signs of the debtor's insolvency occurred or later, up to the acceptance of the application on debtor's insolvency by the court can be recognised as the person controlling the debtor. Therefore, a list of such persons is non-exhaustive and vague.

The latest court decisions on this matter raise huge concerns. In particular, courts impose subsidiary liability on general accountants and accounting outsourcing companies, spouses and children of managing director additionally to debtor's management. There were attempts to impose subsidiary liability on legal firms, but it was unsuccessful.

"The main issue to be kept in mind is that Russian insolvency law does not recognise foreign insolvency automatically"

Processes and procedures

Russian insolvency law provides for four procedures available for financially troubled debtors: supervision, financial rehabilitation, external management, and bankruptcy proceedings (liquidation). In practice, only two of these procedures are applied: supervision and bankruptcy proceedings.

Supervision

The first procedure – supervision – helps to preserve the assets of the debtor. Supervision is introduced automatically after acceptance by a court of the first insolvency application (the exception: insolvency under the simplified procedure of the debtor in liquidation and insolvencies of some special entities).

It is important to note that at the stage of supervision, the relative independence of the company and its governing bodies maintains, despite the emplacement of the arbitration (insolvency) manager. At this stage, the insolvency manager analyses a debtor's financial state, completes a creditors' register, and holds the first creditors' meeting.

The term of the supervision is seven months and after that, the first creditors' meeting has to decide the next stage of the insolvency proceedings and agree it with the court.

Bankruptcy proceeding (liquidation)

The next frequently used procedure – the bankruptcy proceeding – aims to satisfy creditors' claims through the sale of the debtor's assets.

If the financial condition of the debtor has not improved, the court makes a decision on declaring the debtor bankrupt and initiating insolvency proceedings. The court appoints the insolvency manager (the same or different form the previous stage) to act until the insolvency proceeding is completed.

At this stage, the powers of the debtor's general director and other managing bodies (with minor exceptions) are terminated. Managing bodies are vested with the insolvency manager.

The insolvency manager has exclusive rights over the disposal of the debtor's assets during the execution of sale procedure. The term of execution sale is six months.

It is important to note, that the group of companies does not receive special treatment. On the contrary, the establishment of the affiliation of the debtor and the creditor causes the 'subordination' of the claims of such a creditor, which means a decrease in the priority of satisfaction of his claims.

Formal filing

As mentioned before, after being accepted by a court, the first insolvency application first stage of insolvency (supervision) automatically starts.

Introduction of supervision is connected with a wide range of consequences, such as:

- Creditors' claims against the debtor and its assets are submitted only through the court supervising the insolvency proceedings; as a rule, no individual enforcement possible, accrual of financial penalties are terminated;
- Deadlines for the execution of obligations has arrived;
- The execution of court decisions is suspended;
- The restrictions on the disposal of the debtor's property is removed; and
- Transactions aimed at transferring property from an entity to its participants are prohibited.

The introduction of the supervision is not a reason for the automatic termination of contracts, but it otherwise can be provided in conditions of the contract.

Sale of distressed debtor's assets

Within the bankruptcy proceeding (liquidation), the insolvency manager offers the debtor's assets for sale at two consecutive auctions. At the first auction, the sale price shall be approved by the meeting of creditors' decision, while the sale price at the second auction has to be 10% lower than the initial sale price. If the second auction fails, the property is to be sold by way of a public offer with a gradual decrease in the price.

A feature of the sale of secured assets is that if the second auction fails, the secured creditor is entitled to appropriate the secured property at a value that is 10% lower than the offered sale price at the second auction.

Directors' duties

The director (individual executive body, CEO) of the company in financial difficulty has to file the insolvency application with a court to initiate insolvency proceedings against the company they are managing if one of the insolvency criteria below is met:

- If claims against the debtor's assets are enforced, the debtor will be unable to continue, or will be hard to enable its activity in continuing;
- The debtor passes a test – 'inability to pay': the debtor fails to perform its payment obligations when due as a result of the stress of money;
- The debtor passes a test – 'insufficient assets': the value of the debtor's payment obligations exceed the value of its assets; or
- As a result of the stress of money, the debtor is unable to pay its labour obligations that are outstanding for more than three months.

If the director violates the obligation to file an application during the first month since the company satisfies the insolvency criteria, they can be held subsidiary liable for obligations of the debtor (company). It means that if the company is unable to pay debts to creditors at the expense of its assets, the creditors' claims must be paid at the expense of the assets of the director.

Creditors

Since the debtor's assets are limited, creditors are interested to keep as few claims as possible included in the register of creditors' claims.

The insolvency law grants creditors the following rights in this regard:

- To state demands for the exclusion of other creditors from the register;
- To provide the court with objections to the application of other creditors for their inclusion in the register of creditors' claims; and
- To challenge the debtor's transactions, on the basis of which the creditors want to include their claims in the register.

All of them are frequently used during the insolvency procedures.

Challenging transactions

Challenging transactions are one of the main mechanisms of protecting the interests of creditors, making it often used during insolvency proceedings in Russia. However, creditors cannot challenge every transaction. According to Russian legislation and court practice, creditors are able to challenge a transaction if:

- The transaction was aimed at asset stripping, and/or
- Transaction puts some creditors in a predominant position, and/or
- Transaction is obviously disadvantageous for the debtor.

Another important issue is the moment of entering into the transaction. It is possible to challenge the transaction if it was made up to three years ago (depending on the ground of the challenge) based on special insolvency provisions.

Post-petition credit

The insolvency law protects the interests of creditors whose claims appear after the initiation of insolvency proceedings (current payments). Current payments include monetary obligations, wage claims, and mandatory payments. There are also current requirements for payment for the goods supplied, services rendered and work performed, aimed at preserving the debtor's working capacity, and the safety of his assets.

Current payments are priority claims because the moratorium on the satisfaction of the creditors' claims does not apply to them. Moreover, current payments are satisfied earlier than another claims. There is a sequence of current payments: court expenses, remuneration of employees, and remuneration of labour of persons that engaged by the arbitration manager, maintenance payments, and other current payments.

Special regimes

Russian legislation provides for special insolvency regimes for certain industrial sectors. In particular: city-forming organisations, agricultural organisations, financial and credit institutions, strategic enterprises, monopolies, and developers. The insolvency procedure of all the above legal entities includes special conditions, which are due to the specifics of their activities.

For example, the insolvency procedure of financial and credit organisations is carried out by the Central Bank of the Russian Federation. Supervision, financial rehabilitation, external management and settlement agreements do not apply.

The insolvency procedure for individuals is significantly different. For example, starting in 2021, individuals can file applications of insolvency out-of-court.

Key stakeholders

Beyond common creditors, key stakeholders that could have a material impact on the outcome of a reorganisation is the Deposit Insurance Agency (DIA) and the Federal Tax Service. The DIA plays the role of an insolvency manager in a bank's insolvency procedure. The Federal Tax Service has the extended creditors' rights within insolvency and is also empowered to bring subjects to administrative responsibility for offences in the field of insolvency.

Crossing-borders

The main issue to be kept in mind is that Russian insolvency law does not recognise foreign insolvency automatically. As a rule, foreign court decision on insolvency of the debtor may be recognised in Russia in accordance with the international treaties or based on reciprocity. As Russia is not a member of any international treaty connected with cross-border bankruptcy proceedings, the recognition of foreign bankruptcy is a challenge. For example, in one case, the Russian court rejected the recognition of a Czech bankruptcy referring to a lack of reciprocity and all higher courts supported this decision.

Consequently, a foreign insolvency manager may not have the opportunity to exercise his powers over the property located in Russia, and this may create subsequent problems.

Russian insolvency law does not provide a special provision for the opportunity of insolvency of a foreign company. Therefore, this issue is the matter of judicial discretion.

"As the Russian proverb says: 'forewarned is forearmed'"

In the vast majority of cases, courts provide that only companies incorporated in Russia might be recognised bankrupt in Russia. The main reason for such a conclusion is the provision of conflict of law rules that provide that liquidation of legal entities shall be defined in accordance with the law of the place of incorporation. Another reason is that in accordance with the procedural rules, the claim for bankruptcy of the debtor should be filed in place of location of the debtor (for legal entities – a place of registration). The same approach will be applicable if a foreign legal entity has a branch or representative office registered in Russia. The approach will be different with regard to insolvency of the natural person, that can be found insolvent in accordance with Russian law based on the principle of sufficient ties.

Assistance to foreign proceedings

The recognition of foreign bankruptcy procedures by Russian courts depend on the type of court decision that is required to be recognised.

There is no unified approach to recognising foreign bankruptcy decisions. Paragraph 6, Article 1 of the Federal Law on Insolvency (Bankruptcy) dated October 26 2002, No. 127-FZ, provides that insolvency decisions of foreign state courts shall be recognised in accordance with international treaties of the Russian Federation, but in the absence of such treaties – on the basis of reciprocity.

The Russian Federation is not party of any international treaties related to foreign insolvency proceedings, therefore it is necessary to get recognition based on reciprocity. It is difficult to prove reciprocity in other states where the decision was delivered, therefore Russian state courts regularly refuse to enforce insolvency decisions.

It is impossible to enforce decisions based on the imposition of interim measures. The Supreme Arbtitrazh (commercial) Court stated that: "The rulings of foreign courts on the application of interim measures are not subject to recognition and enforcement on the territory of the Russian Federation, since they are not final judicial acts on the merits of the dispute issued in adversarial proceedings".

Therefore, if there is a key asset of the debtor in Russia, and it is necessary get interim measures due to the asset, it would be more effective to open bankruptcy of the debtor in a Russian state court (if possible).

Looking ahead

When assessing the efficiency of the measures implemented by the government to prevent massive insolvency, the results do seem unsuccessful. The number of bankruptcy cases have increased since the lifting of the moratorium on January 7 2021. This especially applies to small and medium-sized businesses. Related statistics confirm the concerns of experts who predicted that a moratorium on the initiation of bankruptcy proceedings without additional tax breaks, leasing payments breaks, or the subsiding of salary payments, will simply postpone the bankruptcies, but will not help to avoid them.

Looking into the future, there are many changes that businesses would like to see in insolvency regulations. The key point is for the introduction of effective procedures for the restructuring of debts with active participation of representatives of the debtor, shareholders and creditors, which will allow saving business activity of the debtor.

The main practical trends for the near future in the field of bankruptcy are:

- Mass involvement of the controlling persons of the debtor (for example, members/shareholders of the company, directors, chief accountants, members of the board of directors, etc.) to subsidiary liability, while directors will be held subsidiary liable in almost 100% of cases;
- Bypassing the ban on offsetting counterclaims by balancing. In fact, an offset is prohibited, and if the company offset claims in a pre-bankruptcy state, there are risks of challenging the transaction in the future. But for the creditor there is a way out – the balancing of counter claims, to which the courts are much more favourable. Recently, the Supreme Court has been gradually trying to soften the strict prohibition on offset by developing the theory of balancing, which is a way of calculating the final liability; and
- Active participation of banks in the search and foreclosure of assets abroad, bypassing the receiver in the Russian bankruptcy.

As the Russian proverb says: "Forewarned is forearmed". The experience caused by Covid-19 shows that it is ultimately important to choose the contractors with due diligence, to document execution under the contracts in compliance with law and current practice, to make regular update of financial state of contractors, to make timely debts collecting and to catch the possibilities this new reality gives for growing of business.

Switzerland

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The first wave of Covid-19 infections hit Switzerland in March 2020, causing the Swiss federal government – the Federal Council – to enact strict measures to combat the spread of the virus. In particular, it imposed restrictions on border crossings and ordered that all schools, shops, restaurants and bars, as well as all entertainment and leisure facilities, be closed, such measures only to be eased gradually in the course of May and June 2020.

Due to again rapidly increasing number of infections in September and October 2020, both the Federal Council and cantonal governments tightened public health measures again, without, however, imposing a strict lockdown in order to find a balance between epidemiological necessity and economic viability. Whereas restaurants, bars and entertainment and leisure facilities generally had to close only on December 22 2020 until April/May 2021, shops selling non-essential goods remained open until January 18 2021 and then were only shut down until March 1 2021. In contrast, all schools stayed operational throughout the second wave of infections.

Even though the Swiss economy was undoubtedly dealt a severe blow, as many companies were forced to temporarily restrict or even – in certain sectors – suspend their activities in the wake of these measures, the worst economic fears have so far failed to materialise. While the GDP initially was expected to plunge by approximately 6%, it eventually only decreased by 2.9% over 2020 as a whole. Unemployment currently stands at approximately 2.7%, whereas it was 2.3% in 2019. The number of new bankruptcy proceedings has so far not significantly increased.

Covid-19

To counteract the negative effects of its public health measures, the Federal Council enacted a wide variety of support initiatives to give troubled businesses a hand. Of

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these initiatives, in hindsight, four broad responses emerged as the most significant.

In the first, the Federal Council adopted temporary changes to short-time work compensation, which in general proved to be an effective instrument to combat the economic impacts of Covid-19, being namely the following:

- The entitlement was extended to certain employees who were previously not covered, such as temporary employees, apprentices and, under certain conditions, employees on call. Such extended entitlement will continue to apply until September 30 2021;
- The period of entitlement was initially prolonged from 12 months to 18 months and thereafter further extended to 24 months, lasting until February 28 2022; and
- The general process was also simplified and streamlined and the period of authorisation was extended from three to six months. While the simplified pre-application process remained in place until August 31 2021, the simplified accounting process will be retained until at least September 30 2021, whereas the prolonged period of authorisation will be phased out until December 31 2021.

A second key initiative was government-backed bridge loans. On March 25 2020, the Federal Council established a secured bridge loan-programme, which was designed to provide secured bridge loans in a rapid and unbureaucratic manner. It consisted of two types of bridge facilities:

- Covid-19-Loan: loans up to CHF500,000 (approximately $539,000), 100% (indirectly) secured by the Swiss Confederation by means of a joint surety and granted within a short timeframe, based solely on the information and documentation provided by the applicant and without any further credit checks.
- Covid-19-Loan-Plus: loans exceeding CHF500,000 and up to a maximum of CHF20 million, 85% (indirectly) secured by the Swiss Confederation by means of a joint surety and preceded by a credit check by the relevant lending bank in line with standard industry practice.

The maximum credit amount was limited to 10% of the applicant's turnover in the preceding financial year. Notably, companies (i) with a turnover over CHF500 million or (ii) not being (significantly) economically affected by the pandemic were not eligible.

Covid-19-Loans/Covid-19-Loans-Plus could only be applied for until July 31 2020 and the programme was eventually not renewed. The relevant ordinance of the Federal Council was, however, transformed into statutory law as of December 18 2020. Key provisions include the following:

- Term: The term initially was set at up to five years with the possibility of a hardship-extension for an additional two years. The Swiss parliament prolonged the term to up to eight years, thereby keeping the aforesaid option for a hardship-extension.
- Interest: The interest rate was set at 0.0% per annum, for Covid-19-Loans, whereas Covid-19-Loans-Plus bear an interest rate of 0.5% per annum on the amount which is (indirectly) secured by the Swiss Confederation. The interest rate on the remaining, unsecured part of the Covid-19-Loans-Plus is at the discretion of the parties. Such interest rates may generally be increased once per year to take into account any market developments.
- Purpose: Covid-19-Loans/Covid-19-Loans-Plus are designed to satisfy liquidity needs only. Insofar, a borrower is generally no longer permitted to distribute dividends/royalties, reimburse capital contributions or grant, refinance or repay intragroup loans (subject to certain exceptions). Since December 18 2020, the use for necessary new investments is permitted. Non-compliance with these restrictions may trigger civil law liability and criminal law sanctions.

A third initiative, initiated after the bridge-loan programme had expired and was not renewed in Autumn 2020, introduced so-called hardship measures. The relevant ordinance of the Federal Council entered into force on November 25 2020. It grants the cantons the right to support businesses in the form of loans, sureties or guarantees or non-repayable contributions, of which – subject to certain requirements – the Swiss Confederation will (indirectly) bear 50%. Preconditions include, alternatively, a decrease of turnover of at least 40% compared to the average turnover of 2018

and 2019 or closure of the business for at least 40 days between November 1 2020 and June 30 2021 due to the public health measures. Any company benefitting from hardship measures may generally no longer distribute dividends/royalties or grant loans to its shareholders in the relevant business year and thereafter for a period of three years, unless the relevant financial support is repaid earlier.

A fourth key pillar of the government's response was the modified insolvency regime. In mid-March 2020, the Federal Council ordered a stay of enforcement from March 19 to April 4 2020 (prolonged by the statutory enforcement holidays until April 19 2020) and a standstill or extension of the deadlines in court proceedings from March 21 until April 19 2020. On April 16 2020, the Federal Council enacted substantive, temporary measures in relation to the Swiss insolvency regime that remained in force until October 20 2020 only and included the following:

- A suspension of the duty of the board of directors to notify the bankruptcy court in case of over-indebtedness in certain circumstances (see below under 'Directors' duties');
- A new Covid-19-Moratorium for small and medium-sized enterprises, which provided such companies with a simple and straightforward procedure to obtain a temporary deferral of their payment obligations in order to reorganise and prepare for the time after the crisis; and
- Certain other amendments such as facilitations to enter into a moratorium and an extension of the provisional moratorium to six months.

Basic framework

Under Swiss insolvency laws, there is no group insolvency concept, so each entity must be dealt with separately. However, sector-specific rules may apply. In particular, insolvencies of banks, securities firms, insurance companies, collective investment schemes and fund managers are subject to special regimes.

Enforcement proceedings are generally not initiated *ex officio*, but rather require a petition. The debtor itself must initiate insolvency proceedings in the event of overindebtedness (i.e. when its liabilities exceed the value of its assets (see below under 'Directors' duties')). If a creditor seeks to initiate insolvency proceedings, it must file an enforcement request with the competent debt collection office and pass through an introductory phase. As a rule, this introductory phase is mandatory; in extraordinary circumstances, however, the debtor, a creditor or the statutory auditors can directly apply for declaration of bankruptcy to the bankruptcy court.

Broadly, the Swiss Federal Debt Enforcement and Bankruptcy Act (DEBA) provides for three types of debt enforcement:

- Enforcement of unsecured claims against individuals will, subject to the below, be pursued by way of seizure and realisation of assets belonging to the debtor to the extent necessary to cover the claim.
- Enforcement of unsecured claims against individuals and legal entities registered in the Swiss commercial register will lead to bankruptcy proceedings opened against the debtor. In limited circumstances, bankruptcy proceedings are available also for individuals not registered in the commercial register. Once bankruptcy proceedings have been opened, all the debtor's assets form an estate over which the debtor can no longer dispose. The estate is then realised, and the proceeds are distributed among the creditors, taking into account their claims' value and priority.
- Enforcement of secured claims both against natural persons and against legal entities might have to be pursued by way of realisation of the collateral.

To avoid bankruptcy, debtors facing financial distress may be able to apply for a moratorium under Swiss corporate law (or, until October 20 2020, were able to apply for a Covid-19-Moratorium). In addition, as an alternative to bankruptcy proceedings, the DEBA provides for statutory composition proceedings, which allow for a restructuring of the company with a view to continuing its business on a sounder basis and for liquidation of the company in a manner that is more beneficial to creditors than bankruptcy proceedings. Composition proceedings provide for the ability to achieve reorganisation during a moratorium by way of a composition agreement between the debtor and its creditors. Eventually, any composition agreement needs to be approved by the competent court and thereafter becomes binding on all creditors.

Directors' duties

In case of a substantiated concern of over-indebtedness, the board of directors of the relevant company has to procure that an (audited) interim balance sheet be drawn up based on (i) liquidation values and (ii) going concern values. For purposes of this calculation, any Covid-19-Loans (unlike Covid-19-Loans-Plus) and any loans, sureties or guarantees based on the hardship measure framework will not be taken into account, and the interim balance sheet did not have to be audited for the period until October 20 2020. If the interim balance sheets show over-indebtedness, the board of directors must notify the bankruptcy court without delay. Non-compliance with this obligation may expose the board of directors to both civil law liability and criminal law sanctions and the statutory auditors have the obligation to notify the competent court in such case.

The board of directors need, however, not file for bankruptcy if: (i) creditors with claims in an aggregate amount not lower than the amount of the over-indebtedness subordinate their claims against the claims of all other creditors; (ii) if there is a substantiated likelihood for an informal workout within a relatively short period of time; or (iii) under the Covid-19 modified insolvency regime, which expired on October 20 2020, if there was a prospect that the over-indebtedness will be

"While the GDP initially was expected to plunge by approximately 6%, it eventually only decreased by 2.9% over 2020 as a whole. Unemployment currently stands at approximately 2.7%, whereas it was 2.3% in 2019"

eliminated by December 31 2020, provided that the debtor was not already over-indebted on December 31 2019.

While the criterion of over-indebtedness is based on a balance sheet test (rather than a liquidity test), the loss of the going concern assumption leads to an obligation to account for liquidation values, which will, in turn, typically result in over-indebtedness. Under Swiss law, such going concern assumption is lost if it is intended or probably inevitable that all or some activities of the company will cease in the next 12 months.

To that effect, the board of directors must examine the current economic situation and future business development with a budget and a liquidity plan, taking into account the order book, the situation *vis-à-vis* lenders, the procurement of liquidity through the sale of assets, etc. As soon as the debtor loses such going concern assumption for accounting purposes, going concern values become irrelevant and the test is exclusively based on liquidation values. In times of financial distress, the board of directors must therefore intensify its supervision and monitoring activities in general and place enhanced scrutiny on the ongoing assessment of the going concern assumption.

The board of directors generally has a fiduciary duty to safeguard the interest of the company and, as such, in times of financial distress, must convene regularly and prepare restructuring and/or refinancing strategies as well as contingency plans. If the prospects of successful restructuring and/or refinancing fade, its fiduciary duty shifts, however, towards safeguarding the interests of the creditors.

Challenging a debtor's transactions

The insolvency administration and certain creditors may, under certain conditions, void transactions. A transaction that is detrimental to the debtor's creditors may be voided in the following cases:

- The debtor has made a gift or a disposal of assets without any or with a disproportionate consideration, provided that the debtor made such transaction within the last year prior to the seizure, the opening of bankruptcy proceedings or the granting of a moratorium.
- In addition, certain actions are voidable if performed by the debtor within the last year prior to the seizure, the opening of bankruptcy proceedings or the granting of a moratorium, provided that the debtor was already (recognisably) overindebted at that time: (i) granting of security for already existing claims, provided that the debtor was not previously obliged to grant such security, (ii) payment of a monetary obligation in any way other than by payment in cash or other customary means of payment, and (iii) the payment of a debt not due.
- Any acts performed within the last five years prior to the seizure, the opening of bankruptcy proceedings or the granting of a moratorium performed by the debtor with the (perceptible) intention to disadvantage its creditors, discriminate some creditors against others or to favour some creditors to others are voidable.

> *"Swiss businesses have so far generally coped well with the adverse economic environment and the challenges they are facing in connection with Covid-19"*

Crossing borders

Switzerland's international insolvency law is governed by the Swiss Federal Act on Private International Law (PILA). In the event that bankruptcy, composition or similar proceedings are initiated outside Switzerland, the debtor's assets located in Switzerland cannot directly be handed over to the foreign administrator. The foreign administrator is generally not allowed to collect assets located in Switzerland or take any legal actions unless and until the foreign proceedings have been recognised in Switzerland pursuant to articles 166 et seq. PILA.

The relevant procedure can be summarised as follows: The foreign administrator or creditor needs to request recognition of the foreign bankruptcy or composition decree. Recognition is only granted if certain conditions are met (for example, competence of the relevant non-Swiss court, no violation of Swiss public policy etc.). If recognition is granted, the court opens auxiliary proceedings with respect to the assets of the debtor located in Switzerland (secondary proceedings). Following liquidation, the proceeds are used to pay down the collateralised claims and privileged claims of Swiss creditors. Where there is a surplus, its distribution depends on how the other Swiss creditors' claims are treated in the schedule of accepted claims in the foreign proceeding. The surplus is transmitted to the foreign proceedings only where such claims are adequately addressed. Otherwise, the surplus is paid out to the Swiss creditors.

Under certain circumstances, however, a dispensation from secondary proceedings may be granted. If this happens, the foreign administrator will be conferred the same powers in Switzerland as it has under the laws of the main proceedings. Also, if the foreign debtor has a branch in Switzerland, the law allows for the initiation of separate bankruptcy proceedings with regards to that branch. Such proceedings will be governed by the DEBA.

Looking ahead

Swiss businesses have so far generally coped well with the adverse economic environment and the challenges they are facing in connection with Covid-19. Even the second wave of infections and the related public health measures in Autumn 2020 did not unravel their continuous good state and a wave of bankruptcies has – for the time being – not occurred, not least because of the governmental support measures which have proved effective, notably in respect of securing liquidity.

However, while certain Swiss business have done relatively well in recouping their pre-crisis turnover due to a generally solid demand, it remains to be seen how swiftly business areas that still are considerably affected by the pandemic (e.g. tourism) can recover. Also, only time will tell whether the burden due to any additional debt incurred during the crisis will prove to be too heavy for certain Swiss businesses, in particular if (and when) governmental support measures will be fully lifted.

CYPRUS

Elias Neocleous & Co

Chrysanthos Christoforou

The place to be for investment firms and investors

Cyprus is a long-established international business centre which guarantees safety, stability and prosperity for foreign investors for a number of reasons. To name just a few there is:

- The island's advanced commercial infrastructure;
- Its stable economy;
- The robust and transparent legal system;
- Its political stability;
- The friendly environment for foreign investors, and
- The Republic of Cyprus is a full member of the EU.

Together they have rendered the island an attractive destination for investors from CIS countries, the Middle East, China and lately, the US. If you add to the above the country's strategic location, and of course its attractive tax regime offering numerous incentives and advantages to both foreign individuals and corporate entities, you have the perfect recipe for investment growth.

Also, Cyprus has become a harbour for investment firms. A Cyprus investment firm (CIF) is one of the most useful tools in the EU, and not only for those who intend to provide and perform investment services and activities either within Cyprus or abroad on a professional basis.

Cyprus has managed to put in place a robust regulatory framework which is constantly monitored by the Cyprus Securities and Exchange Commission (CySec). CySec is the regulatory body for the financial industry in Cyprus. Its mission is to exercise effective supervision in order to ensure investor protection and a prosperous development of the securities market, the collective investment market and the asset management sector. CySec also regulates the establishment of all financial services companies and particularly fund management companies which have been set up by hedge fund managers.

Obtaining a CySec licence

There is a certain process to be followed, and there are strict criteria and conditions which must be satisfied, in order to get the relevant CySec license for the provision of 'Investment Services'.

The examination of the application can take up to six months depending of course on various factors, the most important of which is the range of the services to be provided by the applicant company. Some of the very basic criteria would include the firm having local offices and a minimum number of native directors. Of course additional key personnel may also be required. These might include a compliance officer, an AML Officer as well as an Officer authorised and licensed to provide the respective 'Investment Service'. Additionally, depending on the 'investment services' to be provided and whether or not the firm will hold client funds, there is a minimum capital requirement (for more information and guidance as to how you may register a CIF please contact the author or any member of our financial services dedicated team).

Investor protection

Investor protection is taken very seriously by CySec and investors in general should feel comfortable that their complaints, if any, against CIFs will be thoroughly examined. Although CySec itself does not have restitutionary powers it has put in place a three-step complaint procedure for investors.

In brief, each complaint is given a unique reference number by CySec. The CIF has to respond and position itself in relation o the investors complaint within a certain period of time (maximum of three months from the day of the complaint). If the investor is not happy with the CIF's response he or she can reach out to the Financial Ombudsman (FO). The FO provides an independent service for settling disputes between CIF's and their clients, however, his decisions are not binding. Hence, it is open for the investor to take the matter to court if he is not satisfied with the decision of the FO.

CySec has also put procedures in place regarding the receipt and follow-up of reports of infringement pursuant to Article 32 of the Regulation (EU) No. 596/2014 on market abuse and has even set-up a specific electronic address for this purpose (whistleblowing@cysec.gov.cy).

Finally, segregation of client and corporate funds is a must for CySec which has also set up the ICF (Investors Compensation Fund). In a nutshell the ICF's task to compensate investors, provided of course the conditions for compensation are fulfilled.

Conclusion

It could be argued that the last 10 years or so have shown that Cyprus is the place to be for both investment firms and investors as, unlike other jurisdictions, it offers a stable and safe environment for investment. Whilst there may have been some isolated instances in the past where some investors did lose funds, these incidents were generally confined to unregulated firms.

However, there is no room for complacency. The fact that this business is indeed thriving and the volume of the funds that are being invested on a daily basis is by all means massive, calls for a diligent approach on the part of the regulatory authority. CySec is committed to constant monitoring and supervision of the sector. However, at the same time, investors must also act responsibly. They are advised to be extra cautious and diligent when choosing an investment firm and to ensure that they act promptly when they suspect foul play on behalf of the latter.

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INDIA

Trilegal

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De-mystifying the reporting obligations of depository receipts

During the 25 years since they were introduced as an investor class, foreign portfolio investors (FPIs) have shared a piquant relationship with the Securities and Exchange Board of India (SEBI), the Indian securities market regulator.

FPIs, as they are commonly referred to, are significant contributors to the Indian public markets and have been subject to increasing regulatory supervision in India over the past couple of decades, on issues ranging from their beneficial ownership structures, offshore derivative products and the nature of reporting requirements they have to adhere to in India.

October 2020 saw the introduction of a significant requirement, in the context of global depository receipts issued by Indian companies. It mandated FPIs to "report details of all such FPIs forming part of the same investor group as well as offshore derivative instruments subscribers and/or DR holders having common ownership, directly or indirectly, of more than fifty percent or on the basis of common control, to its designated depository participant".

After multiple rounds of discussions between industry participants and the SEBI, this circular has been put in abeyance (but not withdrawn) until further notice, but not before it drew attention to certain critical legal and operational issues, some of which is discussed here.

Controversy surrounding GDRs

Global depositary receipts (GDRs) are negotiable instruments which represent ownership of underlying shares of a company and growing complexities in ownership structures, tax considerations, money laundering, etc. has made is essential for financial regulators to be aware of the ownership structure of key shareholders in Indian listed corporates.

With despositary receipts (DRs), the de-mystification process gets tougher, since these are listed overseas and the identity of the ultimate natural owner is not always known. The fact that the DR holders overseas have trading accounts and are KYCed as per local norms is of considerable comfort, but matters get more knotted where voting rights are exercised by DR holders and collusion becomes harder to detect.

In terms of relevant SEBI circulars, voting rights "shall be exercised by the DR holder through the Foreign Depository pursuant to voting instruction only from such DR holder". The SEBI had been raising its concerns on the American depositary receipt (ADR)/GDR regime as the same are difficult to monitor and may be used for money laundering, market manipulation and round tripping and over the years, the SEBI has undertaken massive probes and taken stringent action against companies where DR issues have been found to be misused.

> *"Formulating a predictable compliance and regulatory culture within the securities market is essential for cross-border markets to thrive"*

Requirements cast by the SEBI

In an attempt to address the above issues including identification of DR holders and preventing any unwarranted and indirect breach of foreign shareholding limits, the SEBI, in October 2020, devised a reporting framework for foreign portfolio investors (FPIs) having exposure in Indian securities, although the operational details were left to the depositories.

The SEBI directed that FPIs must report details of all FPIs forming part of the 'same investor group', along with offshore derivative instrument holders and DR holders to SEBI, through their depository participant. Thereafter, on a monthly basis, the number and value of securities (including through DR) held by such same investor group was to be reported to its custodian, in order to monitor foreign holding limits.

Interestingly, the scope of 'same investor group' has to be determined on the basis of common control or ownership in such entities and the SEBI's directive remains unclear on whether non-FPI entities, without any business or economic presence in India, would have been brought within the fold of such calculation as well. This raised concerns around extra-territorial powers of the SEBI which has some judicial backing in India, especially in the context of depository receipts and its effect on the Indian markets, but when juxtaposed with data privacy/confidentiality limitations, stirs the pot considerably.

Such requirements are also burdensome on the intermediaries involved; in case of this SEBI directive, the impact on custodians and depositories as the chief collators of data that they have no ownership or oversight on, caused considerable confusion, particularly in computing the foreign investment limits of client FPIs and accounting thereof.

What would be the liability (both organisational and personal) for erroneous reports or passive breaches, how would that be contractually solved for between the FPI and the custodian are all issues that the industry continues to grapple with, given the inevitable complexities in ascertaining and accessing such information on the shareholding?

Regulatory reaches made outside of their territorial domain is not uncommon; but whether it is merely an outreach to aid better regulation, or an overreach, has been a question of some debate.

There are a number of imperatives that fuel the requirements for regulators to cast reporting requirements upon entities that do not have a physical presence or a business relationship directly within their territorial domain.

From the SEBI's standpoint, managing the risks that radiate out of a complex market structure requires newer reporting structures, data security features and novel information sources to be tapped into. However, such demands can pose multiple constraints on market participants and deepen the costs of doing business in a country. Enforcing powers akin to long arm statutes requires a degree of financially strong arming that not many economies are always equipped to wield.

Formulating a predictable compliance and regulatory culture within the securities market is essential for cross-border markets to thrive.

It is too soon to tell if this SEBI mandate to disclose DR holdings has turned cold or if it will soon resurface, in a modified form or otherwise. But the lesson at both ends of this experience is to modify the design of our regulations and seek to use international platforms like IOSCO to enhance inter-regulatory cooperation and reduce the barriers for cooperation. This ensures that domestic regulators do not feel the need to stockpile information from

varied sources, in anticipation of an enforcement action that may require a swift joining of the dots.

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JAPAN

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EPSF plots to build a financial system that supports sustainability

Prime Minister Yoshihide Suga announced Japan's aims for carbon neutrality and substantially zero CO2 emissions by 2050, in his October 2020 policy speech. He also announced at the climate change summit held in April 2021 that Japan aims to reduce its greenhouse gas emissions by 46% in FY2030 from its FY2013 levels.

In order to achieve these types of environmental goals, many major countries consider that large scale of private funds would be required for the transition towards such new industrial and social structures. The amount of private funds needed to achieve the sustainable development goals (SDGs) worldwide is estimated at ¥3,000 trillion ($27.2 trillion) — and countries are regularly encouraging sustainable finance by implementing relevant policies.

As a part of these efforts, the Japanese Financial Services Agency (FSA) established the Expert Panel on Sustainable Finance (EPSF) in December 2020 so as to promote sustainable finance in financial institutions and capital markets, and to ensure more foreign and domestic investments addressed to the efforts by Japanese companies, in regard to decarbonisation and climate changes.

The EPSF has met eight times to discuss various measures, while conducting hearings from relevant parties since January 2021. Then the ESPF published the 'Report by the Expert Panel on Sustainable Finance' which mainly focuses on climate change as the most important issue among SDGs.

> *"The amount of private funds needed to achieve the sustainable development goals worldwide is estimated at ¥3,000 trillion"*

Contents of the report

Sustainable finance requires institutional investors, pension funds trustees, and asset managers to take their responsibilities seriously and generally put their clients' or beneficiaries' interests before their own, as well they should. It has been controversial whether such responsibilities, called fiduciary duties, requires them to take into consideration ESG issues. However, the report expresses the opinion that consideration of ESG factors is beneficial to fulfilling their fiduciary duties.

Moreover, the report states the following points regarding enhancing sustainable finance:

- Impact finance: a wide range of approaches need to be sought to raise awareness and accumulate business practices regarding impact finance.
- Taxonomies and transition finance: it is important to participate in international discussions on taxonomies for suitable activities and promote transition finance (including the formulation of roadmaps for high emission industries).
- Corporate disclosure: comparable and consistent sustainability reporting standards should be required, and climate-related disclosures should be based on the Task Force on Climate-related Financial Disclosures (TCFD) recommendations.
- Capital market functions: a 'green international finance centre' which can contribute to more loans and investment should be developed, and a platform for practical information related to green bonds should be established.
- Financial institutions' risk management: the FSA should develop a risk management system for climate change.

Based on the background that Japanese companies typically rely on loans rather than securities as the way to raise funds, the report emphasises the importance of financial institutions' roles in sustainable finance.

The report asks financial institutions to support transition finance for borrowers and integrate the related risks when determining and implementing their business strategy through accumulating know-how and developing analytical tools. In addition, the report also expects FSA to develop a supervisory guidance on climate transition supports and risk management.

In relation to such risk management, the following points are expected to be incorporated into the guidance:

- To adopt a strategic approach to cater for climate-related risks;
- To clearly define and assign responsibilities within existing governance arrangements;
- To have policies and procedures in place to identify, assess, monitor, report and manage all material risks;
- To develop methodologies and tools (e.g. scenario analysis and stress testing) necessary to capture the size and scale of climate-related risks; and
- To disclose information and metrics on the climate-related risks to be in line with the TCFD recommendations.

A trend in mega banks' activities

In light of the government's efforts, mega banks in Japan, which are sometimes criticised for having large proportions of loans and investments connected with fossil fuels, announced plans to strengthen sustainable finance initiatives.

For instance, Mitsubishi UFJ Financial Group raised the target amount of sustainable finance loans from 20 trillion to 35 trillion and disclosed information based on the TCFD recommendations, and Sumitomo Mitsui Banking Corporation launched the 'green deposit' which are

allocated to finance the environmental segment of ESGs.

It should be noted that the report is a set of recommendations for the FSA, and businesses should be vigilant in regard to how the government implements these proposals from the EPSF as policies.

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MACAU SAR

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New regime for the protection of consumer rights and interests

On July 12 2021, Law 9/2021 was published in the Macau SAR's Official Gazette and will enter into force on January 1 2022. Whilst revoking Law 12/88/M, it sets up the new regime for the protection of the consumer's rights and interests, with the aim to be "a step forward in clarifying the rights and duties in the transactions between consumers and businesses and in reducing consumer's conflicts, in view of the creation of a fair, impartial and transparent consumer environment".

The new law applies to both the sale of goods and the provision of services in Macau SAR. Expressly excluded from the scope of application of the new law are contractual relationships in the fields of gambling, gaming and betting, healthcare, education, legal, accounting, auditing and finance.

Among others, consumers have the right to receive an array of information (e.g. as to the features of the goods, terms and conditions of respective quality guarantee, price and payment methods, or post-sale assistance), the right to products and services of quality and the right to judicial assistance and accessible justice. The duty to inform applies not only to the seller – or service provider – but to all operators in the chain of supply (including producers, distributors and importers).

Shall the consumer be handed a defective product, he/she may exercise the corresponding rights (for repair or change of the product, for reduction of the price or to terminate the contract) within one year from delivery of the product, but notice shall be given to the seller within the 30 days after detecting the defect and judicial action started within six months therefrom.

The new law prohibits and sanctions commercial practices it defines as unfair, deceitful or aggressive, as it happens when the enterprise falsely claims to be accredited by a consumer's agency, deceives the consumer as to the producer of the goods, or ignores the consumer's request not to be contacted for marketing at his/her domicile. Sanctions for acting in such manner may range from MOP20,000 (approximately $2,493) to MOP60,000.

Some special forms of contracting are expressly regulated, as is distance selling (such is the case e-commerce, provided that the enterprise operates within the Macau SAR and that part of the transaction takes place in the territory – either the delivery or the expedition of the goods, or the provision of the service), selling outside the business establishment (where buyer physically meets the seller, but outside the latter's establishment) and pre-payment selling (where payment is made in advance of the delivery of the desired product).

Consumers contracting on either of these forms have special information rights and can freely terminate the contracts, without reason, within seven days. This, however, does not apply, e.g. to the sale and purchase or lease of real estate, the provision of financial services and others.

The new law privileges mediation and arbitration to resolve consumer disputes and does set mandatory arbitration for the conflicts in provision of public services defined as essential (such as water and electricity supply).

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PORTUGAL

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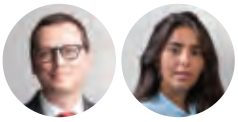

Eduardo Paulino and Francisca Osório de Castro

Upcoming rules on multiple voting shares in Portugal

Government bill No. 94/XIV/2 was submitted to the Portuguese Parliament on May 14 2021. This bill proposes the 39th amendment of the Portuguese Securities Code, and the proposed changes are expected to be approved later in 2021.

One of the proposed amendments introduces the possibility of certain companies issuing multiple voting shares, which already exists in other jurisdictions, and has recently become the subject of wide attention and even considered one of the key tools to attract fast-growing tech companies (and especially their founders) to listing in regulated markets.

Accordingly, the stated purpose of these amendments is "[t]o improve the attractiveness and competitiveness of our market (…). This possibility constitutes an additional instrument to promote the dispersion of capital in the market, available to companies already in the market, but also to companies that wish to be admitted for the first time".

If approved, this amendment will put an end to the discussion of whether the issuing of shares with multiple voting rights is possible for listed companies, taking into consideration paragraph 5 of Article 384.º of the Portuguese Commercial Companies Code (CCC), which establishes the general prohibition of establishing plural votes in the Articles of Association of joint-stock companies.

A small fraction of Portuguese scholars (amongst others, see madalena perestrelo de oliveira *in* Revista de Direito das Sociedades, year VII (2015), 2, pp. 435-470) have argued for a more permissive approach to the interpretation of this provision, so as to deem it inapplicable to listed companies, for example claiming that the specificities of listed companies make the 'one share, one

vote' principle void in terms of its intended content and motivations, but this understanding has understandably lacked traction and clear legal guidelines are expected before the mechanism is considered by companies and their shareholders.

Multiple voting will add a new tool for ensuring a disproportion between the fraction of capital held by certain shareholders and their voting power, which until now was only possible, within the Portuguese legal framework, essentially through either (i) the establishment of limits to the number of votes that may be exercised, when issued by the same shareholder (voting caps), or (ii) through the use of non-voting preferred shares.

There are a few relevant practical aspects to note from the draft. Firstly, the creation of shares with plural-voting rights is available for companies admitted to trading on regulated market or multilateral trading facility as well as for companies seeking admission, capped at five votes per share.

The introduction of such rights can be achieved, either *ab initio*, as stipulated in the articles of association, or subsequently, in the context of a capital increase (in which case the then current shareholders will have a pre-emptive right limiting the impacts of any potential dilution of their shareholding)or the conversion of common shares, in which case, its approval must follow the general rules for statutory amendments, i.e. it must be approved by a two-thirds majority, if shareholders representing at least one-third of the capital are represented on a first call, or, on a second call, by simple majority, if shareholders representing half of the capital are present (assuming no special majorities are established in the articles of association).

If other classes of preferred shares already exist, considering that the creation of new categories of shares with equivalent or superior special rights will indirectly affect the privileged shareholders, such shareholders may be called to give their consent for the creation of plural-voting stock at a special meeting, by a two-thirds majority.

Other design issues have been discussed extensively in other jurisdictions, notably, whether multiple voting stock should be perpetual or terminate (or 'sunset') at a given moment in time, and whether it should be transferable as such (amongst others, see clara hochleitner in "Dual-class Technology Firms", Drexel Law Review, Volume 11, 2018-19, pp. 101-147). An increasingly common view is that multiple voting stock should precisely sunset if and when it is transferred, which would imply its automatic conversion into ordinary shares.

At this stage the draft law does not provide for such possibility, which may raise practical doubts in light of the reinforced protection regime surrounding the cancellation of special rights and restrictions on transferability.

Despite recent doubts as to the effectiveness of this tool in the context of recent IPOs in Europe (e.g. Deliveroo) and the importance of proper drafting of the final legislative piece, all in all this seems to be a positive step forward in adding flexibility to founders, investors and other market participants. The future will tell whether this will effectively assist in bringing more Portuguese companies to the capital markets or will be reduced to an interesting academic exercise.

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SLOVAK REPUBLIC

CREDIS Law

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Changes in the lease of agricultural land

Investments in the purchase of arable land for the purpose of its subsequent lease to farmers are popular in the Slovak Republic.

This time, however, Slovak and foreign investors should draw attention, especially if they are not used to taking an active interest in their arable land.

With effect from May 2021, there are changes in the legal regulation of leases of agricultural land, the aim of which is to resolve the legal position between the landlord of agricultural land and its tenant, this time preferencing the interests of landowners.

The changes affect two specific institutes of agricultural lease, namely the legal presumption of the establishment of a lease and the right of pre-emption on extension of a lease on the side of the land tenant.

In practice, there often arise cases where individual farmers or cooperatives use and cultivate agricultural land without having entered into a formal written lease contract with the landowner, which is the result of a passive approach mostly by both parties involved.

The law has so far dealt with this situation through the fact that the law contained a presumption of the establishment of a lease for an indefinite period in favour of the actual user of the land, even if he used the land without a lease contract.

In principle, it was sufficient for the land user to prove that, although he had proposed to the landowner to enter into a written lease, the landowner had nonetheless neither refused to enter into the lease within two months of the date of receipt of the proposal, nor called on the land user to return the land. If, however, the landowner had entered into a written lease contract with another person before delivery of a proposed lease contract from the 'contractless' land user, such formal lease contract took precedence and the contractless land user had to return the land to the landowner.

This presumption of tenancy was often criticised by the professional public as vague and set to the detriment of landowners. Although the change in the law effective from May 2021 has retained the principle of the presumption of lease, it has added several other conditions that a land user without a written lease must meet and prove in order to continue using the land.

In particular, under the new law, the land user must be a so-called authorised user, and thus must be able to point to some specific, even if outdated, legal reason for using the land without a written lease. It is therefore not possible for someone to just start cultivating someone else's land, and thus eventually later lease it from the owner in the form of the aforementioned presumption of a lease.

The landowner can also, under the new law, enter into a written contract with

someone other than the contractless land user, up to two months after receiving an invitation to enter into a lease contract from the land user.

Furthermore, the land user will not just have to inform the landowner in the invitation to enter into a lease contract that if the landowner neither rejects nor calls upon the land user to return the land to the landowner, a tenancy will thereby be established between them, but also has to explicitly instruct the landowner on the form and manner of rejecting the proposal. A legal safeguard, though, lies in the fact that a landowner will be able to terminate a lease contract concluded in the form of presumption of lease only with one year's notice period, and this always as at November 1 of the calendar year.

As of May 2021, the pre-emptive right of an existing tenant to conclude a new lease contract is also removed from the legislation.

Until now, if the tenant had duly and timely fulfilled his obligations under a lease of agricultural land, he had the pre-emptive right to enter into a new lease contract for the land that the tenant had already been using, and this for the rent in the usual amount. The landlord was able to refuse the right to unilateral extension of the lease contract only for reasons listed exhaustively in the law, such as if the landlord himself was engaged in agriculture, or the tenant was a close or related person of the landlord, or if there was a transfer of ownership of the land. A breach of the pre-emptive right of an existing tenant invalidated any lease contract with a third party other than the tenant.

Although the amended law has kept the possibility for the tenant to claim against the landlord the right to extend the lease contract, the landlord can now refuse such a proposal for any reason until the expiry of the lease contract.

It should be added that application practice has also pointed to the need for further legislative changes, which have not yet been adopted, such as the long unresolved problem of co-ownership of fragmented agricultural land in Slovakia, where a particular piece of land may have dozens of co-owners, which is associated with legal problems in handling these lands, and which in turn subsequently limits their usability.

The Ministry of Agriculture and Rural Development of the Slovak Republic is already working on a completely new law on the lease of agricultural and forest land, which should solve this and certain other complex problems.

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Quantification of damages in post-M&A disputes under Swiss law

A recurring issue in post-M&A disputes is the quantification of damages. If, for example, the share price paid by the buyer in a share deal turns out to be inflated, the buyer must prove both the existence and the amount of the incurred damage in a sufficiently concrete and substantiated manner in order to prevent the dismissal of its damages claim by a court or arbitral tribunal. The proof and calculation of the (reduced) value of a company can be very challenging, especially, if the M&A contract does not contain any information on the basis for the price calculation.

This article summarises the legal qualification of share and asset deals and the common methods employed to calculate the value of a company in post-M&A disputes under Swiss law. It further references the burden of proof and limitations of liability in such disputes.

Qualification of share and asset deals

Under Swiss law, the legal provisions on the sale of goods pursuant to Article 187 ff. of the Swiss Code of Obligations (CO) apply in principle also to contracts for the sale of a company.

In case of share deals, however, the position of the Swiss Federal Supreme Court (Federal Court) is that the object of the purchase are the shares as such, rather than the business they represent.

In case of asset deals, the company's assets constitute the object of the purchase. The Federal Court thus qualifies the asset purchase agreement as a contract *sui generis*. However, it typically applies the provisions on the sale of goods also to asset deals.

Since for share deals the shares constitute the object of the purchase, Swiss jurisprudence holds that the default warranty provisions in Articles 192 ff. and 197 ff. of the CO apply only insofar as defects in the rights sold with the shares or the share certificates are concerned, but not in case of defects in the business of the company. Therefore, the seller is liable for the economic value of the shares only if it has given specific representations or warranties in this respect. While doctrine almost uniformly objects to the Federal Court's position, it remains the current state of Swiss law.

Definition of damage and valuation of a company

Under Swiss law a damage is the involuntary decrease in assets (including loss of profit) or increase in liabilities. It is calculated as the difference between the current state of the creditor's assets and the hypothetical state that the creditor's assets would have had without the damaging event. This includes all heads of damages, such as direct damages, incidental damages and consequential damages, notably lost profit.

Quantification, first of all, follows any method on which the parties may have agreed in their contract. Absent such agreement, quantification is based on the so-called 'relative calculation method'. According to this method, the purchase price is to be reduced by the same ratio that the objective value of the defect-free object of purchase has to the objective value of the defective object of purchase. Unless the parties have agreed otherwise, the relevant point in time for the calculation of the reduced value is the time of the transfer of risk (Article 185 of the CO), i.e. the time of closing.

Obviously, determining the objective value of a company for the purposes of this quantification method can be difficult. The choice of the valuation method can thus be decisive for the quantification of damages in M&A disputes.

Common valuation methods can be

divided into three main categories. The 'asset-based approach' encompasses methods which focus on the values of individual assets that constitute the business, such as the book value method or the net asset value method. The 'income-based approach' covers methods that focus on future economic benefits and convert such benefits into a single present value amount. It includes e.g. the discounted cash flow (DCF) method and the earnings value method. Finally, the 'market-based approach' establishes the value of an asset by comparing it to similar assets sold on the market (e.g. market price for listed shares in share deals).

The Federal Court employs different valuation methods depending on the particularities of each case (e.g. the profitability or size of the company, the available information, etc.). It typically takes a combined approach by considering both the net asset value and the capitalised earnings value. While the Federal Court has hardly ever (if at all) used the DCF method for the calculation of damages, such method has gained widespread application in business valuation in international arbitration.

Burden of proof

The burden of proof for the existence and the amount of damage lies with the buyer. Since the valuation of a company requires specialised expertise, party- or court/tribunal-appointed valuation experts are often involved in post-M&A legal proceedings.

In terms of discharging the burden of proof, parties may find Swiss state courts to apply rather restrictive standards, whereas, very broadly speaking, international arbitral tribunals may show somewhat more flexibility.

The quantification of damages often consumes considerable resources, time and costs. This is especially true in cases of suspected fraud where the finding of evidence to substantiate the damage often requires additional efforts (e.g. forensic email reviews and accounting, interviews of key personnel, etc.).

Some relief may be provided by Article 42(2) of the CO which, in cases where the exact value of the damage cannot be quantified, gives the court certain discretionary power to estimate the damage. However, while this provision lightens the burden of proof under certain conditions, it does not eliminate it.

Alternative to claiming the reduced company value, it can be easier for the buyer to claim compensation for individual damage positions based on breaches of specific warranties (e.g. reduced value of means of production, lost profit, etc.).

Limitations of liability

M&A contracts typically contain limitation of liability clauses. Swiss law restricts the parties' ability to limit or exclude liability primarily in two provisions.

Article 100(1) of the CO stipulates that any agreement excluding liability for unlawful intent or gross negligence in advance is void. Thus, any exclusion of specific types of damage (e.g. consequential damages) does not apply if the party in breach acted in gross negligence or willfully.

Specific to warranty obligations under sales contracts, Article 199 of the CO provides that the seller may exclude all warranty obligations except for having fraudulently concealed a defect. There remains some legal uncertainty whether and to what extent sellers can invoke such exclusions with respect to express representations and warranties.

Conclusion

The quantification of damages in post-M&A disputes depends largely on the applied valuation method, with contractually agreed valuation methods taking priority. Otherwise the Federal Court uses a plurality of methods to determine the objective value of the company and on that basis the recoverable loss. Obviously, the role of a party in the transaction as seller or buyer will often be a factor in such party's readiness to agree to a valuation method in advance.

With respect to drafting forum selection clauses, differences between litigation and arbitration currently remain regarding the valuation methods applied absent a contractually agreed method and the standards applied to discharging the burden of proof.

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Where to start with start-ups

You have an idea, you have the expertise and there is a niche in the market for it, you might even have some contacts that will help you in getting started or that could be your first potential clients. It is exciting and overwhelming in equal measure.

Most start-ups are experts in their field but do not necessarily know what they need to focus on commercially or legally to start or grow a business. Founders starting a business for the first time will likely do endless research on growing a business, tips for marketing and how to get customers through the door. They will often also make it a commercial priority to pick a web designer and a social media platform for the new business.

In our experience, the legal side, the part that will protect the founders and the business falls to the bottom of the list due, mainly, to cost. Start-ups cannot afford expensive lawyers when they have no income, no clients and are often fronting the costs of set-up out of their own pocket. Unfortunately, disregarding the legalities early on can often lead to expensive legal issues further down the line, this usually culminates in one of three ways: (i) issues with the corporate structure, (ii) issues between the founders and/or (iii) customer liability issues.

Starting up in the UAE can be cost effective and with multiple jurisdictions that are income and capital gains tax free and a diverse pool of entrepreneurs, it is an attractive market for start-ups. It is key to take some legal steps early on and founders should be considering the legalities and the liabilities of a business from day one.

Do you have the correct licences and consents, how will the founders make decisions, will you re-invest your profit or take it out of the business, what happens when the founders do not agree or one does not hold their end up, what if your

customers do not pay, what if a customer makes a complaint, or sues you?

In acting for start-ups, Ibrahim & Partners would always suggest the following 'start-up' checklist:

1. Take corporate structuring advice

Unlike other jurisdictions, the UAE has a wealth of options in terms of setting up a company. Whether you go with a mainland limited liability company, pick a free zone or offshore entity, will mainly depend on what type of commercial activities you are intending to carry out.

However, location will also play a factor, as will your intended corporate structure, especially regarding foreign ownership. Picking a functional corporate structure early on will avoid costly restructuring and transfer later. No one can predict all eventualities, however, planning for the future will affect your corporate structure and should be a consideration when incorporating.

Your corporate structure will also affect your visa and office requirements. Most jurisdictions will require the leasing of an office space or a flexi-desk, although there are some options for start-ups to avoid this cost in the company's infancy such as the instant office offered by the Dubai Department of Economic Development.

2. Get a licence

In the UAE, you cannot trade without a licence and to get a commercial trade licence, you need a corporate entity (even if you are a sole proprietor or trader).

Determining your commercial activity is important not only structurally (see below) but also to ensure that you can continue to carry out the activities you foresee as the business grows.

3. Agree how to run the business

People go into business together every day, friends, family, colleagues, acquaintances, people with common experience. Every business relationship, like every other kind of relationship, will disagree at times. It is a common belief that founders have discussed all the key points with their co-founders and that everyone is on the same page as to how to move forward. It is also a common belief that everyone will act honourably, with good faith and for the best interests of the business at all times.

Unfortunately, what is deemed honourable, in good faith and in the best interests of the business often differ from person to person. Founders disagree, they cannot see eye-to-eye, mistakes are made, people react, the founders can end up wanting to take the business in completely different directions or with a different partner.

It is crucial to agree the legal fundamentals – how is profit dealt with, how do you want to raise capital, are there commercial decisions that should be agreed jointly, who will run the day-to-day operations and if jointly what happens when you do not agree, what happens if someone is incapacitated long term or dies, will other shareholders be brought in, are you going to have restrictions on competing with the company if one person leaves, should there be circumstances where you can force someone out.

Please note, that the articles of association of the company will likely need amending to ensure there is no conflict with the agreement between the shareholders.

4. Customer terms and conditions

Finally, do not underestimate the importance of your customer terms, having a formal contract with customers will be crucial if you need to enforce things like payment against your customers. Similarly to your shareholders' agreement, they will also govern the obligations and expectations on both parties, so that the commercial relationship is clear and any restrictions on customers are set out contractually and expressly agreed to.

There has been an increase in consumer protections under UAE law recently, if you are providing services or goods to consumers rather than businesses, you will need to ensure that you are not breaching consumer rights and also it will be of more importance to mitigate risks of litigation. Terms and conditions can start as a simple set of basic terms that will be amended and moulded as the business develops.

5. Get insurance

Finally, get insurance, irrespective of the type of services or goods you are providing, publicor/product liability insurance and any others that are industry specific insurances are crucial so that you have a safety net, a single claim on insurance can bankrupt a young company.

Ultimately, preparing for the worst (whilst hoping for the best) will protect you and your growing business, it will also showcase your commercial sophistication thereby placing you in a better market position from kick-off.

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Climate conundrum

Climate change is international in scope. The challenge has required, met ineffectively for the most part, cross-border cooperation on an unprecedented scale. Every nation has a role, and the US can set an example for how to curtail climate change through an admired legal and financial system.

The largest economies in Asia- China, India, Japan, Indonesia, Turkey, and South Korea - must cooperate, alongside the US, with EU nation leaders on climate that are furthest along - including Germany and France that have scheduled the most ambitious climate goals.

We're talking about planetary survival.

For better or worse, the macroeconomic method to effect climate that wealthy countries have decided, is through finance and business. While individual actions to limit carbon footprint are important, these contain inherent insufficiencies.

Noted by US late night show host Stephen Colbert, collective corporate accountability dwarfs individuals importance.

Research from the Climate Accountability Project has indeed determined that fossil fuels contribute outsized emissions when compared to individuals and that 20 companies alone account for about one-third of all carbon emissions.

Colbert also joked in a Climate Week segment, with research armed, that older Americans care much less about the future of the planet than younger people.

"I'm surprised so few senators believe it," Colbert said. "Chuck Grassley must be shocked at all the changes he's seen since his childhood in Pangea."

While not putting on too fine a point, the reason is simple: the older you are, the less time you have remaining on this planet.

Grassley, a conservative Iowa senator, received an approval rating of just 8% environmental for 2020, and 18% lifetime from the League of Conservation Voters, for votes on climate in 2020 and for his lifetime as a lawmaker.

If you're older, you may misunderstand or feel targeted, but that's not the intent. It is imperative that US citizens are educated about what future is likely for generations after us. After all, isn't the air we breathe, the oceans and sky, and the world, for the living? And that's no laughing matter.

A final note

It is clear that the face of journalism has been irrevocably changed over the course of the last few decades. One by one, print publications are falling by the wayside and succumbing to the pressures that readers want. Fast paced, instant gratification – yesterday's news is in the past, tell me what is happening now. Newspapers and magazines around the world are coping with this change by moving resources away from print towards digital offerings, and IFLR is no different.

This edition marks the final print copy of IFLR. We have joined the ranks.

But, it is important to look at this in a positive light. At the peak of print journalism, probably some 80 years ago, when the population was smaller but still vast, think how many trees were felled on a daily basis to produce enough paper to print them all, or how many units of electricity were used to run the press, or how much fuel was needed to distribute globally. A lot.

Every magazine that stops its print run is a success story for the environment and for the planet. I've been to countless legal offices in my time with IFLR and seen screeds of newspaper, reports and rankings, magazines, all largely untouched. The days of sitting in office waiting rooms are over, so we don't need to litter them with paper anymore.

If any of you are unhappy with the way things are going, remember that the capacity for online journalism and the information you receive can only increase as resources grow. The decline of print is simply a byproduct of the rise of digital, so go listen to IFLR's podcast and think about the good you are doing to the world.

Change isn't good or bad. It just is.

Estimated carbon footprint of producing one magazine

0.82kg	of carbon dioxide per one issue
3km	Greenhouse gas emissions driving distance equivalent
99	smartphones fully charged
0.002	barrels of oil consumed
0.906	pounds of coal burned

If you have any questions about our move away from print, please email john.crabb@euromoneyny.com