BUSINESS INSIGHTS

Recalibration of the Asset Footprint

Focusing on International Platforms in Bankruptcy or Insolvency

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Cross-border loan workouts and enforcement of security interests across multiple jurisdictions is a complex matter and greatly depends on the venue of the insolvency and the location of the collateral. These factors are also intertwined with the overall reach of the credit facility. A deep understanding of the multiplicity of issues that may arise during a workout or insolvency can not only enhance a lender's ability to be made whole in an enforcement scenario, but can also create opportunity for liquidity providers to expand their geographic offerings and create unique value for their global borrowers.

This is the third and final article on the topic of recalibration of the asset footprint across cross-border jurisdictions from the perspective of the asset-based lender. In the first article we addressed the benefits and perils of financing a borrower's global expansion plans within the confines of an asset-based loan structure. The second article outlined the key practical considerations of valuing collateral assets spread among different countries. This article focuses on what a lender should expect when confronted with a cross-border insolvency or bankruptcy of its borrower.

The subject of cross-border insolvencies is as broad-ranging and diverse as the countless number of separate legal regimes and countries across the globe. A single article can offer only a brief summary of such an intricate topic. Nonetheless, there is a common narrative in most cross-border workouts. As we illustrated in the first two articles, the location of both the borrower and the collateral are the key starting points to be considered when underwriting a cross-border loan. The same logic applies to a cross-border workout. Presumably, long before being confronted with an event of insolvency, a lender and its professionals will have structured the facility with a view toward the eventuality of enforcement in multiple jurisdictions (consistent with our prior recommendation to obtain expert local advice and a country-specific valuation in each relevant jurisdiction). In many countries, however, the letter of the law is only one factor among many to reflect upon.[1] Unwritten local customs and practices are often as, if not more, important to understand in order to protect an asset-based lender's interests.

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Despite the array of jurisdictions, and countless variations of practices and conventions among and within each territory, most countries' legal systems fall into one of two broad groups: common law and civil law. Whether the insolvency is underpinned by one or the other will have a material impact on the secured lender's capacity to enforce its rights. All things considered, insolvency laws in common law countries tend to provide the secured lender with a greater degree of protection and enforcement rights over all forms of collateral.[2] This does not imply that civil law systems are not lender-friendly, but beyond taking security over real property or through the actual possession of movable assets – which tends to be well developed almost everywhere – security over the kind of movable or intangible collateral on which many asset-based loans rely are much more difficult to enforce with any high degree of confidence in these jurisdictions. To simplify our comparison, we will focus on the US and UK when looking at common law systems and Continental European countries as their civil law counterpart.[3]

Legal regimes based on common law – which are typical of most English-speaking countries – generally afford secured lenders a greater level of predictability when it comes to insolvency (or even enforcement in a solvent context). The range of options vary significantly from country to country, though. From the unilateral ability of a secured lender to select and appoint an administrator after a default without court supervision in places like the United Kingdom or Australia, to the debtor-in-possession Chapter 11 bankruptcy process in the United States, secured lenders faced with a credit in insolvency in a common law country are, more often than not,

able to proactively protect their interests. This often includes the ability to force a sale of the collateral or require other recapitalization structures intended to protect the lender.

In stark contrast, most civil law jurisdictions (e.g., virtually all countries in Continental Europe) tend to be more debtor-friendly and most processes are court-supervised. As a general rule, these insolvency systems frown upon an immediate liquidation or prompt sale of the collateral. The initial expectation is for a deliberate and unhurried process that leads to a reorganization or a going concern sale of the productive units of the insolvent business. A sale of collateral, in particular assets that are essential to the ongoing operations of the debtor, is very rarely permitted until the prospect of a going concern sale has been exhausted. In many of these countries, secured creditors are mere spectators, allowed little more than the basic right to file their claims as any other creditor. Moreover, secured creditors may only get repaid through the distribution of the proceeds of sale of their collateral under a court-supervised process in which they have limited ability to object or even credit bid. Even the length and efficacy of the sale and distribution in many of these systems often depends on the specific court and professionals involved. Similarly, the actual duration of the filing, sale, and distribution phase are court-specific, as the terms provided by the law are often deemed to be indicative and not mandatory.[4] Finally, civil law systems are more likely to give priority over a secured lender's claim to a number of statutory claims like certain taxes and labor claims.

With the ever-increasing globalization of trade and the apparent political and social volatility in many developed countries, there has been a push for changes into well-established tenets of secured lending laws. For example, the United Kingdom has historically been a creditor-friendly system. This, in turn, has given rise to a robust ABL market and corresponding high liquidity. Not unexpectedly, the political and economic uncertainty of the last few years, coupled with some high-profile insolvencies, have put the system under a greater degree of scrutiny. This has led legislators to consider some drastic changes to the well-established insolvency statutes, which, if enacted, could swing the pendulum towards a more debtor-friendly scheme.

Starting in April of 2020, certain tax claims will have super-priority ranking (so-called "secondary preferential creditors") and the right to be repaid out of the collateral of a floating charge holder (the so-called "Crown Preference"). This may deplete the security pool available to lenders that are reliant upon floating charges to fully secure their advances. Where an asset- based lender is particularly reliant upon floating charge assets, they may be forced to reduce or even withdraw existing facilities.

Several matters are currently under discussion. Including the following, among others:

- the introduction of an early automatic stay (even for out-of-court proceedings) that would restrict the rights of a floating charge holder;
- the creation of a new, stand-alone procedure which would allow the cram down of a dissenting class of creditors; and
- a prohibition on the enforcement of contractual termination rights which arise solely because a party has entered into an insolvency procedure (so called "ipso facto" clauses) which may have significant consequences for suppliers of goods and services.

Whether these reforms will be ultimately made into law, and in which form, remains to be seen, but the impact on asset-based lending could be profound.

Conversely, in recent years, several European jurisdictions have made efforts to improve liquidity by introducing creditor-friendly reforms, including the opportunity for extrajudicial enforcement of some types of pledges and a methodology for lenders to get security over movable and after-acquired assets. Some notable examples of these reforms in Europe are Belgium and Italy.[5] In Belgium, there is now an electronic pledge register, and the enforcement of a properly registered pledge will no longer require court intervention. Pledgors and pledgees will be able to agree to the terms of enforcement, including the option for the lender to repossess and/or sell the pledged assets. Similarly, in Italy[6] a floating-charge equivalent should become effective once the specific electronic registry becomes fully operational. Also in this case, enforcement will no longer require court involvement if the parties have agreed to sale procedures in advance. These new laws, however, have not yet been adequately tested in their respective judicial systems. Given the legacy of hostility to self-enforceable remedies in civil law systems, it will take time for these advances to be fully understood and relied upon for underwriting purposes.

It is worth mentioning that the European Parliament and Council formally adopted last June a Directive on preventive restructuring frameworks,[7] which unmistakably resembles the US Chapter 11 process. The goal of the Directive is to harmonize the laws and procedures of EU member states in restructurings, insolvency, and the discharge of debt. It introduces a set of baseline principles, along with more targeted rules in some specific cases, and allows member states discretion to go beyond these basic principles when incorporating rules into national law. Some notable features of the Directive's framework are as follows:

- a debtor-in-possession process;
- automatic stay;
- performance of essential executory contracts;
- prohibition of ipso facto clauses;
- protection of new financing or interim financing; and
- classes of creditors, cross-class cram down, and best interest of creditors test.

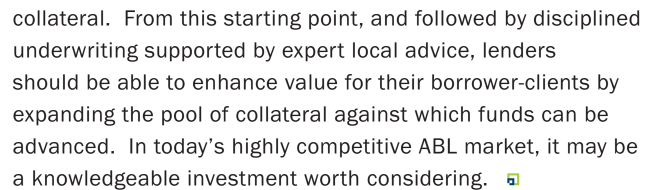
This development should be encouraging to creditors familiar with the overall predictability of the U.S. bankruptcy system. Yet, the Directive also introduces a controversial feature: Member States can opt-in to adopt a "relative" priority rule instead of the "absolute" priority rule that is the mainstay of the Chapter 11 system's protection of secured lender's rights.

As readers of this publication are surely aware, the absolute priority rule in Chapter 11 requires senior classes to be paid in full before any junior class can receive any distribution under a cram-down plan. In stark contrast, the optional relative-priority rule in the Directive would allow confirmation of a cram-down plan so long as all senior classes are treated more favorably than junior classes, even if not repaid in full. EU officials in support of this relative priority rule have argued that it would result in a more objective and pragmatic treatment of creditors. However, this rule would in all probability allow shareholders to retain much of the enterprise value while forcing secured and other creditors to accept far less than full repayment. This rule is squarely at odds with the stated purpose of the Directive. If adopted by any Member States, it is certain to generate uncertainty and make the underwriting of risk for loans very challenging.

Regardless of the prevailing civil or common-law system, a well-structured cross-border secured loan bolstered by solid underwriting not only ensures that the secured lender's downside is protected, but also allows the sale of collateral in one or more jurisdictions to become an effective tool in the restructuring of the credit for both the lender and borrower. For instance, unwinding an unprofitable territory may assist the borrower's reorganization efforts by simultaneously reducing the lender's exposure and improving the borrower's overall performance. Yet, this can only be accomplished in the context of the borrower's country exit or wind down if the secured lender's rights are not impaired by the borrower's local insolvency process. In other words, the sum of the parts in cross-border transactions is often more valuable than the whole.

It is worth pointing out that in many countries, financing activities are regulated and reserved to banks or authorized financial institutions. This should always be addressed during the original underwriting, as it is too late to remedy a breach of lending regulations once the loan is funded. Our experience suggests that this is not always the case, even with sophisticated capital providers. In such instances, the rights of a secured lender may be impaired by unforeseen exposure to civil and, in some cases, criminal, liability.

As highlighted in the beginning of this article, loan workouts and enforcement of security interests in a cross-border setting is a multifaceted topic that occupies entire law library sections. We have attempted to provide a broad introductory overview by summarizing some essential elements that are common to all of these processes. The gating factors are the venue (or venues) of the insolvency and the location (or locations) of the collateral. From this starting point, and followed by disciplined underwriting supported by expert local advice, lenders should be able to enhance value for their borrower-clients by expanding the pool of collateral against which funds can be advanced. In today's highly competitive ABL market, it may be a knowledgeable investment worth considering.



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[1] Given the limited scope and length of this article, we are specifically not touching upon the knotty venue issues that arise in the context of many cross-border insolvencies. Instead, we are assuming that the lender's professionals will have advised the lender on the insolvency regimes that may apply to enforcement of the underlying security, by analyzing the Center of Main Interest of the borrowers and guarantors, and the applicability of cross-border statutes in the applicable countries.

[2] We are mindful that this is a broad generalization made for the sake of brevity, which omits the many material differences of secured loan treatment between insolvency systems within the common law tradition. Nevertheless, we believe that this distinction is reasonably accurate based on our extensive practical experience with cross-border secured transactions in both kinds of legal systems.

[3] Obviously lumping all Continental European countries into one for legal analysis is also fraught with the risk of overgeneralization. However, there are some important similarities between the many civil law systems in the EU, and as addressed later in this article, a growing centralized approach to insolvency legislation which is conducive for us to offer a joint perspective.

[4] In recent years, some European jurisdictions have introduced the possibility of an out-of-court enforcement for specific forms of pledges, but many of these new laws have not yet either been enacted or tested in court to provide sufficient underwriting comfort in the ABL context.

[5] Law 11 July 2013 entered into force 1 January 2018

[6] Law Decree 2016, converted into Law 119/2016

[7] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on Restructuring and Insolvency).