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Intra-group financing and enterprise group insolvency: problems, principles and solutions

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Part III

Principles of Insolvency Law and How to Balance Them

4 Principles of Insolvency Law and Principle-based Approach[■]

4.1 Introduction

Commenting on the methodological foundations of modern law scholarship, Burrows observes that "we rarely find doctrinal scholars analysing the precise methodological approach that they are adopting."[1] When interpreting law and making normative suggestions one can rely on different methods. For example, one can use economic arguments, examining law from ex ante and ex post positions.[2] Empirical research methods are also becoming more popular. Another method is to focus on underlying legal principles. This method is embraced by this book, in combination with comparative analysis and periodic references to pragmatic or economic arguments.

In the choice of the research methodology, we are inspired by the writings of Reinhard Bork, professor at the University of Hamburg (Germany).[3] In his works, Bork collects and describes the main principles of international and national insolvency law, systematises and contextualises them, and devotes attention to the benefits of using principles as a tool to examine and better understand law, and to make suggestions for its improvement. Wessels notes that the "principle-based approach provides inspiration for evaluating research and may lead to reconsider proposals for shaping and

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■ This chapter builds upon the following previously published work by the author:
- I. Kokorin, Intra-Group Financial Support in a Crisis: Between Rescue and Abuse, Norton Journal of Bankruptcy Law and Practice, Vol. 29, 2020, pp. 378-420.
- I. Kokorin, The Rise of 'Group Solution' in Insolvency Law and Bank Resolution, European Business Organization Law Review, Vol. 22, 2021, pp. 781-811.
- I. Kokorin, B. Wessels, annotation: European Court of Human Rights 5 July 2018, no. 41299/09 & 11132/10, *JOR* 2019, 3; 778-790 (*JOR* 2019/64, *Boyadzhieva and Gloria International Limited Eood v. Bulgaria*).

1 A. Burrows, Remedies for Torts, Breach of Contract, and Equitable Wrongs, OUP, 4th edn, 2019, p. 21.

2 R. Posner, Economic analysis of law, 8th edn, Austin, TX: Wolters Kluwer Law & Business, 2010.

3 R. Bork, Corporate Insolvency Law. A Comparative Textbook, Intersentia, 2020; R. Bork, Principles of Cross-Border Insolvency Law, Intersentia, 2017. The principle-based approach was followed in a more recent book, written by Bork together with Michael Veder, professor at Radboud University (the Netherlands). See R. Bork and M. Veder, Harmonisation of Transactions Avoidance Laws, Intersentia, 2022.

improving cross-border insolvency law."[4] But what is a principle-based approach? Essentially, it boils down to a legal analysis based on a taxonomy of relevant and widely-accepted standards. It entails a study of rules (i.e. positive law), their assessment through the lens of legal principles with the purpose of developing optimal policy choices.

There are multiple benefits of using the principle-based approach. Legal principles represent broad standards and core values behind practice and behaviour. Better understanding these values is crucial to grasp the essence of law, which is key to better interpretation and application of legal rules. The principle-based approach can also facilitate change and harmonisation efforts, because it helps to find principle-based solutions to similar problems experienced by various legal systems. Finally, clarity of legal principles allows a deliberate and well-informed balancing exercise to solve conflicts between legal principles.

The choice of the principle-based methodology in this book is premised on the realisation that financial distress within international enterprise groups gives rise to complex legal and financial issues, which are not always possible and easy to conceptualise or codify into rigid rules. Going back to the legal principles is one way to deal with this complexity. However, any study of law benefits from the use of different research methods. Considering this book's subject – intra-group financing and insolvency within enterprise groups, often driven by economic considerations – incursions into law and economics are inevitable. This is why some chapters of this book will use economic insights when analysing group relationships, problems and potential solutions. This analysis is not meant to be full or comprehensive. After all, the goal of economic efficiency that underpins law and economics scholarship may need to give way to the rationale of legal coherence, seen as a unifying or internal structure of law.[5] In addition to preserving coherence, law may be driven by the pursuit of goals other than economic ones.[6]

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4 B. Wessels, Book Bork on Cross Border Insolvency Law, 2 October 2017 <https://bobwessels.nl/blog/2017-10-doc1-book-bork-on-cross-border-insolvency-law/> (accessed 3 December 2022).

5 E.J. Weinrib, The Idea of Private Law, OUP, 2012, p. 30, noting that "coherence points to the existence of some sort of internal connection between the various features that cohere."

6 A. Keay, Insolvency Law: A Matter of Public Interest? Northern Ireland Legal Quarterly, Vol. 51, 2000, pp. 509-534; E. Warren, Bankruptcy Policymaking in an Imperfect World, Michigan Law Review, Vol. 92, 1993, p. 355, arguing that insolvency policy should give consideration to the distributional impact of business failures on parties who are not creditors. Paterson describes the debate among scholars adopting an economic approach to corporate reorganisation law and scholars adopting a progressive approach, as a "debate about the ways in which a capitalist economy promotes public interest and social welfare." S. Paterson, Corporate Reorganization Law and Forces of Change, OUP, 2020, p. 2.

The chapter proceeds as follows. Section 4.2. deals with an unavoidable issue of definitions. Section 4.3. identifies those legal principles which are of the highest relevance for our analysis. Section 4.4. explores how the legal principles apply in a group insolvency setting. Section 4.5. concludes.

4.2 Defining a Legal Principle

Law is connected to fundamental societal values by way of legal principles. These principles express certain basic standards and constitute the normative core of a legal system. There are continuous academic debates about the definition of a legal principle, its true meaning, content and nature.

According to Dworkin, a major proponent of the principle-based theory of law, a "principle" is a "standard that is to be observed, not because it will advance or secure an economic, political or social situation deemed desirable, but because it is a requirement of justice or fairness or some other dimension of morality."[7] Yet the notions of justice and fairness are themselves difficult to grasp. They also tend to depend on specific context, historical and cultural factors and individual perceptions. This is not to say that the formation of legal principles is free from the influences of prevailing moral and social customs and practices. However, the principles discussed in this book are primarily derived from rules and regulations rather than solely from the dimension of morality.

For Alexy, legal principles are optimisation commands or requirements (*Optimierungsgebot*), which signal or dictate that something should "be realized to the greatest extent possible given the legal and factual possibilities."[8] This forward-looking character of principles was highlighted by Ávila, who argues that "principles" are "immediately finalistic, primarily future regarding norms which intend to be complementary and partial, whose application requires assessing the correlation between the state of affairs to be promoted and the effects of the conduct seen as necessary to its advancement."[9] Thus, legal principles set forth valuation guidelines which should be followed in order to achieve an ideal state of affairs. But they fall short of describing the exact behaviour needed to accomplish the goals.

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7 R.M. Dworkin, The Model of Rules, The University of Chicago Law Review, Vol. 35, 1967, p. 23. For criticism of the Dworkin's theory of principles, see L. Alexander, K. Kress, Against Legal Principles, Iowa Law Review, Vol. 82, 1997, p. 745, arguing that "principles that fit the legal rules and that are assessed for moral attractiveness are not themselves moral principles." In other words, Alexander and Kress assert that legal principles arise from the body of posited, canonical legal rules, which does not mean that they are the morally best principles.

8 R. Alexy, A Theory of Constitutional Rights, OUP, 2010, p. 47.

9 H. Ávila, Theory of Legal Principles, Springer, 2007, p. 40.

Instead, they complement decision-making, and their realisation depends on a specific situation, as well as the existence of other principles at play.

The difficulty of offering a universal definition of a "legal principle" is evident from an overview of documents produced by the standard-setting organisations. For example, the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (World Bank Principles)[10] and INSOL International's Statement of Principles for a Global Approach to Multi-Creditor Workouts II[11] describe principles as the "distillation of international best practice" and "statements of best practice" respectively. In the ALI/III Global Principles for Cooperation in International Insolvency Cases,[12] principles are mentioned alongside "core values". Other documents not directly or solely related to insolvency, such as the Principles of European Contract Law[13] and the UNIDROIT Principles of International Commercial Contracts,[14] equate principles to "general rules". The Draft Common Frame of Reference follows the above instruments in considering principles as rules of "a more general nature, such as those of freedom of contract and good faith."[15]

Treating legal principles as fundamental rules, norms,[16] meta-norms,[17] important topics and statements of best practices is confusing and does not clarify the meaning of a principle for the purposes of this study. Much more useful is the distinction between legal principles and legal rules. According

10 The World Bank, Principles for Effective Insolvency and Creditor/debtor Regimes, 2021.

11 INSOL International, Statement of Principles for a Global Approach to Multi-Creditor Workouts II, 2nd edn, 2017.

12 ALI/III Transnational Insolvency: Global Principles for Cooperation in International Insolvency Cases, 2012.

13 The Principles of European Contract Law (PECL), Article 1:101(1): "These Principles are intended to be applied as general rules of contract law in the European Communities."

14 UNIDROIT Principles of International Commercial Contracts (UPICC), 2016, Preamble: "These Principles set forth general rules for international commercial contracts."

15 C. von Bar et al. (eds), Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference (DCFR), Outline Edition, Sellier, 2009, p. 9.

16 Raz refers to legal principles and legal rules as "general legal norms" since both of them guide human behaviour by proscribing a certain course of action. J. Raz, Legal Principles and the Limits of Law, The Yale Law Journal, Vol. 81, 1972, pp. 823-854. Schauer writes that "in the contemporary conception of norms, norms are the prescriptive rules […] about human behavior that are not written down in canonical form, but which arise largely from our social existence." F. Schauer, The Force of Law, HUP, 2015, p. 140. Schauer distinguishes these social norms from legal norms, which are supported by "the force of law".

17 J.A.E. Pottow, Greed and Pride in International Bankruptcy: The Problems of and Proposed Solutions to 'Local Interests', Michigan Law Review, Vol. 104, 2006, p. 1929, defining a meta-norm as a "a norm that is a step removed from the baseline content of a specific statutory provision." Pottow provides an example of "employee protection" as a bankruptcy meta-norm.

to Dworkin, rules apply in an all-or-nothing fashion.[18] Thus, if the conditions for the application of a rule are satisfied, this rule must be followed (if → then). If there is a conflict between the rules, one of them ought to be considered invalid, unless an exception to the rule applies. Unlike rules, principles have a higher level of abstraction and often do not prescribe a particular course of action or conditions that make their application necessary.[19] Ávila notes that rules are distinct from principles to the extent that they constitute "immediate descriptive norms" and contain obligations, permissions and prohibitions.[20] Alexy emphasises that unlike rules, principles are not definitive but only *prima facie* requirements or reasons that can be displaced by other *prima facie* reasons.[21]

Consider the following example of a provision in the law containing a rule, backed by a specific legal principle or principles. Article 372(3) of the Dutch Bankruptcy Act permits the debtor to submit a request to the court and ask for a stay (cooling-off period) for the benefit of third parties – group guarantors, collateral providers or co-debtors. This rule is underpinned by the principle of procedural efficiency – third parties do not need to file separately to benefit from a stay. As a result of this extended stay, creditors cannot enforce claims against group entities and thereby destroy group synergies and disrupt restructuring efforts. Thus, there are at least two principles behind the rule: procedural efficiency and estate value preservation and maximisation. Another example is § 365(e) of the US Bankruptcy Code. Under it, ipso facto clauses – provisions in executory contracts and unexpired leases that terminate or modify such contracts upon the commencement of a bankruptcy case are unenforceable. If a clause in an executory contract falls within the scope of this rule (if → then), it has no legal effect. The reason behind an ipso facto ban relates to the fact that ipso facto clauses could hamper rehabilitation efforts and lead to the unnecessary liquidation of economically viable businesses.[22] This rule, therefore, contributes to the principle of value preservation and maximisation.

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18 R.M. Dworkin, The Model of Rules, The University of Chicago Law Review, Vol. 35, 1967, p. 25.

19 H. Gribnau, Legitimacy of the Judiciary, in E.H. Hondius, C. Joustra (eds), Netherlands Reports to the Sixteenth International Congress of Comparative Law, Intersentia, 2002, pp. 25-45, observing that rules may be seen as "operationalisations of principles", which have more concrete and "technical" character. Gribnau distinguishes rules from principles by pointing out that the former are commands formulated by authorised institutions, while the latter lack the imperative quality but possess normative quality.

20 H. Ávila, Theory of Legal Principles, Springer, 2007, p. 34.

21 R. Alexy, A Theory of Constitutional Rights, OUP, 2010, p. 57.

22 Report of the Committee on the Judiciary together with Separate Supplemental, and Separate Additional Views, H.R. Rep. No. 95-595, 1977, at 348, explaining that the goal of § 365(e)(1) is to restrict the application of clauses that frequently hamper rehabilitation efforts.

In sum, legal principles are distinguished from rules and positive law, more generally, that may or may not reflect a particular legal principle. A rule might contradict a legal principle and may need to be revised or re-interpreted in order to bring it in line with a principle. Legal principles are manifestations of fundamental values in a legal system. They can find their way into a variety of rules, sometimes in different areas of law.[23] Societal and economic background is capable of affecting our understanding of legal principles. It may also cause new principles to appear and substitute or supplement the existing ones. In other words, legal principles develop over time to accommodate different values and views. Yet they are more stable than rules which can be introduced on a whim. The next section discusses the legal principles that are most relevant for this book.

4.3 Core Legal Principles at Play in Insolvency

4.3.1 Classification of legal principles

Bork divides the principles of insolvency law into three broad categories: (i) jurisdictional, (ii) procedural, and (iii) substantive principles.[24] Jurisdictional principles deal with the relationships between sovereign states and include, among others, principles of unity, universalism, mutual trust, communication and cooperation in insolvency cases. Procedural principles relate to the organisation of a procedure, which must comply with the standards of efficiency, transparency, predictability and procedural justice. Many of these principles are not peculiar to insolvency proceedings and apply to a general civil procedure. The third category is substantive principles. These principles are often unique, reflecting the influence of insolvency on the substantive rights and legal position of different parties, including creditors, debtors and shareholders.

Among the substantive principles, Bork mentions: (i) equal treatment of unsecured creditors, (ii) the best possible realisation of debtor's assets (insolvency estate value maximisation), and (iii) protection of legitimate expectations, also referred to as protection of trust. The latter is closely related to the principles of party autonomy and freedom of contract. As such, protection of trust and freedom of contract are not the principles "of" insolvency law, but the principles "relevant for" insolvency law. The book

23 For example, the principle of protection of legitimate expectations and certainty of transactions justifies special treatment of rights *in rem*, both in the context of property, contract and insolvency law. This principle is further evidenced in concrete rules, for instance, in Article 8 of the EIR Recast, which in some cases insulates rights *in rem* from the effects of *lex concursus*.

24 R. Bork, Principles of Cross-Border Insolvency Law, Intersentia, 2017, pp. 16-17.

focuses on these principles in view of their relevance in a group financing and insolvency context. As noted in the introductory chapter, private international law falls outside the book's scope, thereby making jurisdictional principles less relevant for our discussion. The same applies to procedural principles, at least to the extent they do not directly implicate one of the substantive principles.

The selection of principles in this book does not dismiss the importance of other legal principles. On the contrary, their significance must be expressly recognised. One example is the principle of social protection, which often plays a distinct role in structuring and executing corporate and financial restructuring.[25] Yet its relevance to the main subject of this book is not leading. Given the wide range of social standards and policies protecting employment,[26] and specific national variations of such standards, any in-depth and well-deserved analysis of the principle of social protection cannot be undertaken within these pages. Similarly, the application of jurisdictional principles in group insolvencies merits a separate book.

4.3.2 Principles of insolvency law v. principles of restructuring law

One may wonder (and rightly so) whether the principles of insolvency law, listed above, should equally apply to the types of restructuring proceedings that require neither (full) collectivity (Dutch WHOA plans, English schemes of arrangement and Part 26A restructuring plans) nor a set degree of financial distress or, indeed, insolvency (US Chapter 11, English schemes of arrangement). This is an important consideration that becomes more evident as we dive into the comparative analysis of national laws in the subsequent chapters of this book.

The type of procedure cannot be ignored because it affects the scope of available tools. For example, transaction avoidance is not available in English company voluntary arrangements and schemes of arrangement,

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25 A. Kastrinou and S. Vullings, 'No Evil is without Good': A Comparative Analysis of Pre-pack Sales in the UK and the Netherlands, International Insolvency Review, Vol. 27, 2018, pp. 320-339, discussing the effects of the CJEU's ruling in *Estro/Smallstep* on pre-packaged restructurings (pre-packs). Also, Article 369(4) of the Dutch Bankruptcy Act (*Faillissementswet* or Fw), stating that the provisions on WHOA schemes do not apply to rights of employees arising from employment contracts.

26 J.L.L. Gant, Studies of Convergence? Post-Crisis Effects on Corporate Rescue and the Influence of Social Policy: the EU and the USA, International Insolvency Review, Vol. 25, 2016, pp. 72-96, noting strong path dependence in labour law, grounded in different cultural and traditional ideologies. Also J.L.L. Gant, Balancing the Protection of Business and Employment in Insolvency: An Anglo-French Perspective, Eleven International Publishing, 2017.

as well as in Dutch WHOA schemes. Yet transactions can be challenged in a Chapter 11 procedure, English administration, and Dutch bankruptcy procedures. Another example is third-party releases (Chapter 10), which have a statutory basis in the rules on WHOA schemes, but not in the rules concerning bankruptcy and suspension of payments. Given how different these procedures are, can they be subject to the same set of legal principles?

Arguing that the realms of insolvency and restructuring law and the legal principles underpinning them should be separated, Madaus writes that "a restructuring agreement would be the result of restructuring proceedings which do not respond to a common pool problem, but instead aim at facilitating the conclusion of a contract and, thus, are governed by contract (and company) law rules and principles."[27] For Madaus, the said realms are distinguished on the basis of the problem that law aims to solve – a collective action problem (insolvency law) v. anticommons (restructuring law). Bork and Veder also observe that the principles of insolvency law are not applicable "where the proceedings are not dependent on the debtor's insolvency and therefore not collective proceedings."[28] Hence, for Bork and Veder, the realms are separated based on the requirements of "substantive insolvency" and "collectivity".[29] This means that restructuring proceedings used at an early stage of the financial crisis and those not entailing collectivity are not covered by insolvency law and its principles. By contrast, Mevorach and Walters state that "[i]nsolvency and restructuring law is […] a unified body of law that maps onto the continuum, rather than two discrete bodies of law."[30]

Any attempts to strictly delineate insolvency and restructuring laws are problematic for several reasons.

27 S. Madaus, Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law, European Business Organization Law Review, Vol. 19, 2018, p. 630.

28 R. Bork, M. Veder, Harmonisation of Transactions Avoidance Laws, Intersentia, 2022, para. 3.5.

29 Ibid., para. 3.6., defining "substantive insolvency" as "comprising not only present but also likely and imminent inability to pay debts as they fall due […]." Thus, it covers actual insolvency, likely insolvency (inability to pay debts in the foreseeable future with likelihood of >50%) and imminent insolvency (inability to pay debts within the next few months). Note, however, that Bork and Veder discuss substantive insolvency in the context of transaction avoidance law and argue that its application would be difficult to justify in restructuring proceedings for companies "in the state of looming, but not likely imminent or present, inability to pay."

30 I. Mevorach and A. Walters, The Characterization of Pre-insolvency Proceedings in Private International Law, EBOR, Vol. 21, 2021, p. 879.

- First, the same procedure may be used for the collective resolution of financial distress or for targeted debt restructuring (e.g. Dutch WHOA scheme). If we adopt collectivity as a distinguishing criterion, the same procedure can fall under the insolvency or restructuring realm, depending on how it is being used in a concrete case. Besides, a combination of proceedings could be utilised to reach the desired goal. For example, in the UK, schemes and CVAs are often combined with administration. Applying different principles to these interlinked procedures creates unnecessary rigidity.
- Second, financial distress is a fluid concept, reflecting a demise curve or a downward spiral. In practice, looming insolvency can easily turn into a likely insolvency, imminent insolvency, or real insolvency. This is why it is rather difficult and, perhaps, arbitrary, to use the degree of financial distress as a qualifying criterion to determine if we are still dealing with restructuring law principles, or whether insolvency law principles have already kicked in. Think of Chapter 11. Since it does not mandate any degree of financial distress, one cannot determine in the abstract whether it belongs to the realm of insolvency or restructuring law.
- Third, given that group restructuring may be realised via different procedures – whether fully collective and insolvency-driven or not, a broad and open approach is well justified. The framing of law as either restructuring or insolvency does not easily fit this approach.
- Fourth, and finally, the chosen principles appear to be so fundamental and transpiring that they should and, as demonstrated below, do apply in both "traditional" insolvent liquidations and restructuring proceedings.

In sum, the choice of legal principles in this book is not substantially affected by the type of proceeding, as long as such a proceeding seeks to address the debtor's financial distress, wherever it is located on the demise curve.

4.3.3 Value preservation and maximisation

The principle of value preservation and maximisation aims to "facilitate higher distributions to creditors as a whole and reduce the burden of insolvency."[31] Insolvency law is often viewed as a way to resolve creditors' claims in the most efficient way. In principle, this is done through a collec-

31 UNCITRAL Legislative Guide, Part one, Ch. I, para. 5. In practice, however, due to privileges granted to certain groups of creditors, it is often not creditors "as a whole" who benefit from insolvency estate value maximisation, but privileged groups of creditors. See C.G. Paulus, Multinational Enterprises and National Insolvency Laws: Lobbying for Special Privileges, EBOR, Vol. 29, 2018, pp. 393-415.

tive procedure that replaces individual enforcement by creditors. The court supervises the use and disposition of assets and holds them together to preserve and maximise their value.

According to Baird, we need insolvency law "to ensure that the self-interest of individuals does not run counter to the interests of the group."[32] Bork and Veder distinguish the principles of the best possible realisation of debtor's assets (optimisation) and the best possible satisfaction of creditors' claims (satisfaction).[33] The former deals with assets which comprise the insolvency estate at the time of the opening of an insolvency proceeding and strives to secure the highest price for these assets. It does so by, among other things, providing for the termination of onerous contracts and keeping the costs of the proceeding low. The latter addresses any disadvantage caused to the general body of creditors and enriches the insolvency estate by, inter alia, undoing detrimental acts and economically revoking their disadvantageous effects. For simplicity and given how close these principles are – representing different sides of the same coin – this book refers to the unified principle of value preservation and maximisation.

This principle is recognised as a guiding principle of insolvency law by the World Bank,[34] UNCITRAL,[35] the European Bank of Reconstruction and Development,[36] the EU instruments[37] and many national legal systems.[38] The goal of value preservation and maximisation in the insolvency context has two major aspects – procedural and substantive efficiency. The former focuses on minimising the direct and indirect costs associated with insolvency proceedings. These costs include court fees and fees of IPs, but also reputational damage, workforce attrition, reduced access to credit, and unwillingness of third parties to continue trading with a financially

32 D.G. Baird, A World Without Bankruptcy, Law and Contemporary Problems, Vol. 50, 1987, p. 184.

33 R. Bork, M. Veder, Harmonisation of Transactions Avoidance Laws, Intersentia, 2022, paras. 2.43-2.50.

34 The World Bank, Principles for Effective Insolvency and Creditor/debtor Regimes, 2021, C1, mentioning that an effective insolvency system should aim to "[m]aximize the value of a firm's assets and recoveries by creditors."

35 MLCBI, Preamble, listing among is objectives the protection and maximization of the value of the debtor's assets.

36 EBRD Core Principles of an Effective Insolvency System, September 2020, Principle 2, stating that "[i]nsolvency procedures should be designed and implemented to preserve and maximise the total value ultimately available to creditors."

37 Restructuring Directive, Recital 2, noting that, among other policy goals, restructuring frameworks should help to maximise the total value to creditors.

38 L.G.A. Janssen, EU bank resolution framework: A comparative study on the relation with national private law, E.M. Meijers Instituut, 2020, p. 190, noting that in the UK, Germany and the Netherlands, the objective of maximising the returns to creditors is regarded as the primary objective of insolvency law.

distressed or insolvent entity. By some estimates, direct costs of insolvency range between 1% and 10% of the firm value, while indirect costs could reach up to 23%.[39]

The substantive dimension of efficiency underpins an array of mechanisms and tools utilised by insolvency law to preserve the existing value or to maximise it. This can be accomplished by means of transaction avoidance, prohibition of ipso facto clauses and protection of rescue financing. Some of these tools primarily aim to preserve the present value and protect it against losses. For example, a stay on individual enforcement actions, termination of disadvantageous contracts and limitations of contract clauses which could dissipate the value, all seek to keep the current asset base intact. Other tools are used to enlarge this base by, inter alia, holding debtor's directors liable for insolvency-related misbehaviour.[40] To facilitate the analysis in the following chapters of the book, a number of preliminary points should be addressed.

First, insolvency estate value can be established as either the liquidation value or the going concern value. The former represents the value of the debtor's assets if they were to be sold on the market on a piecemeal basis. The latter refers to the net present worth of the business as a going concern, taking into account its operational continuity and future income (going concern surplus)[41]. Westbrook stresses that the "going concern value may be much greater than market value (and therefore, much, much greater than liquidation value) because a living business […] may well bring a higher price as a unit than would the sale of each asset separately."[42] The preservation of the going concern value of the debtor's business may be achieved through restructuring.

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39 Z. Sautner, V. Vladimirov, Indirect Costs of Financial Distress and Bankruptcy Law: Evidence from Trade Credit and Sales, Review of Finance, Vol. 22, 2018, pp. 1667-1704, arguing that indirect costs can be reduced by increasing the likelihood of out-of-court restructuring.

40 Case C594/14 *Simona Kornhaas v. Thomas Dithmar*, 10 December 2015, para. 20, holding that director liability action in question contributed to the "attainment of an objective which is intrinsically linked, mutatis mutandis, to all insolvency proceedings, namely the prevention of any reduction of the assets of the insolvent estate before the insolvency proceedings are opened."

41 Black's Law Dictionary defines the "going concern value" as the "value of a commercial enterprise's assets or of the enterprise itself as an active business with future earning power, as opposed to the liquidation value of the business or of its assets." Black's Law Dictionary, 8th edn, Thomson Reuters, 2004, p. 1587.

42 J.L. Westbrook, The Control of Wealth in Bankruptcy, Texas Law Review, Vol. 82, 2004, p. 811.

Second, restructuring is often achieved by one of the following methods: (i) postponement of liabilities into more distant future, (ii) conversion of debt into equity, and (iii) debt reduction or write-down.[43] The UNCITRAL Legislative Guide connects the choice between liquidation and reorganisation to the objective of value maximisation.[44] Similarly, the Conference of European Restructuring and Insolvency Law concludes that the "rules which support restructuring efforts conceivably enforce the principle of optimal realisation of the debtor's assets."[45] Restructuring can also contribute to the accomplishment of other goals, such as the prevention of job losses and facilitation of competition. Yet whether restructuring can be seen as a substantive principle in and of itself is debatable. Bork and Veder argue that restructuring "is not a core value in itself, since goals and policies are to be distinguished from principles."[46] We agree.

Third, when comparing rescuing distressed companies and individuals, Judge Conner pointed out that "a corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[47] In order to distinguish which companies could (and should) be restructured to safeguard their value, the concept of economic viability needs to be explained. Viability is a complex concept, which may indicate the competitiveness of the debtor's business model and good prospects for its post-restructuring survival. It also characterises businesses whose going concern value exceeds the hypothetical liquidation value.[48] Economic viability, as contrasted with financial viability (i.e. the ability to pay off debt obligations), is often established as an eligibility threshold or a filtering

43 M. Crystal and R.J. Mokal, The Valuation of Distressed Companies – a Conceptual Framework, International Corporate Rescue, Issues 2 and 3, 2006 <https://ssrn.com/abstract=877155> (accessed 15 July 2023).

44 UNCITRAL Legislative Guide, Part one, Ch. I, para. 6, stating that insolvency law "should include the possibility of reorganization of the debtor as an alternative to liquidation, where creditors would not involuntarily receive less than in liquidation and the value of the debtor to society and to creditors may be maximized by allowing it to continue."

45 CERIL Report 2017-1, 26 September 2017, para. 35.

46 R. Bork, M. Veder, Harmonisation of Transactions Avoidance Laws, Intersentia, 2022, para. 2.46.

47 *In re Investors Funding Corp. of New York Sec. Litig.*, 523 F. Supp. 533, 541 (S.D.N.Y. 1980).

48 L. Tsioli, Viability assessment in corporate debt restructuring: Optimizing the filtration effect of the European directive on restructuring and insolvency, Norton Journal of Bankruptcy Law and Practice, Vol. 30, 2021, p. 400; M. Kahl, Economic Distress, Financial Distress, and Dynamic Liquidation, The Journal of Finance, Vol. 57, 2002, p. 141, arguing that "[v]iable firms should be continued because their continuation value is higher than their liquidation value."

screen for restructuring proceedings.[49] This is based on the assumption that restructuring of non-viable firms can lead to the destruction of value, instead of its preservation.[50]

Fourth, the principle of estate value preservation and maximisation does not touch upon the issue of distribution among creditors. It does not deal with value allocation. Nevertheless, there is an important safeguard connected to it, namely the protection of a certain entitlement baseline. This baseline transpires in the ubiquitous best-interests-of-creditors test, similar to the NCWO test mentioned in Chapter 3.[51] This test sets out a reference point, commonly, the expected distribution in an insolvent liquidation or an alternative scenario.[52] The reference point shields the value of the existing creditors' entitlements, promotes substantive fairness and ensures the protection of property rights. Thus, if a reorganisation plan facilitates business survival and increases the debtor's value but harms creditors' interests, as compared to a baseline (minimum) scenario, such a plan is unlikely to be confirmed unless the affected creditors consent to it. As a general rule, the interests of economic efficiency judged from the perspective of net benefits and costs cannot trump the interests of individual creditors. This signifi-

49 The viability test may take different forms and can be applied at different stages of the process. For example, in the USA, viability is not checked at the start of Chapter 11, but it surfaces in the norms on involuntary conversion and dismissal (11 U.S. Code § 1112) and relief from the stay (11 U.S. Code § 362). In the UK, as a part of a new moratorium procedure, a monitor should at the outset assess and state that it is likely that the moratorium would result in the rescue of company as a going concern. Insolvency Act 1986, Part A1, A(1)(e). See also StaRUG, § 14, stating that a "restructuring plan is to be accompanied by a substantiated declaration concerning the prospects for eliminating the debtor's imminent illiquidity through the plan and for ensuring or restoring the debtor's viability." For Dutch law, see Rb. Den Haag 2 March 2021, ECLI:NL:RBDHA:2021:1798, noting that the rules introduced by the WHOA primarily focus on companies which are in danger of becoming insolvent due to over-indebtedness, but have businesses that are still viable. The court accepted that it is primarily up to the creditors to form an opinion on the viability of the debtor's business. Yet it found itself competent to determine that the business would not be viable post-restructuring. As a result, the WHOA plan was not approved.

50 H. Eidenmüller, Contracting for a European Insolvency Regime, EBOR, Vol. 18, 2017, p. 288, emphasising the filtering function of insolvency law, which should be available "to restructure only viable firms and liquidate the non-viable ones." Eidenmüller also notes that the "economic costs resulting from this mistake [letting non-viable firms restructure] are surely not trivial."

51 11 U.S. Code § 1129(a)(7). On the US origins of this principle, see C.J. Tabb, The History of the Bankruptcy Laws in the United States, ABI Law Review, Vol. 3(1), 1995, pp. 5-51. This test manifests itself in national laws of many European jurisdictions. See e.g. InsO, § 251(1); Fw, Article 384(3). It is also mandated by the Restructuring Directive in Recital 52, Article 10(2)(d). The NCWO principle is the fundamental principle governing the protection of creditors' rights in bank resolution. See BRRD, Article 34(1)(g).

52 A. Krohn, Rethinking priority: The dawn of the relative priority rule and the new "best interests of creditors" test in the European Union, International Insolvency Review, Vol. 30, 2021, pp. 75-95.

cant restriction on the utilitarian or majoritarian approach to insolvency is derived from constitutional law.[53]

4.3.4 Protection of legitimate expectations, freedom of contract and party autonomy

Insolvency is a foreseeable risk, as in principle no business is immune from it.[54] It is therefore important that creditors, debtors and other stakeholders are able to calculate ex ante the insolvency-related risks, particularly when engaging in transactions with financially distressed but not yet insolvent debtors.

Virgós and Garcimartín explain that "parties shape their relationships "in the shadow" of a specific legal environment; an environment that includes the degree of "resistance" of [their] rights in the event of the insolvency of the debtor, which is the most typical risk faced by any creditor."[55] When parties enter into agreements, they do so with the expectation that their claims will be fully satisfied. However, in the event of insolvency, this may not be possible. The likelihood and extent of satisfaction depend on many factors, such as the insolvency forum, applicable law (*lex concursus*) and its impact on contractual rights (e.g. permissibility of set-off, termination of executory contracts, enforceability of ipso facto clauses, protection of rights *in rem*, transaction avoidance).

The ability to assess these factors, and therefore respond to them in one way or another, improves risk calculation (where risk is understood as the uncertainty of future returns), creates incentives to engage in financial relationships ex ante, and reduces the costs of insolvency ex post.[56] By contrast,

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53 S. Madaus, Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law, European Business Organization Law Review, Vol. 19, 2018, p. 638.

54 "Insolvency-proofness" existed in France with reference to establishments of industrial and commercial character (EPICs in their French acronym), such as La Poste. In French administrative law, EPICs are legal entities governed by public law. Yet they have a legal personality distinct from the state. The status of an EPIC entailed certain legal consequences, including inapplicability of insolvency procedures. As a result, creditors of La Poste effectively had an implied and unlimited state guarantee that their unpaid claims would not be cancelled. This immunity, however, was considered to be a source of state aid, triggering specific obligations. Case C-559/12 P, *French Republic v. European Commission*, 3 April 2014. Another example comes from Russia, where the law makes certain types of legal entities completely immune from insolvency. See Russian Civil Code, Article 65.

55 M. Virgós, F. Garcimartín, The European Insolvency Regulation: Law and Practice, Kluwer Law International, 2004, p. 87.

56 J-C. Bricongne, M. Demertzis, P. Pontuch and A. Turrini, Macroeconomic Relevance of Insolvency Frameworks in a High-debt Context: An EU Perspective, European Commission Discussion Paper 32, June 2016.

breach of trust and legitimate expectations result in social costs in the form of foregone transactions (transactions that did not take place due to legal uncertainty), higher interest rates that limit access to credit due to increased costs, extended screening or due diligence expenses, and protracted litigation.

In his analysis of the major principles of international insolvency law, Bork noted that the protection of creditors' expectations and trust "is an important pillar of every legal order and a basic tenet to be enforced under the rule of law."[57] There are two important aspects of this principle.

The first aspect relates to the general protection of property rights. Thus, the violation of legitimate expectations may amount to a breach of the right to property.[58] A challenging task is to evaluate which expectations are legitimate. The European Court of Human Rights (ECtHR) held that a legitimate expectation must be of "a nature more concrete than a mere hope and be based on a legal provision or a legal act such as a judicial decision, bearing on the property interest in question."[59] In the case of *Boyadzhieva and Gloria International Limited Eood v. Bulgaria*,[60] the ECtHR found a violation of the right to property where national law permitted (automatic) invalidation of all transactions concluded within the so called "suspect period", determined as the period after the initial date of insolvency – the date of the debtor's inability to meet its obligations towards creditors. Transactions concluded within the suspect period were subject to avoidance without any proof of bad faith and without any assessment of whether they had adversely affected the insolvency estate or the interests of creditors. In reaching its decision, the court referred to the Bulgarian Parliament, which amended the legislation in question, citing the rule of law concerns and the "foreseeability of business activities and legal transactions", and noting that the risk of indefinitely lengthy "suspect periods" undermined legal certainty. The ECtHR saw no reasons to depart from the national parliament's view that the applicable law did not offer a balanced approach and failed to protect the principle of legal certainty.[61]

57 R. Bork, Principles of Cross-Border Insolvency Law, Intersentia, 2018, p. 143.

58 The right to property is guaranteed by Article 1 of Protocol No. 1 to the ECHR. M. Sigron, Legitimate Expectations under Article 1 of Protocol No. 1 to the European Convention on Human Rights, Intersentia, 2014.

59 *Gratzinger and Gratzingerova v. the Czech Republic*, Appl. no. 39794/98, Decision (GC), 10 July 2002, Reports 2002-VII, 399, § 73.

60 *Boyadzhieva and Gloria International Limited Eood v. Bulgaria*, Appl. nos. 41299/09 and 11132/10, Judgment, 5 July 2018, § 44.

61 Ibid., § 46. For case analysis, see I. Kokorin and B. Wessels, annotation: European Court of Human Rights 5 July 2018, no. 41299/09 & 11132/10, *JOR* 2019, 3; 778-790 (*JOR* 2019/64 *Boyadzhieva and Gloria International Limited Eood v. Bulgaria*).

The second related aspect concerns the principle of freedom of contract. According to this principle, parties should be free to choose each other as contractual partners and to determine the terms of their agreement.[62] Generally, the onset of the insolvency process does not alter the entitlements or vested interests created before it.[63] In this respect, the World Bank stresses that the "rights of creditors and the priorities of claims established prior to insolvency proceedings […] should be upheld in an insolvency proceeding *to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships*"[64] (emphasis added). However, while freedom of contract takes precedence in contract law, it faces significant limitations under insolvency law. At this point, three remarks should be made.

First, there are ways to contractually affect the insolvency process and, to one extent or another, determine its outcome. For example, secured creditors derive their priority and power from pre-insolvency contractual relationships, which guarantee a preferential position in insolvency or the ability to exercise significant control over the insolvency process. In some jurisdictions (e.g. the Netherlands), secured creditors are essentially immune from bankruptcy proceedings. In others (e.g. in the USA), they do not enjoy such immunity, but they typically lead bankruptcy proceedings and dictate the conditions of the business sale.[65] Another example is intercreditor agreements or agreements between creditor(s) and a debtor. These agreements could entail claim subordination, where one creditor or a group of creditors agree to subordinate their rights in insolvency, effectively contracting out of the *pari passu* principle.[66] A new form of insolvency-related contracting are restructuring support agreements, used primarily in the

62 E. McKendrick, Contract Law: Text, Cases, and Materials, 6th edn, OUP, 2014, p. 13. Freedom of contract is not absolute and there are many exceptions imposed to protect weaker parties, ensure competition and fairness. M.J. Trebilcock, The Limits of Freedom of Contract, Harvard University Press, 1997; P.S. Davies and M. Raczynska (eds), Contents of Commercial Contracts: Terms Affecting Freedoms, Hart Publishing, 2020; R.A. Epstein, Contracts Small and Contracts Large: Contract Law through the Lens of Laissez-Faire, in F.H. Buckley (ed), The Fall and Rise of Freedom of Contract, Duke University Press, 1999, p. 28, distinguishing three interrelated concepts: security of exchange, sanctity of contract and freedom of contract.

63 M. Veder, Party Autonomy and Insolvency Law, in R. Westrik and J. van der Weide (eds), Party Autonomy in International Property Law, Sellier European Law Publishers, 2011, p. 261.

64 The World Bank, Principles for Effective Insolvency and Creditor/debtor Regimes, 2021, C12.1.

65 It is noted that without consent from a secured creditor, it may not be possible to sell property in a 363 sale free and clear of liens. C. Mallon, S.Y. Waisman and R.C. Schrock (eds), The Law and Practice of Restructuring in the UK and US, OUP, 2011, para. 2.21.

66 R. Goode, Principles of Corporate Insolvency Law, 4th edn, Sweet and Maxwell, 2011, p. 241; V. Finch and D. Milman, Corporate Insolvency Law: Perspectives and Principles, 3rd edn, CUP, 2017, p. 530.

USA to lock up contractual arrangements and support a particular plan to be later implemented via a pre-packaged deal. These arrangements provide certainty and facilitate "a clearer, quicker, and more reliable path toward exit from Chapter 11."[67] The rise of contractual "regulation" in insolvency led Skeel and Triantis to conclude that US bankruptcy law is considerably less mandatory than it appears to be and that a new contract paradigm seems to be emerging, even if somewhat inconsistently.[68]

Second, not all expectations are to be protected, but only legitimate ones. Ávila points out that the "application of the legal certainty principle requires a link to a *legal reality*, or in simpler language it presupposes a comparison between one norm (the legal certainty principle itself) and another norm (which may be legal, administrative or judicial)"[69] (original emphasis). According to Ávila, "legitimate trust is protected only when there is a sound basis for such trust, perceived as state manifestations so unequivocal as to create expectations."[70] Ávila also asserts that without trust in the legal system, individuals cannot exercise "the right to free self-determination and a decent life."[71]

The legitimate expectations and trust in the stability of legal relations are created by the existing legal rules and their judicial interpretation.[72] If law restricts contractual freedom in the context of insolvency, parties should be able to take this into account when entering into a transaction and calculating their risks. In order to protect parties' expectations, law must be predictable, foreseeable, clear and uniform. In other words, while expectations are "fluid" and change over time under the influence of legal developments, the law itself must possess the elements of stability, foreseeability and clarity. Therefore, the discussed principle does not support the claim that a legal position, once agreed, is set in stone and is absolute. It is not the rationale

67 D.G. Baird, Bankruptcy's Quiet Revolution, American Bankruptcy Law Journal, Vol. 91, 2017, p. 604.

68 D.A. Skeel and G. Triantis, Bankruptcy's Uneasy Shift to a Contract Paradigm, University of Pennsylvania Law Review, Vol. 166, 2018, pp. 1777-1818. The increase in the ability of "creditors in possession" to influence the conduct of business prior and during a Chapter 11 was noted by Rasmussen, who mentions several instruments of control, including covenants in credit agreements, loan-to-own strategies, appointment of a chief restructuring officer, debtor in possession financing, plan support and restructuring support agreements. See R.K. Rasmussen, Taking Control Rights Seriously, University of Pennsylvania Law Review, Vol. 166, 2018, pp. 1749-1776.

69 H. Ávila, Certainty in Law, Springer, 2016, p. 65.

70 Ibid., p. 153.

71 Ibid., p. 183.

72 R. Bork, M. Veder, Harmonisation of Transactions Avoidance Laws, Intersentia, 2022, para. 2.54, observing that "where people trust in the stability of their legal position, they do so in the context of a wider regime of the applicable law, which can include rules weakening their legal position under certain conditions […]."

of the legitimate expectations argument to grant immunity from insolvency, but to ensure that reasonable contracting parties can assess and calculate the risks of counterparty's insolvency prior to entering into relations with it. This can be done if the reliability, stability and calculability of rules, certainty of law and through law, are guaranteed in the legal system.

Third, the issue of legitimate expectations and their protection should be distinguished from party autonomy – a fundamental principle of private law. Party autonomy and its operation in insolvency are the topics of spirited academic debates with no signs of emerging consensus.[73] Whereas legal certainty relates to the foreseeability, predictability and accessibility of legal rules, autonomy speaks to the boundaries of such rules in the first place. Autonomy, as a right to control one's own future, is linked to dignity.[74] A contract is an instrument of party autonomy. The virtue of party autonomy, viewed as an extension of individual autonomy, does not mean that parties' ability to bargain must be unlimited. Indeed, measures to protect public interest,[75] weaker parties (e.g. consumers) and third parties (e.g. creditors) influence the scope of party autonomy and impact ex ante choices.

One example where party autonomy is curbed is the rules on insolvency-related transaction avoidance. Due to the collective nature of insolvency proceedings and the role played by the principles of equal treatment of creditors and estate value maximisation, some otherwise valid transactions become void or voidable. And yet transaction avoidance rules and other rules leading to a collapse, subordination or re-characterisation of a transaction limit a debtor's ability and its counterparty's willingness to enter into a transaction in the first place. They can discourage value-creating transactions.[76] Another example of a collision between freedom of contract and principles of insolvency law is the invalidation or "deactivation" of

73 S.L. Schwarcz, Rethinking Freedom of Contract: A Bankruptcy Paradigm, Texas Law Review, Vol. 77, 1999, pp. 515-604, arguing that the fundamental policies underlying the US Bankruptcy Code, including equality of distribution among creditors and debtor rehabilitation should in certain cases be able to limit contractual freedom. See also J.L. Westbrook, Commercial Law and the Public Interest, Penn State Journal of Law and International Affairs, Vol. 4, 2015, pp. 445-458, stressing the importance of protecting public interest in insolvency and concluding that the latter cannot be ensured through the reliance on creditors' contracting.

74 J. Raz, The Authority of Law: Essays on Law and Morality, Clarendon Press, 1979, p. 221; H. Ávila, Certainty in Law, Springer, 2016, p. 111, arguing that legal certainty is at the service of individual autonomy and that it is an instrument to realise the value of freedom.

75 M. Haentjens, Party Autonomy, Public Policy and European Bank Insolvency Law, Hazelhoff Research Paper Series No. 7, 2015, p. 11, arguing that public interest and welfare maximisation should be balanced against party autonomy.

76 S.L. Schwarcz, Collapsing Corporate Structures: Resolving the Tension Between Form and Substance, The Business Lawyer, Vol. 60, 2004, p. 110, noting that "[w]hen economically beneficial transactions are prevented, all parties suffer."

certain contractual provisions, such as ipso facto clauses. Indeed, a debtor and a creditor may bargain ex ante in view of the applicable law, restricting ipso facto clauses. However, this does not mean that any encroachment on party autonomy is in itself desirable or justifiable, given the importance of respecting commercial bargains and ensuring freedom of contract. Unless there are negative externalities or other convincing reasons, law should strive to interfere with parties' freely made choices as little as possible. And even then, any interference must be proportionate.

4.3.5 Equal treatment of creditors

The principle of equal treatment of creditors means that similarly situated creditors (creditors of the same rank) are to be treated similarly or identically, both in terms of their procedural and substantive rights.[77] The principle goes by different names. For example, it is referred to as *pari passu* (from Latin "on equal footing") or *par est condicio omnium creditorum* (from Latin "the condition of all creditors is equal"). The emphasis is often placed on the pro-rata or rateable distribution of the realised assets within the same creditor class.[78] On an abstract level, the principle of equal treatment of creditors rests on the idea of equality, a sense of fairness,[79] distributive justice and an aversion to inequity, present in many cooperative animals, most notably in humans.[80]

77 R. Bork, Corporate Insolvency Law. A Comparative Textbook, Intersentia, 2020, p. 8.

78 K. Akintola, Creditor Treatment in Corporate Insolvency Law, Edward Elgar Publishing, 2020, paras. 3.29-3.30.

79 R. Dworkin, Taking Rights Seriously, HUP, 1977, p. 180, describing a right to equality as "a right to equal concern and respect." Keay and Walton observe that the "underlying aim behind the use of the equality principle is to produce fairness, so that every creditor is treated in the same way." A. Keay and P. Walton, The Preferential Debts' Regime in Liquidation Law: In the Public Interest? Company Financial and Insolvency Law Review, Vol. 3, 1999, pp. 93-94.

80 M. Tomasello, A. Vaish, Origins of Human Cooperation and Morality, Annual Review of Psychology, Vol. 64, 2013, p. 243, noting that children of 5 to 6 years of age show a greater sense of equality and fairness, but also that 3-year-old children tend to divide rewards equitably if they obtained the rewards by working collaboratively. S.F. Brosnan and F.B.M. de Waal, Evolution of responses to (un)fairness, Science, Vol. 346, 2014, pp. 314-321, arguing that some non-human species, such as apes, not only passively or actively protest against receiving less for the same task, but also seek to equalise the outcomes to their own detriment. According to the authors, the latter most likely "reflects an attempt to forestall partner dissatisfaction with obtained outcomes and its negative impact on future cooperation."

Equal treatment of creditors is considered to be a "centrepiece of insolvency law",[81] where the *pari passu* principle is closely related to the collective enforcement regime. This collectivism can help reduce strategic costs, maintain the status quo, and facilitate a proportionate distribution of value among creditors.[82] However, while collectivity is instrumental in securing equality in the treatment of creditors and in resolving the common pool problem, it is not a pre-requisite to its realisation. This is evident in laws that do not require full collectivity.[83] For example, under the Dutch WHOA, the court shall deny a request to confirm a plan if "the plan was procured by deception, *by favouring one or more creditors* or shareholders with voting rights or by other unfair means"[84] (emphasis added). The Restructuring Directive also stipulates that one of the conditions for the approval of a restructuring plan is that creditors with sufficient commonality of interest in the same class are treated equally and in a way proportionate to their claims.[85] The principle of equal treatment of creditors can be found in national law,[86] EU legislation[87] and soft law instruments.[88]

Some level of detail should be provided on the operation of the *pari passu* principle. In the EU, where equality before the law is considered to be a general principle of EU law, this principle is interpreted to mean that "comparable situations should not be treated differently and that different situations should not be treated in the same way, unless such different treatment is objectively justified."[89] This formulation is reminiscent of the idea of formal equality (as opposed to substantive, universal or moral equality),

81 CERIL Report 2017-1, 26 September 2017, para. 14; R. Goode, Principles of Corporate Insolvency Law, 3rd edn, Sweet & Maxwell, 2005, p. 175; R. Bork and M. Veder, Harmonisation of Transactions Avoidance Laws, Intersentia, 2022, para. 2.38.

82 T.H. Jackson, The Logic and Limits of Bankruptcy Law, Harvard University Press, 1986, pp. 16-17, viewing the role of insolvency law as one of "ameliorating a common pool problem created by a system of individual creditor remedies." L.C. Ho, Goode's Swan Song to Corporate Insolvency Law, European Business Law Review, Vol. 17, 2006, p. 1737, arguing that the *pari passu* principle does not underpin collectivity and that maintaining the status quo is not meant to preserve any particular level of priority.

83 See e.g. StaRUG, § 10.

84 Dutch Bankruptcy Act, 384(2)(g).

85 Restructuring Directive, Article 10(2)(b).

86 Insolvency Act 1986, section 107 (UK); Code de commerce, Article L643-8 (France); Federal Law "On Insolvency (Bankruptcy)", Article 142(3) (Russia); InsO, §1 (Germany); Bankruptcy Code, § 726(b) (USA).

87 EIR Recast, Article 23(2); BRRD, Recital 13; CIWUD, Recital 12.

88 UNCITRAL Guide on Insolvency Law, Parts one and two, 2004; Key Attributes of Effective Resolution Regimes for Financial Institutions, 2014, para. 5.1; Principles for Effective Insolvency and Creditor/debtor Regimes, 2021, C1.

89 Case C-313/04, *Franz Egenberger*, 11 July 2006, para. 33; Case C101/12, *Herbert Schaible v. Land Baden-Württemberg*, 17 October 2013, para. 76.

phrased by Aristotle as the need to "treat like cases as like."[90] Following this logic, UNCITRAL prescribes equal treatment of "creditors of the same class"[91], while the World Bank promotes "equitable treatment of similarly situated creditors."[92] Bork describes the principle as "equal treatment of (unsecured) creditors belonging to the same class".[93]

This reference to a particular category or class of creditors rather than to all creditors reflects the current insolvency law reality, where creditors are treated in accordance with their priority rankings.[94] Mokal[95] and other scholars[96] have noted the diminished role of the principle in modern insolvency theory and practice. According to them, the erosion of this principle manifests itself in the plethora of priorities established by statutes, as well as other tools, such as set-off, which may create de facto preferences for some creditors. The relativity of the principle is apparent in cases where other conflicting principles or values are at stake. For example, in a recent case of the Dutch WHOA scheme, the court in Rotterdam approved unequal treatment of unsecured creditors. It reasoned that such treatment was justified by considerations of value preservation. It noted that unequal treatment did not harm the interests of the affected creditors because, in the alternative liquidation scenario, they would receive nothing.[97] Thus, inequality was tolerated to the extent that it was necessary to further another principle.

90 Aristotle, Nicomachean Ethics, 1131a (translated by H. Rackham), stating that "for if the persons are not equal, they will not have equal shares; it is when equals possess or are allotted unequal shares, or persons not equal equal shares, that quarrels and complaints arise." The crucial question is how to determine equality in the first place. Harari calls the idea that all humans are equal a "myth" or an "imagined order". According to him, we cherish equality not because it is objectively true, but "because believing in it enables us to cooperate effectively and forge a better society." Y.N. Harari, Sapiens: A Brief History of Humankind, McClelland & Stewart, 2014.

91 UNCITRAL Legislative Guide, Part two, Ch. IV, para. 26.

92 The World Bank, Principles for Effective Insolvency and Creditor/debtor Regimes, 2021, C1.

93 R. Bork, Principles of Cross-Border Insolvency Law, Intersentia, 2017, p. 115.

94 US Bankruptcy Code, § 1123(a)(4), stating that "a plan shall provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favourable treatment of such particular claim or interest." InsO, § 226 ("[w]ithin each group equal rights shall be extended to all parties concerned. Any differing treatment of the parties in a group is only permitted with the consent of all parties concerned").

95 R.J. Mokal, Priority as Pathology: The *Pari Passu* Myth, Cambridge Law Journal, Vol. 60, 2001, p. 582, arguing that the principle is "less important than it is sometimes made out to be, and does not fulfil any of the functions often attributed to it."

96 D.A. Skeel, The Empty Idea of "Equality of Creditors", University of Pennsylvania Law Review, Vol. 166, 2018, p. 701, analysing US practice and observing that "[b]ankruptcy courts often bless arrangements that give one group of general creditors starkly different treatment than other groups." B. Wessels, Moeten schuldeisers altijd gelijk behandeld worden? Nederlands Juristenblad, 6, 2010, p. 340, explaining that in Dutch law equality is not a hard and fast principle, and that exceptions to it may follow from the considerations of effectiveness (e.g. better pay-offs to creditors), reasonableness and fairness.

97 Rb. Rotterdam, 3 March 2021, ECLI:NL:RBROT:2021:1769, *JOR* 2021/137, m.nt. Tollenaar.

The relative weight of the *pari passu* principle is evident in cases involving financial contracts and financial institutions, especially if financial stability is at stake.[98] For example, in *Private Equity Insurance Group SIA v. Swedbank AS*, the Court of Justice of the EU (CJEU) had to decide whether granting financial collateral takers the right to enforce the collateral despite the commencement of insolvency proceedings in respect of the collateral provider breached the *pari passu* principle. The CJEU acknowledged that the Financial Collateral Directive conferred an advantage on financial collateral in comparison with other types of security falling outside its scope. However, according to the CJEU, the different treatment in question was permissible as based on an objective criterion that related to the legitimate aim of the Directive, namely "to improve the legal certainty and effectiveness of financial collateral in order to provide stability in the financial system."[99]

The departure from the equal treatment of creditors can also be found in the rules governing bank resolution. For example, both the BRRD and the SRMR provide that certain categories of creditors (e.g. covered deposits, employees, commercial or trade creditors providing critical services) are excluded from the application of bail-in (i.e. write-down or conversion powers).[100] Resolution authorities may also exempt other liabilities from bail-in, where such an exemption "is strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines" or when it is needed to prevent widespread contagion.[101] Clearly, in these cases, the principle of equal treatment is superseded by other principles, including the protection of public interest. As a result, in certain circumstances, even similarly situated creditors may be treated differently in bank resolution.[102]

Without entering into the debate about the "viability" or relevance of the principle of equal treatment of creditors in the modern insolvency law theory, it suffices to say that the equality of creditors is relative, rather than

98 For criticism of this special treatment, see C.G. Paulus, The Wonderful World of Privileges – The Par Condicio Creditorum vs. Closeout-Netting, ECFR, Vol. 11, 2014, pp. 531-553.

99 Case C-156/15, *'Private Equity Insurance Group' SIA v 'Swedbank' AS*, 10 November 2016, para. 51.

100 BRRD, Article 44(2); SRMR, Article 27(3). While interbank short-term liabilities are generally excluded from bail-in, this exclusion does not apply to intra-group situations, so that intra-group short-term liabilities may be subject to bail-in ("liabilities to institutions, excluding entities that are part of the same group").

101 BRRD, Article 44(3); SRMR, Article 27(5).

102 BRRD, Recital 13. M. Schillig, Resolution and Insolvency of Banks and Financial Institutions, OUP, 2016, para. 11.16. Different treatment of creditors in the same class is also allowed under the Key Attributes, para. 5.1, noting that the departure from the general principle of equal treatment of creditors of the same class may be permitted, "if necessary to maximise the value for creditors […] or to minimise the potential systemic impact of a firm's failure."

absolute. At the same time, once the similarity of their position has been determined, the principle is stronger and requires a compelling reason or competing principle to override it.

4.4 Application of Legal Principles in Group Insolvencies

4.4.1 Value preservation and maximisation within enterprise groups

The previous section focused on legal principles, which have, for the most part, been developed and applied in the context of a single-debtor insolvency. One may inquire whether the same principles are relevant in a case where several companies comprising an enterprise group are financially distressed or insolvent. We argue that there are no compelling reasons for such principles to lose their salience. However, the realisation of these principles might require certain re-adjustments. It needs to be more group-mindful or group-sensitive.[103] For example, in economically integrated and interdependent groups, where legally separate entities act as a single enterprise, preservation and maximisation of estate value may necessitate a group-wide strategy. A failure of one group member can be contagious and lead to a domino-like fall of other group members, resulting in a piecemeal sale of assets, suboptimal returns to creditors and liquidation of a viable but distressed business.

Imagine the following (rather typical) scenario of a group that consists of legal entities playing different roles: (i) a company issuing debt instruments and lending the received funds to other group members (FinCo), (ii) a company managing and owning assets essential for the group's business, including intellectual property, licenses, know how, real estate (SPV), (iii) a company exercising managerial control over the entire group and acting as a group treasury through the operation of a centralised cash management system (HoldCo), and (iv) operational companies offering services or manufacturing products in different countries (OpCos). Administering such companies separately in insolvency can be difficult and suboptimal in terms of maximising the insolvency estate value, as the entity-by-entity treatment could trigger a breakup of intra-group links and cut the access to vital resources and lifelines.

103 I. Mevorach, Enterprise Groups in Insolvency: Recent International Developments, in J. Sarra (ed), Annual Review of Insolvency Law, Toronto: Carswell, 2013, p. 285, noting that the promotion of insolvency law goals, such as wealth maximisation and equitable treatment of creditors "may require treating the group as the relevant body or acknowledging inter-connections among group members."

This scenario materialised in the insolvency of the Lehman Brothers group (section 1.1.1.). When the parent company (LBHI) filed for bankruptcy, many of its subsidiaries lost access to valuable sources of finance and information.[104] The corporate legal shields separating the legal entities in the group did not prevent their failure. At least one of the reasons was that behind these shields, the entities (the "empire of subsidiaries") were tied together in a web of debt and cross-guarantees.[105] They depended on each other for the provision of financing, debt refinancing and services. As an example, information on accounts and trades related to group companies was frequently concentrated in one jurisdiction. Thus, LBHI's UK subsidiary, LBIE, recorded data on financial notes relevant to other group entities, including its Dutch subsidiary, LBT. When the latter went bankrupt in the Netherlands, the trustees needed this information to make asset distribution in the Dutch proceedings.[106] After intense negotiations, Dutch IPs obtained an important part of LBT's records from LBIE. A similar case can be imagined if in insolvency group entities lose their access to assets held by other entities in the group, including patents, licenses and customer databases. As a result, operational activity might be paralysed, and the group entities may end up in a piecemeal liquidation.

A well-known example illustrating the importance of a group-wide strategy is the insolvency of KPN Qwest. KPN Qwest was a telecom group that owned and operated rings of fibre-optic cable around Europe and the USA.

104 Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report (Valukas Report), 2010, p. 1550, describing the Lehman Brothers' centralised intra-group cash pooling system. O. McDonald, Lehman Brothers: A crisis of value, Manchester University Press, 2015, p. 117, explaining the practical issues as each subsidiary was cut off from the others and LBHI, so that "[i]t was not possible to generate information and liquidate assets efficiently and identify ways to maximize value." Just how complex the situation was can be derived from the words of the late Lehman's lawyer Harvey Miller, who reported that "[a]ll the accumulated information in Lehman's systems totals 2,000 terabytes of data, an amount that would completely fill 20,000 computers to the maximum. This vast sea of information spreads across 2,700 software systems applications and is dispersed throughout ledger accounts in the numerous subsidiaries […]. The financial information must be retrieved […] and collated and cross-referenced for accuracy and consistency." See Testimony of Harvey R. Miller before the Subcommittee on Commercial and Administrative Law of the House of Representatives Committee of the Judiciary, 111th Congress, 1st Session for Hearings on "Too Big to Fail: The Role of Bankruptcy and Antitrust Law in Financial Regulatory Reform", 22 October 2009.

105 K. Pistor, The Code of Capital: How the Law Creates Wealth and Inequality, Princeton University Press, 2019, p. 51; J.A. Kirshner, International Bankruptcy: The Challenge of Insolvency in a Global Economy, University of Chicago Press, 2018, p. 5, observing that uncoordinated insolvency proceedings faced the problem of separating intercompany arrangements, representing an elaborate system of cross-collateralisation and intercompany guarantees.

106 F. Verhoeven, Lehman Brothers Treasury, in M. Haentjens and B. Wessels (eds), Research Handbook on Cross-Border Bank Resolution, Edward Elgar Publishing, 2019, p. 349.

Notably, parts of the cable belonged to different group entities – the French part by the French subsidiary, the German part by the German subsidiary, and so on. When the Dutch holding company KPN Qwest N.V. collapsed in 2002, its subsidiaries were forced to file for insolvency and their assets were sold on a country-by-country basis.[107] This result was suboptimal as the value of the ring was much higher compared to the value of its isolated parts. The opposite outcome was reached in the case of Nortel Networks (section 1.1.2.). As a result of a commercially sensible solution to pool the assets of the group and realise them on a global scale, which was possible due to successful cooperation between parallel proceedings running in Canada, the United States and Europe, Nortel's assets were sold for USD 7.3 billion. This amount was significantly larger than could have been expected in a piecemeal local liquidation of licenses and intellectual property rights.

4.4.2 Legitimate expectations and group reality

Legitimate expectations do not exist in a vacuum. They are shaped by the existing factual and legal reality. Therefore, the group reality and the rules adopted to deal with group insolvencies play a role in the formation of parties' expectations. The exact substance of these expectations may vary depending on the totality of facts and circumstances. Several relevant factors come into play, such as the group's business (operational) integration and interconnectedness, the intensity of intra-group financial arrangements and financial integration, the role of the debtor company within the group, past experiences and assurances (e.g. on continued intra-group support), as well as the type and sophistication of creditors themselves (e.g. qualified investors, credit institutions and other professional financiers vs. micro, small and medium-sized enterprises (MSMEs) trade creditors and tort victims). In the case of an integrated enterprise group, the adoption of a group-wide insolvency or turnaround strategy – as opposed to a "singular" entity-by-entity approach – may align with the expectations of creditors who could view the group as a single enterprise. This impression can be supported by the use of the same brand, endorsements of transactions by other members of the group, the filing of consolidated financial statements[108] and the prevalence of intra-group financing.

107 N.H. Cooper, Insolvency proceedings in case of groups of companies: prospects of harmonisation at EU level, Briefing Note, 2011, p. 7; Commission Staff Working Document, Impact Assessment accompanying the document Revision of Regulation (EC) No 1346/2000 on insolvency proceedings, SWD/2012/0416 final.

108 S. Pepels, Defining groups of companies under the European Insolvency Regulation (recast): On the scope of EU group insolvency law, International Insolvency Review, Vol. 30, 2021, p. 108, noting the inclusion of companies in consolidated financial statements creates the legitimised expectation that such companies are doing business as a group.

It may be argued that the more centralised and integrated the group is, and as long as this fact is ascertainable by the relevant third parties, the stronger is the argument that a group-sensitive solution should be expected in insolvency. This line of reasoning was articulated by Justice Ramesh (Supreme Court of Singapore), who observed that "creditors' expectation that their investment will be undisturbed in a group insolvency is to some extent a mere reflection of the orthodoxy of separate legal personality."[109] Referring to the fluidity of expectations, he stressed that more frequent incursions into the separate legal personality doctrine may weaken the argument of legitimate expectations when used to justify separate (atomistical) treatment of group companies in insolvency. This point refers to the development of legal doctrine and norms of insolvency law, within which expectations crystallise. If legal rules or their application and interpretation contain group-mindful solutions, creditors should be able to take them into account. When it comes to enterprise group insolvencies, such solutions may refer to issues of international insolvency jurisdiction (e.g. determination of the centre of main interests (COMI)), procedures (e.g. procedural consolidation) and substance (e.g. availability of third-party releases).

The issue of protecting trust and party autonomy usually arises with respect to intra-group transactions and their assessment in the context of transaction avoidance, when a party to a transaction is or becomes insolvent. The question is whether the group reality and indirect group-related benefits should be taken into consideration and to what extent. If the answer is not clear, this is problematic from the perspective of the protection of legitimate expectations and legal certainty. Voidness or voidability of a transaction also has an effect on party autonomy to the extent that, as noted in the preceding section, a contract is one of its key instruments. At this point it suffices to cite UNCITRAL, which adopts the position that "[i]n considering […] intra-group transactions, it will be desirable for the court to be able to take the group context into account […]."[110] The positions taken by UK, US and Dutch law on this issue will be discussed in Chapter 8.

4.4.3 Explicit and hidden priorities in group insolvencies

The principle of equal treatment of creditors may appear to be least affected by enterprise group considerations. Bufford observes that the *pari passu* principle "has a diminished role in the insolvency of an enterprise group (apart from the insolvencies of particular members thereof)."[111] This asser-

109 K. Ramesh, Synthesising Synthetics: Lessons learnt from Collins & Aikman, 2nd Annual GRR Live New York, 26 September 2018.

110 UNCITRAL Legislative Guide, Part three, Ch. II, para. 50.

111 S.L. Bufford, Coordination of Insolvency Cases for International Enterprise Groups: A Proposal, American Bankruptcy Law Journal, Vol. 86, 2012, p. 694.

tion is based on the idea of entity separateness, which results in a separation of insolvency estates and pools of creditors of entities comprising the group. In the absence of substantive consolidation, equal treatment of creditors must be maintained and preserved with respect to each separate group entity. In other words, overarching intra-group creditor equality does not exist. This is why the NCWO and best-interest-of-creditors tests are applied on an entity basis (section 3.5.). Yet there are a few patterns that fine-tune the operation of the *pari passu* principle in a group setting.

The first pattern concerns a special approach to "related" creditors and transactions concluded with them. Insider creditors (e.g. shareholders and group affiliates) may enjoy less protection against transaction avoidance. Besides, in some jurisdictions their claims are subordinated – downgraded in the priority ladder (Chapter 7).

The second pattern is that some creditors can have the same claim against several companies within the group. One of the characteristic features of intra-group financing is the existence of various cross-entity liability arrangements. Among them are cross-guarantees, co-debtorship and collateral arrangements, where at least one other group member acts as a guarantor, co-debtor or a collateral provider for the benefit of another group member. Should the latter be in default, a guaranteed creditor can request performance from that other member, or from both entities simultaneously. As a result, this creditor enjoys covert priority or structural seniority, arising from a combination of entity separateness and its simultaneous perforation by cross-entity liability arrangements. This substantially alters outcomes for non-guaranteed unsecured creditors and elevates the position of the guaranteed creditor.[112] Emphasising the problematic nature of cross-guarantees from an equality perspective, Westbrook submits that "guarantees within a corporate group are a central instrument of priority and obfuscation."[113] This book has two chapters on intercompany guarantees – Chapters 6 and 10.

112 A.L. Jonkers, Selective Perforation by Means of Guarantees: Dutch Law, in The 800-Pound Gorilla. Limits to Group Structures and Asset Partitioning in Insolvency, NACIIL 2018 report, Eleven International Publishing, 2019, pp. 81-84, offering examples of how cross-guarantees affect the distribution among unsecured creditors. See W.H. Widen, Corporate Form and Substantive Consolidation, George Washington Law Review, Vol. 75, 2007, p. 240, noting that intragroup guarantees dilute claims for those creditors without guarantees – the phenomenon referred to as the "squeeze down effect".

113 J.L. Westbrook, Transparency in Corporate Groups, Brooklyn Journal of Corporate, Financial & Commercial Law, Vol. 13, 2018, p. 44. Westbrook explains that as a general rule, creditors of the parent company have only indirect claim on the subsidiary's assets. The position of these creditors is therefore subordinate to the creditors of the subsidiary. An upstream guarantee allows a guaranteed creditor to escape structural subordination and compete with non-guaranteed creditors of the subsidiary.

4.5 Conclusion

This chapter lays down a theoretical foundation for the analysis performed in this book. There are various paths one can take to find answers to the questions raised in Chapter 1. One can draw on insights from economic and finance theory to investigate ex ante and ex post effects of the existing or proposed rules. This book takes a different, principle-based approach. It looks at legal principles – understood as fundamental standards, examines how they transpire in concrete rules, and analyses how such rules can be better aligned with these principles. In their operation, universality and relative stability, legal principles are different from positive law with the sea of its constantly changing rules and norms.

The first step is to determine which legal principles are most relevant in light of this book's aims and scope. Following the classification of Bork, three such principles are identified: (i) estate value preservation and maximisation, (ii) protection of parties' legitimate expectations, freedom of contract and party autonomy, and (iii) equal treatment of creditors. The subsequent chapters will demonstrate that these principles frequently underlie insolvency law rules, reinforce and complement each other, or indeed collide with each other, thereby necessitating balancing and leading to various degrees of execution and compromise.

The second step is to establish whether the chosen principles remain relevant and could be relied on in the group insolvency context to the same extent as in a single-debtor scenario. We argue that this is the case and that the core of these principles is unaltered. Yet it is submitted that our understanding of such principles and their pursuit needs to be adjusted to the group legal and economic reality. This reality impacts preservation and maximisation of enterprise value, influences parties' legitimate expectations, guides their behaviour and transactional choices, and further complicates the achievement of the ideal of equal treatment of creditors by creating more room for preferences and unequal treatment.