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The continued use and disposal of encumbered assets during the Restructuring Directive's stay

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Abstract

The Restructuring Directive provides for a temporary stay on individual enforcement actions to support the negotiations on a restructuring plan. The stay should enable the debtor to continue operating or at least preserve the value of their estate during the negotiations. Under normal (going concern) circumstances, the debtor often may use or sell encumbered or third-party owned assets free of security rights in the debtor's ordinary course of business. If (pre-) insolvency proceedings are opened and a stay applies, the continued use and disposal of encumbered or third-party owned assets is not always self-evident. During the Directive's stay, secured creditors cannot enforce their security rights and are at risk of depreciation and value fluctuation of the encumbered assets and the time value cost of delay. A secured creditor may want to terminate the use and disposal if there is uncertainty as to whether he will be (re)paid out of the proceeds or whether their security right passes into the proceeds. The Directive ignores this asset deployment problem, since (1) it does not clarify whether and to what extent powers under the security agreement are affected, and (2) it does not require Member States to protect secured creditors during the stay. The author illustrates how Member States could sensibly deal with the deployment of encumbered assets during the stay by analysing how a stay affects asset deployment in three Member States' (formal) insolvency procedures aimed at restructuring (Austria, Belgium and the Netherlands), and by drawing inspiration from the UNCITRAL Legislative Guide on Insolvency Law.

Keywords

Restructuring Directive, stay, moratorium, adequate protection, asset deployment, pre-insolvency, secured credit, executory contracts, security rights, disposal of encumbered assets.

1. Introduction

The Restructuring Directive (hereafter: the **Directive**)[1] requires that debtors have access to a temporary stay on individual enforcement actions (hereafter: **stay**) to support the negotiations on a restructuring plan. The stay should enable the debtor to continue operating or at least preserve the value of their estate during the negotiations.[2] The stay may cover all types of claims, including secured claims and preferential claims.[3] Member States may provide that the stay is general, covering all creditors, or limited, covering one or more individual creditors or categories of creditors.[4]

The Directive does not harmonise all the effects of the stay on creditors' rights and Member States must fill in some of the blanks. One of the blanks is the (continued) deployment of encumbered or third-party owned assets in the debtor's ordinary course of business. Under normal (going concern) circumstances, the debtor often may use or sell encumbered or third-party owned assets free of security rights in the debtor's ordinary course of business. In some jurisdictions, this power is conferred by law upon the debtor. In other jurisdictions, secured creditors contractually waive their right to follow the asset into the hands of third parties and thereby enable the debtor to generate the income from which he can repay the

[1] Directive 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).
[2] Preamble to the Restructuring Directive, para 32.
[3] Art 6 (2).
[4] Art 6 (3).

secured obligation(s). Various legal systems across the globe provide that the security right automatically passes into the proceeds generated by the sale of the encumbered asset.[5]

If (pre-)insolvency proceedings are opened, the continued use and disposal of encumbered or third-party owned assets is not always self-evident. A secured creditor may want to terminate the use and disposal if there is uncertainty as to whether he will be (re)paid out of the proceeds or whether their security right passes into the proceeds. The secured creditor may prefer liquidation of the assets as he knows he has priority in the distribution of the proceeds thereof. Terminating the right to use and dispose of encumbered assets could be in the interest of the secured creditor, but could also prevent the debtor from continuing their ordinary course of business during the pre-insolvency proceedings to the detriment of the general body of creditors. The notion of article 5 (the debtor remaining in control of their assets and day-to-day operation of business) could become illusory and make the prevention of formal insolvency proceedings and liquidation very unlikely.[6]

The Directive, however, does not deal with this problem directly. It is now up to the Member States to provide an adequate solution to this problem in the implementation of the Directive. In this article, I will show where the directive falls short and why Member States need to fill this gap.

Firstly, I will set out how the Directive deals with (non-cooperating) secured and unsecured creditors during a stay (§2). I will use a functional approach to security rights in *movables* by not only discussing limited real rights, such as a right of pledge, but also fiduciary security ownership (*fiducia*) and retention of title devices.[7] The assets in which secured creditors have these security interests shall be referred to as encumbered assets. Secondly, I will analyse how a stay affects (non-cooperating) secured creditors in Member States' (formal) insolvency procedures aimed at restructuring (§3). It is likely that, when implementing the Directive into national law, Member States will draw upon the scope and legal effects of the stay that many Member States already have in their (formal) insolvency procedures regarding restructuring. The focus will be on the ways in which secured creditors usually allow the debtor to sell encumbered assets free of security rights in the ordinary course of business. In §4, I will illustrate how Member States could sensibly deal with the deployment of encumbered assets during the stay by drawing inspiration from the UNCITRAL Legislative Guide on Insolvency Law.

2. The harmonised effects of the stay

2.1 The stay and secured creditors

The preamble of the Directive states that pre-insolvency proceedings should enable debtors in financial difficulties to continue business by restructuring their assets and liabilities.[8] The debtor remains in control of their assets and the day-to-day operation of their business (debtor-in-possession) to avoid unnecessary costs, to reflect the early nature of preventive restructuring and to encourage debtors to apply for preventive restructuring at an early stage of their financial difficulties.[9] Restructuring takes time and a temporary stay should support the negotiations on a restructuring plan by enabling the debtor to continue operating or at least preserve the value of their estate during the negotiations.[10]

Without a stay, some creditors would pursue only their own interest by trying to seize individual assets in order to satisfy their claim.

[5] UNCITRAL Legislative Guide on Secured Transactions, para. 73.
[6] If the debtor's biggest creditors takes these steps, a pre-insolvency arrangement is probably doomed from the start, as they are key counterparties in the negotiation of a restructuring plan.
[7] Every Member State should have retention of title devices because of the implementation of article 4 of Directive 2000/35/EC of the European Parliament and of the Council of 29 June 2000 on combating late payment in commercial transactions.
[8] Preamble to the Restructuring Directive, para 2.
[9] Preamble to the Restructuring Directive, para 30.
[10] Preamble to the Restructuring Directive, para 32. Cf. DG Baird 'The Uneasy Case for Corporate Reorganizations' (1986) 15 Journal of Legal Studies 133; H Eidenmüller and K van Zwieten, *Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency* (European Corporate Governance Institute (ECGI) - Law Working Paper No. 301/2015), Oxford Legal Studies Research Paper No. 52/2015, 14.

This could lead to the piecemeal dismemberment of a viable business and destroy both the going concern value of the debtor's business and jobs in the process. A collective insolvency procedure is often viewed as overcoming a common pool problem, where creditors pursue only their own interest and over-consume the resource, thus depleting it for all.[11]

Member States may decide whether the stay is granted by a judicial or administrative authority or by operation of law. They can provide that a stay can be refused in cases where a stay is not necessary or where it would not fulfil the objective of supporting the negotiations. For example, the stay could be refused if there is a lack of support by the required majorities of creditors.[12]

During a stay, a secured creditor is unable to take recourse against encumbered assets from the debtor. This poses two types of risks for the secured creditor. Firstly, there is the risk of depreciation and value fluctuation of the encumbered assets. Secondly, even if the assets are stable in value, the secured creditor bears the time value cost of delay.[13] He is unable to walk away with the value of the encumbered assets to invest elsewhere.

The Directive protects secured creditors in several ways. Firstly, Member States get to decide whether (certain types of) secured creditors are excluded from the scope of the stay. The scope of the affected creditors by the stay will not be harmonised and may be determined by the Member States. Member States may provide that a stay of individual enforcement actions can be general, covering all creditors, or can be limited, covering one or more individual creditors or categories of creditors (article 6 (3)). Member States may exclude certain claims or categories of claims from the scope of the stay of individual enforcement actions, in well-defined circumstances, where such an exclusion is duly justified and where (a) enforcement is not likely to jeopardise the restructuring of the business or (b) the stay would unfairly prejudice the creditors of those claims (article 6 (4)). As examples of unfair prejudice, the preamble mentions an uncompensated loss or depreciation of encumbered assets.[14]

Secondly, if the stay affects secured creditors and they are unfairly prejudiced by it, they can seek to lift the stay. Member States should provide that the judicial or administrative authorities can lift a stay if creditors are unfairly prejudiced by it or if it becomes apparent that the required majority of creditors does not support the continuation of the negotiations.[15] Again, the preamble relates unfair prejudice to secured creditors whose encumbered assets are likely to decrease in value during the stay and it remarks that the Directive does not contain provisions on compensation or guarantees for secured creditors.[16]

Thirdly, during a stay the debtor is supervised by a practitioner in the field of restructuring. In general, the appointment of a practitioner in the field of restructuring, to supervise the activity of a debtor or to partially take over control of a debtor's daily operations is not required under the Directive.[17] The preamble and article 5 imply that the decision to appoint a practitioner in the field of restructuring should be made on a case-by-case basis depending on the

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[11] TH Jackson, 'Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules' (1986) Am. Bankr. L.J. 402. Cf. RJ de Weijs, 'Harmonisation of European Insolvency Law and the need to tackle two common problems: common pool and anticommons' (2012) 21 International Insolvency Review (2012) 2, 67-83; N Tollenaar, *Pre-Insolvency Proceedings: A Normative Foundation and Framework* (OUP 2019) 2.06.

[12] Preamble to the Restructuring Directive, para 32. Cf. L Stanghellini, R Mokal, CG Paulus, I Tirado (eds), *Best practices in European restructuring. Contractualised distress resolution in the shadow of the law* (Wolters Kluwer 2018) 118 (Guideline #5.2 (Projecting cash flows during the stay)); H Eidenmüller and K van Zwieten, *Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency* (European Corporate Governance Institute (ECGI) - Law Working Paper No. 301/2015), Oxford Legal Studies Research Paper No. 52/2015, 29.

[13] DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment on Adequate Protection of secured Creditors in Bankruptcy' (1984) 51 University of Chicago Law Review 110.

[14] Preamble to the Restructuring Directive, para 34.

[15] Preamble to the Restructuring Directive, para 36.

[16] Preamble to the Restructuring Directive, para 37. Mccormack remarks that the concept of unfair prejudice 'is being asked to do too much and that some of its workload can reduced by more particularised guidance.' G McCormack, 'Corporate restructuring law - a second chance for Europe?' (2017) 42 E.L. Rev. 4, 543.

[17] Preamble to the Restructuring Directive, para 30.

circumstances of the case or on the debtor's specific needs. However, the appointment of a restructuring trustee is mandatory to safeguard the interests of the parties, if a judicial or administrative authority grants the debtor a general stay.[18]

2.2 The continued use and disposal of encumbered assets

The question arises how the stay will affect the power/permission usually given to a debtor by a secured creditor to sell encumbered assets free of security rights in the ordinary course of business. The continued use or disposal of encumbered assets during the stay is in accordance with the most influential justification theory for insolvency law, the Creditors' Bargain Theory. According to this theory, developed in the United States in in the 1980s by the scholars Jackson and Baird, insolvency law should reflect the agreements that creditors would have made on their position in insolvency from an *'ex ante'* position.[19] Creditors would probably agree upfront that their actions be coordinated and even temporarily suspended to preserve the value of assets in the interest of creditors and other investors as a whole. Substantive (pre-insolvency) creditor's rights should only be changed if this leads to the preservation of assets for the collective good of the investor group.[20]

According to Baird and Jackson, '*someone must decide not only how best to deploy the assets, but also how to split up the returns from those assets. The answer to this second question, however, should not affect the determination of how to deploy the assets*.'[21] They added: "*As a first approximation, therefore, the law governing bankruptcy in general, and corporate reorganizations in particular, should ensure that the disposition of the firm's assets is in the interest of the owners as a group. How a firm's assets are deployed should not turn on whether one, ten, or ten thousand people have rights in them. Bankruptcy law, accordingly, should aim to keep the asset-deployment question separate from the distributional question, and to have the deployment question answered as a single owner would answer it*."[22]

A secured creditor would only agree to the continued use and disposal of encumbered assets if the value of their security interest is properly protected. In other words, an infringement on the rights of a secured creditor is only justifiable if the secured creditor is adequately protected. If the value of the encumbered assets is enough to satisfy the secured creditor's claims at the moment insolvency proceedings are opened, a secured creditor does not necessarily benefit from the restructuring. During a stay, the secured creditor's exposure to the debtor could increase because of diminution in the value of the encumbered assets. A stay also prevents secured creditors from taking their money and investing it elsewhere, as they would be able to do if the estate was liquidated immediately (time value of money). The risks that come with a stay should be mitigated by adequate protection. The continued use or disposal of encumbered assets without adequate protection is at odds with the Creditor's Bargain Theory, as this would deprive the secured creditor of the benefit of their bargain or (the value of) their security rights.

The question arises to what extent this approach is applicable to the pre-insolvency procedure of the Restructuring Directive. One can look at the agreements that creditors would have made on their position during pre-insolvency proceedings from an *'ex ante'* point of view but

[18] Preamble to the Restructuring Directive, para 31.

[19] TH Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 Yale L.J. 857, DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment on Adequate Protection of secured Creditors in Bankruptcy' (1984) 51 University of Chicago Law Review 97, and TH Jackson, *The logic and limits of bankruptcy law* (Harvard UP 1986). See for an up-to-date overview of the Creditor's Bargain Theory and its influence: N Tollenaar, *Pre-Insolvency Proceedings: A Normative Foundation and Framework* (OUP 2019) chapter 2.

[20] DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment on Adequate Protection of secured Creditors in Bankruptcy' (1984) 51 University of Chicago Law Review 100-101.

[21] DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment on Adequate Protection of secured Creditors in Bankruptcy' (1984) 51 University of Chicago Law Review 105.

[22] DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment on Adequate Protection of secured Creditors in Bankruptcy' (1984) 51 University of Chicago Law Review 108.

the reality is that the alternative to pre-insolvency is often formal insolvency proceedings and not a legal vacuum. This means that secured creditors may have to accept that their position in pre-insolvency proceedings is not better than in formal insolvency proceedings. For example, secured creditors who presently lose access to out-of-court enforcement of their security rights under national formal insolvency procedures will not actually be deprived of their bargain if they lose their enforcement rights because of the opening of the pre-insolvency proceedings. The Directive's preamble states that "*in restructuring frameworks the rights of all parties involved, including workers, should be protected in a balanced manner*."[23] The Directive's abovementioned provisions on unfair prejudice suggest that saving a debtor´s business and jobs should not happen at any price and offer some protection to secured creditors.[24] How much secured creditors may be prejudiced by the stay remains unclear, as the Directive ignores the asset deployment problem during the stay. It lacks express provisions on the continued use and disposal of encumbered assets. The Directive does, however, contain a set of rules regarding executory contracts, which affect asset deployment during the stay.

2.3 How the provisions on executory contracts affect asset deployment

The Directive prevents creditors from withholding performance or terminating, accelerating or, in any other way, modifying essential executory contracts to the detriment of the debtor, for debts that came into existence prior to the stay, solely by virtue of the fact that they were not paid by the debtor.[25] The preamble states:

> *Early termination can endanger the ability of a business to continue operating during restructuring negotiations, especially when contracts for essential supplies such as gas, electricity, water, telecommunication and card payment services are concerned. Member States should provide that creditors to which a stay of individual enforcement actions applies, and whose claims came into existence prior to the stay and have not been paid by a debtor, are not allowed to withhold performance of, terminate, accelerate or, in any other way, modify essential executory contracts during the stay period, provided that the debtor complies with its obligations under such contracts which fall due during the stay. Executory contracts are, for example, lease and licence agreements, longterm supply contracts and franchise agreements.*[26]

In other words, the creditor is barred from terminating the contract when their debtor is in default and opens a pre-insolvency procedure. The creditor remains bound to the contract as long as the debtor complies with its obligations under the executory contract which fall due during the stay.[27] The Directive's provisions on executory contracts apply to *essential* executory contracts but Member States may also provide that the stay applies to *non-essential* executory contracts. The second sentence of article 7 (4) of the Directive states: "*Essential executory contracts' shall be understood to mean executory contracts which are necessary for the continuation of the day-to-day operations of the business, including contracts concerning supplies, the suspension of which would lead to the debtor's activities coming to a standstill.*" According to the preamble, this will include contracts for essential supplies such as gas, electricity, water, telecommunication and card payment services are concerned.[28] The limitation to *essential* executory causes uncertainty, as the specific circumstances of the case decide which contracts are essential.[29] Stanghellini, Mokal, Paulus & Tirado remark that dealing with these contracts is a thorny issue, as "'*critical vendors', i.e. suppliers and counterparties of the debtor that will not perform their obligations unless they are*

[23] Preamble to the Restructuring Directive, para 3.
[24] See on the justification of pre-insolvency proceedings: N Tollenaar, *Pre-Insolvency Proceedings: A Normative Foundation and Framework* (OUP 2019) chapter 3.
[25] Article 7 (4)
[26] Preamble to the Restructuring Directive, para 41.
[27] Preamble to the Restructuring Directive, para 41.
[28] Preamble to the Restructuring Directive, para 41.
[29] Cf. G G McCormack, 'Corporate restructuring law - a second chance for Europe?' (2017) 42 E.L. Rev. 4, 559.

paid also for the pre-existing debts."[30] If Member States exclude non-essential executory contracts from the stay, these creditors will be able to withhold performance, terminate, accelerate or, in any other way, modify an executory contract if the debtor is in default.

The Directive aims to prevent creditors from evading the restrictions of the stay by terminating executory contracts just before or at the moment of the opening of the pre-insolvency procedure. Article 7 (5) nullifies the effects of so-called *ipso facto*-clauses during and prior to the pre-insolvency procedure. The occurrence of events specified in the contract (e.g., acceleration clauses) usually trigger a debtor's default. This default enables the creditor to withhold performance, terminate, accelerate or, in any other way, modify an executory contract if a specific event occurs. The Directive nullifies (the effects of) clauses providing for such measures, solely by reason of:

(a) a request for the opening of preventive restructuring proceedings;

(b) a request for a stay of individual enforcement actions;

(c) the opening of preventive restructuring proceedings; or

(d) the granting of a stay of individual enforcement actions as such.

Article 2 (1) (5) defines an 'executory contract' *as a contract between a debtor and one or more creditors under which the parties still have obligations to perform at the time the stay of individual enforcement actions is granted or applied*.[31] This broad definition of executory contracts will be new to some European countries, as various legal systems presently have specific rules relating to different types of executory contracts in insolvency.[32] The Directive does not clarify how significant the obligations' performance must be for a contract to be considered executory. Any remaining performance seems to be sufficient. For example, lease and supply contracts could fall under the scope. A contract of sale without the sold goods having been delivered is executory. A contract of sale *with* the sold goods having been delivered could be executory if the creditor is still required to transfer ownership after payment of the purchase price (retention of title). A loan agreement can be executory, if the lender extended a revolving credit facility to their debtor and the debtor has not withdrawn funds up to the pre-approved credit limit. A term loan agreement is no longer executory once the creditor has provided the loan amount to the debtor.[33]

Unsecured creditors are often deprived of their options if they cannot terminate, accelerate or, in any other way, modify the agreement. Secured creditors, however, still have other options, even if they remain bound to the executory contract and are prevented from enforcing their security rights by the stay. A debtor's default on its secured obligations prior to the stay is not without consequence, since it triggers various provisions in the security agreement.

The Directive's stay only prevents secured creditors from enforcing their security rights. A

[30] L L Stanghellini, R Mokal, CG Paulus, I Tirado (eds), *Best practices in European restructuring. Contractualised distress resolution in the shadow of the law* (Wolters Kluwer 2018) 100 fn. 23.

[31] The Directive's approach to executory contract strongly resembles Section 365 of the US Bankruptcy Code on executory contracts. The Code does not define executory contracts but leaves it to the courts to identify executory contracts. The courts have adopted various ways to test the executory character of a contract. An often applied test is the so-called Countryman-test. The American scholar Countryman argued that an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." See: V Countryman, 'Executory Contracts in Bankruptcy, Part I' (1973) 57 Minn. Law Review 439. Some courts use the functional test which works 'backward from an examination of the purposes to be accomplished by rejection, and if they have already been accomplished then the contract cannot be executory' See: In re Magness, 972 F.2d 689, 693 (6th Cir. 1992); Jay Lawrence Westbrook, 'A Functional Analysis of Executory Contracts', (1989) 74 Minn. L. Rev. 227. Cf. J Chuah, 'A thematic and comparative critique' in J Chuah and E Vaccari (eds), *Executory contracts in insolvency law* (Elgar Publishing 2019) 1.10-1.12.

[32] J Chuah, 'A thematic and comparative critique' in J Chuah and E Vaccari (eds), *Executory contracts in insolvency law* (Elgar Publishing 2019) 1.10-1.14.

[33] Cf. US case law, such as In Re Zenith Laboratories, Inc. v Security Pacific National Trust C, 104 B.R. 667 (Bankr. D.N.J. 1989) where it was held that a loan transaction is not an executory contract if the only performance that remains is the debtor's present or future duty to repay the loan.

security agreement usually contains more than just clauses on the (out-of-court) enforcement of the security rights. It mostly contains obligations for the debtor but also some for the secured creditor. For example, the debtor is often required to insure the encumbered assets and offer substitute security if the original encumbered assets perish. The creditor is sometimes required to release excess security. The security agreement also contains clauses that grant powers to the debtor or creditor, such as the power/permission to dispose of encumbered assets free of security rights in the debtor's ordinary course of business. This is often accompanied by provisions on termination/revocation of the power/permission. For example, the secured creditor is free to revoke the permission at any time, under special circumstances, or the debtor's power is automatically terminated from the moment the debtor is in default.

The impact of the Directive on secured creditors' contractual powers (and obligations) under the security agreement is unclear, since the Directive does not clarify how the security agreement relates to the provisions on executory contracts. This raises – at least – three questions. Firstly, do the Directive's provisions on executory contracts apply to the security agreement itself? In most cases, a secured creditor would have no obligations to perform under the security agreement at the moment pre-insolvency proceedings are opened. This would make the security agreement not executory.[34] If the secured creditor would still have obligations to perform under the contract at that moment, for example releasing excess security, the security agreement could be considered executory. Secondly, what happens if the security agreement is not executory but the contract from which the secured claim ensues, is? The Directive's characterisation of the underlying contract as an executory contract does not necessarily include the security agreement. This means that Member States can treat the underlying agreement and security agreement jointly or separately. The joint treatment would mean that a secured creditor that is bound to an executory contract cannot terminate, accelerate or, in any other way, modify the security agreement, solely by reason of (a) a request for the opening of preventive restructuring proceedings, (b) a request for a stay of individual enforcement actions, (c) the opening of preventive restructuring proceedings, or (d) the granting of a stay of individual enforcement actions as such. Thirdly, even if the security agreement itself is executory or it is treated jointly with a secured executory contract, to what extent does this qualification affect the secured creditor's powers under the security agreement? The Directive only prevents creditors from terminating, accelerating or, in any other way, modifying the contract. It does not clarify whether exercising contractual powers is a modification of the contract.

Member States will need to provide answers to these questions, because the present unclarity could make restructuring efforts less effective and have an impact on ex-ante risk assessment and the availability of credit. Without answers, some secured creditors will be able to prevent the debtor from disposing of encumbered assets in the debtor's ordinary course of business (and other creditors will not). There could be roughly three categories of secured creditors. The first category consists of secured creditors that are not affected by the provisions on executory contracts, such as most of the secured lenders. These secured creditors are still able to exercise their powers under the security agreement. This means that they can terminate/revoke the power/permission to dispose of encumbered assets free of security rights in the debtor's ordinary course of business, if it is in the interest of the secured creditor. Consequently, the debtor is prevented from deploying the assets. The second category consists of secured creditors that remain bound to an executory contract but are still able to exercise their powers under the security agreement, because the security agreement is not executory. This category could include suppliers that have a right of (non-possessory) pledge in the delivered assets. As in the first category, these secured creditors can effectively prevent the debtor from

[34] Cf. US case law on the non-executory character of a security agreement: Jenson v. Cont'l Fin. Corp., 591 F.2d 477, 482 (8th Cir. 1979).

disposing of the assets. The third category consists of secured creditors that are prevented from exercising their rights under the security agreement, because it is treated as an executory contract. The debtor can still dispose of the assets in the debtor's ordinary course of business.

2.4 Ways to prevent asset deployment

The Directive ignores asset deployment by letting some secured creditors (the first and second category) prevent the debtor from using or disposing of encumbered assets in the ordinary course of business, even if this means that the debtor is unable to continue their ordinary course of business during the pre-insolvency procedure. This contrasts sharply to the abovementioned Creditor's Bargain Theory that implies that how the debtor's '*assets are deployed should not turn on whether one, ten, or ten thousand people have rights in them*.'[35] The idea is that the continued deployment of assets can be in the interest of the creditors and other investors as a whole. The debtor needs to be able to continue its business to make restructuring feasible.

Secured creditors will (probably) not terminate/revoke the power/permission to dispose of encumbered assets free of security rights in the debtor's ordinary course of business if their interests are adequately protected during the stay. For example, many legal systems across Europe provide that the security right automatically passes into the proceeds.[36] In some Member States, however, the proceeds are unencumbered and creditors require the creation of a new security interest in the proceeds, the direct payment or payment into the debtor's current account to enable set-off. Some creditors get no replacement security. If secured creditors' interests are not properly protected during the Directive's stay, they can seek to lift the stay, prevent the continued disposal of encumbered assets or they can demand protection, for example by demanding (immediate) payment or replacement security. This will give some secured creditors a holdout position which could endanger the restructuring efforts.[37]

The risk that one or several secured creditor(s) will effectively prevent the debtor from continuing the debtor's business during the stay is not just hypothetical. The Directive itself increases the risk that secured creditors may desire to do so, as it does not require Member States to protect secured creditors during the stay. This means that the secured creditor may bear the risk of depreciation and value fluctuation of the encumbered assets and the time value cost of delay.[38] Secured creditors will want these risks to be mitigated by adequate protection and they wish not to be deprived of the benefit of their bargain or (the value of) their security rights.[39] This is particularly the case where secured creditors are worse off during the pre-insolvency proceedings than during formal insolvency procedures. Secured creditors will argue that saving a debtor´s business and jobs should not happen at any price, and certainly not at the expense of secured creditors. The Directive, however, makes protection against these risks *optional* by providing that "*Member States may afford creditors who are bound to essential executory contracts appropriate safeguards with a view to preventing unfair prejudice being caused to such creditor*s".[40] If no appropriate safeguards are offered in national laws, secured creditors will do what it takes to safeguard their interests. They could seek to lift the stay and/or try to terminate

[35] DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment on Adequate Protection of secured Creditors in Bankruptcy' (1984) 51 University of Chicago Law Review 108.
[36] UNCITRAL Legislative Guide on Secured Transactions, para. 73.
[37] Cf. RJ de Weijs, 'Harmonisation of European Insolvency Law and the need to tackle two common problems: common pool and anticommons' (2012) 21 International Insolvency Review (2012) 2, 67-83; N Tollenaar, *Pre-Insolvency Proceedings: A Normative Foundation and Framework* (OUP 2019) 2.16.
[38] DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A comment on Adequate Protection of secured Creditors in Bankruptcy' (1984) 51 University of Chicago Law Review 110.
[39] Conversely, shareholders and unsecured creditors potentially have much to gain from restructuring, as immediate liquidation leaves them with virtually nothing. Cf. TH Jackson, 'Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules' (1986) 60 Am. Bankr. L.J. 411-412.
[40] Art 7 (4).

the continued use and disposal of encumbered assets.[41]

It is clear that there is nothing new under the sun, as similar problems often occur in Member States' current formal insolvency procedures. If secured creditors lose access to out-of-court enforcement of their security rights under national formal insolvency procedures they can also be incentivized to exercise their rights prior to insolvency. If secured creditors believe their interests are served better by liquidation than restructuring, they will not support the restructuring efforts. Member States are free to address these problems as they see fit in their national insolvency legislation, regardless of whether or not effective restructuring can be achieved. However, when it comes to addressing this asset deployment problem in the ***pre-insolvency*** procedure, Member States are required to put in place preventive restructuring procedures which comply with certain minimum principles of effectiveness.[42] This means that if asset deployment is problematic for restructuring efforts in Member States' present formal insolvency procedures Member States could be required to provide a more effective solution to this problem in a pre-insolvency procedure.

3. A comparative analysis of the stay in formal insolvency procedures

How will Member States deal with asset deployment during the stay and the protection of secured creditors? And how likely are secured creditors going to be affected by the provisions on executory contracts after implementation of the Directive? To answer these questions, I have analysed how a stay affects the rights of secured creditors in encumbered assets in some Member States' (formal) insolvency procedures aimed at restructuring. I selected Austria, Belgium and the Netherlands as relevant jurisdictions for this comparative analysis as these three countries have relatively new or upcoming legislation on pre-insolvency procedures and have different approaches to the continued disposal of encumbered assets during a stay. Austria is on one end of the spectrum as it allows for the continued disposal of encumbered assets during a stay. The Netherlands is on the other end of the spectrum as the continued disposal of encumbered assets during a stay is left to the discretion of the secured creditors. For each selected country, I will first introduce the types of security rights in movables. Secondly, I will discuss the effects of the stay on secured creditors in general and subsequently on secured creditors with executory contracts.

3.1. *Austria*

3.1.1. An introduction to security rights in movables

Austria recognises both pledge (*Pfandrecht*) and title transfer (*Sicherungsübereignung*) as security rights in movables. Both security rights require the debtor to transfer control over the movables to the creditor.[43] Movables which are not easily moved, such as big industrial machines, may be labelled to show that they are pledged or transferred. In such case the transfer of control is not required. Secured creditors usually give the debtor permission to sell the assets free of security rights in the debtor's ordinary course of business.[44] If the debtor defaults, the secured creditor can sell the encumbered (or transferred) assets and use the proceeds to satisfy their secured claim.[45]

Suppliers of movables may stipulate a retention of title clause (*Eigentumsvorbehalt*). Suppliers usually give the debtor permission to sell the assets free of security rights in the debtor's ordinary course of business.[46] The supplier retains ownership of the delivered movables as long as the price is not paid in full. If the debtor defaults, the supplier may recover the delivered movables.

3.1.2. Secured creditors are restrained and protected during the stay

[41] Even if Member States consider the security agreement 'executory' they may still choose not to apply the stay to security agreements if they consider such contract to be non-essential.

[42] Preamble to the Restructuring Directive, para 1 and 13.

[43] § 451 (1) ABGB; ECLI:AT:OGH0002:1954:RS0010394.

[44] ECLI:AT:OGH0002:2014:0060OB00208.13A.1009.000.

[45] § 466a ABGB for pledge. Cf ECLI:AT:OGH0002:1980:RS0000832 for title transfer.

[46] ECLI:AT:OGH0002:2014:0060OB00208.13A.1009.000.

Since 2010, Austria has a new Insolvency statute, the *Insolvenzordnung* (IO). The new statute is a joinder of the rules regarding restructuring (*Sanierungsverfahren*) and liquidation (*Konkursverfahren*).[47] The restructuring procedure principally leaves the debtor in control of their assets and day-to-day operation of business.[48] The debtor is supervised by a trustee in restructuring (*Sanierungsverwalter*).

The opening of the procedure entails a stay of six months for secured creditors.[49] The debtor may transfer unencumbered assets in their ordinary course of business without the trustee's permission.[50] However, if assets are pledged or fiduciarily transferred in ownership to a creditor, only the trustee may sell the assets.[51] The trustee requires judicial leave (from the court, referred to as the *Insolvenzgericht*) to sell encumbered assets at a public auction.[52] The trustee must notify the secured creditors if he wants to sell privately. The secured creditors can object to the private sale by making it plausible that a public sale would lead to higher proceeds.[53]

The proceeds of the sale will not be available to the debtor. Secured creditors are referred to as *Absonderungsgläubiger*.[54] This means that they have a right of preference over the proceeds of the sale of the assets.[55] This applies to both creditors with rights of pledge and creditors with fiduciary ownership.[56]

3.1.3. How the provisions on executory contracts affect retention of title devices

Creditors who have retention of title devices, often suppliers, are affected by the Austrian provisions on executory contracts. The contract of sale with a retention of title is an executory contract in the sense of article 21 IO, since ownership is yet to pass.[57]

The Austrian provisions on executory contracts strongly resemble the Directive's provisions and are influenced by the UNCITRAL Legislative Guide on Insolvency Law (2005) and the US Bankruptcy Code with regard to executory contracts.[58] The opening of a restructuring procedure will not automatically terminate executory contracts.[59] If the termination of an executory contract would jeopardise the continuation of the insolvent debtor's business, the creditor cannot terminate the contract on the basis of a lack of timely performance by the debtor prior to the opening of the insolvency procedure.[60] *Ipso facto* clauses that automatically terminate the contract because of the opening of an insolvency procedure are prohibited.[61] As is the case in the Directive, the Austrian code does not nullify clauses that terminate the contract because of events linked to the opening of an insolvency procedure.[62]

If a creditor stipulated a retention of title clause and permitted the debtor to sell the assets free of

[47] § 1 IO. Cf F Mohr and S Riel, 'Das IRÄG 2010 aus Bankensicht' (2010) 639 *RdW* 10, 615.
[48] § 169 IO.
[49] § 11 IO. This applies also to suppliers who stipulated retention of title clauses. If they are not paid by the trustee, they are *Aussonderungsgläubiger* and can recover the assets.
[50] § 171 IO. Secured creditors that have control over the assets may still sell pursuant to the normal execution rules at a public auction. § 120 (3) IO. M Dellinger, P Oberhammer and C Koller, *Insolvenzrecht: Eine Einführung* (Manz 2014) nr 215-7.
[51] § 172 IO.
[52] § 119, 120 and 172 IO.
[53] § 120 (2) IO. Cf M Roth and H Duursma-Kepplinger, *Exekutions- und Insolvenzrecht* (2016) 235.
[54] § 11 (1) IO.
[55] § 48 IO. Cf M Dellinger, P Oberhammer and C Koller, *Insolvenzrecht: Eine Einführung* (Manz 2014) nr 212; Roth and Duursma-Kepplinger (n 31) 233.
[56] § 10 (3) IO. Cf M Roth and H Duursma-Kepplinger, *Exekutions- und Insolvenzrecht* (2016) 234.
[57] For Germany, see C Paulus and M Berberich, 'National Report for Germany, in D Faber, N Vermunt, J Kilborn and K van der Linde, *Treatment of Contracts in Insolvency* (Oxford International and Comparative Insolvency Law Series 2013) 9.43.
[58] F Kernbichler, 'National Report for Austria' in J Chuah and E Vaccari (eds), *Executory contracts in insolvency law* (Elgar Publishing 2019) 4.13.
[59] § 25a IO. See on executory contracts in Austria in general: F Kernbichler, 'National Report for Austria' in J Chuah and E Vaccari (eds), *Executory contracts in insolvency law* (Elgar Publishing 2019) 4.13.
[60] § 25a IO. Kernbichler argues against this restriction by illustrating that it is relatively easy for a creditor to argue that the termination of just one contract will not threaten the continuation of the debtor's business. If all creditors use this argument, however, the continuation will be jeopardised See: F Kernbichler, 'National Report for Austria' in J Chuah and E Vaccari (eds), *Executory contracts in insolvency law* (Elgar Publishing 2019) 4.18-4.19.
[61] § 25b IO.
[62] F Kernbichler, 'National Report for Austria' in J Chuah and E Vaccari (eds), *Executory contracts in insolvency law* (Elgar Publishing 2019) 4.30-4.31. Cf. Article 7 (5) of the Directive.

security rights in the debtor's ordinary course of business prior to the opening of the insolvency procedure, the permission is not automatically withdrawn by the opening of the procedure.[63] The seller must ask whether the debtor/trustee chooses to continue or reject the contract.[64] If the debtor/trustee opts for the non-performance of the underlying contract, the debtor may no longer use or sell the assets. The creditor will become an *Aussonderungsgläubiger* and will have the right to retrieve the assets, once the stay is over.

The debtor's/trustee's choice to continue the contract prevents the seller from terminating the contract on the basis of a lack of timely performance by the debtor prior to the opening of the insolvency procedure.[65] The supplier cannot revoke the permission to sell the assets free of security rights in the debtor's ordinary course of business if this jeopardises the continuation of the debtor's business. The debtor is able to determine how best to deploy the assets. Although the debtor has to comply with its obligations under the executory contract which fall due during the stay, he does not have to cure past breaches (prior to the opening of the pre-insolvency procedure).[66] This means the creditor will not be paid for deliveries prior to the opening of the procedure and the 'collateral' can vanish as the debtor/trustee disposes of the property. The creditor may only terminate the contract if its continuation leads to severe personal or economic damages for the creditor. It is left to legal practice to determine which damages are severe enough to terminate the contract.[67]

3.2 Belgium

3.2.1. An introduction to security rights in movables

On the first of January 2018, the new Belgian Pledge Act came into force. The main innovation of the Pledge Act is the introduction of a central register, enabling a debtor to create a right of pledge in their movable assets without having to hand over control over the assets to their creditor, as the old Belgium provisions only recognised possessory pledge. A right of pledge is perfected by registration in a newly created Pledge Register. Parties can also still opt for possessory pledges. If the debtor defaults, the secured creditor can have the encumbered assets sold and use the proceeds to satisfy their secured claim.[68] Article 21 of the Pledge Act provides that a debtor may dispose of encumbered assets free of rights of pledge in their ordinary course of business, unless the parties agreed otherwise.[69] The creditor's security right will automatically extend to the receivable that replaces the asset if it has been sold (*zakelijke subrogatie*).[70]

Article 69 of the Pledge Act provides a legal basis for a creditor who has stipulated a retention of title clause (*eigendomsvoorbehoud*). The creditor has the right to recover its goods if the buyer fails to pay the price in full. Creditors usually give the debtor permission to sell the assets free of security rights in their ordinary course of business. The creditor's security right will extend to the receivable that replaces the asset if it has been sold (*zakelijke subrogatie*).[71]

3.2.2. Secured creditors can prevent asset deployment during the stay despite protection

Belgium has two formal insolvency procedures: the judicial reorganisation (*gerechtelijke reorganisatie*) and bankruptcy (*faillissement*). The judicial reorganisation offers the debtor the opportunity to sort things out when its business continuity is at immediate or foreseeable risk. One of the options is that the debtor prepares a composition to offer to its creditors. The debtor

[63] ECLI:AT:OGH0002:2014:0060OB00208.13A.1009.000.
[64] § 21 IO.
[65] § 25a IO.
[66] The Austrian legislature did not follow the UNCITRAL legislative guide on insolvency recommendation 79.
[67] According to Kernbichler, severe personal or economic damages are not easily accepted. See: F Kernbichler, 'National Report for Austria' in J Chuah and E Vaccari (eds), *Executory contracts in insolvency law* (Elgar Publishing 2019) 4.25.
[68] Art 47 Pandwet (or Book III, title XVII of the Belgian Civil Code). The secured creditor and debtor can also agree on a forfeiture clause at the time of the conclusion of the pledge contract or afterwards, even after the debtor has defaulted. Cf Art 53 Pandwet (or Book III, title XVII of the Belgian Civil Code).
[69] J. Baeck, *Voorrechten en hypotheken OVH*, *Commentaar bij Art 21 Pandwet*, 56 (23 September 2015) 39.
[70] Art 9 Pandwet.
[71] Art 70 and 9 Pandwet.

remains in possession of the business but is under judicial supervision.[72]

Secured creditors cannot enforce their *rights in rem* from the moment a petition for judicial reorganisation is filed.[73] The stay remains in place when the judge opens the judicial reorganisation for a period of maximum 6 months.[74] Secured creditors do not lose their rights, but are only restricted during a stay period. If encumbered assets are sold by the debtor during the stay with or without the creditor's permission, the creditor's security right will extend to the receivable that replaces the asset (*zakelijke subrogatie*).[75] During the stay, creditors may revoke the permission given to the debtor to sell the assets free of security rights in their ordinary course of business.[76]

Art. XX.56 (2) of the Belgian Code of Economic Law (*Wetboek Economisch Recht*) confirms that the stay does not impact the executory contracts (*lopende overeenkomsten*), as a rule these contracts should be executed.[77] A creditor may not terminate or modify a contract for debts that came into existence prior to the stay, solely by reason of the fact that they were not paid by the debtor. However, the creditor may terminate the contract fifteen days after serving notice to the debtor and thus offering the debtor a chance to fulfil its obligations. This means that the debtor is required to cure past breaches of the contract (prior to the insolvency procedure). Article XX.56 (1) WER nullifies the effects of so-called *ipso facto*-clauses terminating the contract if a reorganisation is requested or opened. The Belgian provisions on executory contracts, however, do not expressly mention the security agreement.[78] This means that the question whether a security agreement should be considered as an executory contract will be determined in light of the facts of the case. It could therefore be relevant whether the security agreement is a separate agreement or whether it is incorporated in an executory contract (e.g., sales contract) that is affected by the stay. Unlike in Austria, however, a sale with a retention of title is not necessarily an executory contract solely on the basis ownership is yet to pass. In short, security agreements that are not affected by the provisions on executory contracts can effectively prevent asset deployment during a stay.

3.3. The Netherlands

3.3.1. An introduction to security rights in movables

The Dutch civil code of 1992 (*Burgerlijk Wetboek; BW*) enables a debtor to create a right of pledge in its movable assets without having to hand over control over the assets to the creditor (*vuistloos* or *stil pandrecht*). This right of non-possessory pledge is created by the drawing up of a notarised deed of pledge or the (non-public) registration of a deed of pledge with the Dutch tax authorities.[79] The Dutch civil code also recognises possessory pledge (*vuistpandrecht*), which requires a transfer of control.[80] Secured creditors usually give the debtor permission to sell the assets free of security rights in the debtor's ordinary course of business. A creditor's security right will, however, **not** automatically extend to the receivable that replaces the asset if it has been sold by the debtor, as it does in Belgium. The parties often create a new right of pledge in the receivables. If the debtor defaults, a secured creditor can have the encumbered assets sold and use the proceeds to satisfy its secured claim.[81]

Suppliers of movables may stipulate a retention of title clause (*Eigendomsvoorbehoud*).[82] Suppliers usually give the debtor permission to sell

[72] Art XX.39 WER.
[73] Art XX.44 WER.
[74] Art 46, § 2 WER. The debtor can request to extend the duration of the stay up to 12 or 18 months, see art. XX.59 WER
[75] Once the money is paid by the third party-buyer to the debtor who sold the asset, however, the secured creditor loses his security. The security right will exist as long as the 'proceeds' are identifiable in the estate of the debtor.
[76] Cf. J. Baeck, *Voorrechten en hypotheken OVH, Commentaar bij Art 21 Pandwet*, 56 (23 September 2015) 39.
[77] Cf. E Dirix and R Fransis, 'National Report for Belgium' in D Faber, N Vermunt, J Kilborn and K van der Linde, *Treatment of Contracts in Insolvency* (Oxford International and Comparative Insolvency Law Series 2013) 29-47.
[78] Cf. E Dirix and R Fransis, 'National Report for Belgium' in D Faber, N Vermunt, J Kilborn and K van der Linde, *Treatment of Contracts in Insolvency* (Oxford International and Comparative Insolvency Law Series 2013) 2.64-2.71.
[79] Art 3:237 (1) BW.
[80] Art 3:236 (1) BW.
[81] Art 3:248 (1) BW
[82] Art 3:92 (1) BW.

the assets free of security rights in their ordinary course of business. The supplier retains ownership of the delivered movables as long as the price is not paid in full. If the debtor defaults, the supplier may recover the delivered movables.

3.3.2. Restructuring and the effects of the stay for secured creditors in general

On 6 October 2020, the Dutch Senate (Eerste Kamer der Staten-Generaal) adopted a bill of an act regarding the introduction of a pre-insolvency procedure in the Netherlands, the so-called Act on the Confirmation of Private Plans (*Wet Homologatie Onderhands Akkoord*, hereafter: **WHOA**).[83] It intends to reinforce the out-of-court debt rescheduling and restructuring process of businesses that, although they are over-indebted and at risk of insolvency, still have viable activities. The act combines elements of the UK scheme with elements of US Chapter 11 and is strongly connected to the implementation of the Restructuring Directive.

The WHOA enables the debtor to request that the court orders a stay in respect of all of its creditors or any number of them.[84] Creditors who are affected by the stay may not enforce their rights against assets belonging to the debtor's estate or require the repossession of assets from the debtor without leave from the court. A temporary stay should support the negotiations on a restructuring plan. A creditor may not terminate a contract for debts that came into existence prior to the stay, solely by virtue of the fact that they were not paid by the debtor.[85] The effects of *ipso facto* clauses are nullified, as article 373 (3) provides that the proposal of a plan is not justification for changing commitments and obligations to the debtor, for suspending performance of an obligation to the debtor or for terminating an agreement concluded with the debtor

To prevent misuse of the instrument by the debtor, the WHOA provides that the court may grant a request for a stay only where there is prima facie evidence that:

- it is necessary to enable the debtor's business to continue during the preparations for and negotiations on the plan;

- it is in the interest of the general body of creditors; and

- it could reasonably be assumed at the time of ordering a stay that it would not materially prejudice the interests of any creditors affected by the stay.[86]

Where the court decides to order a stay, it may make all provisions it deems necessary to secure the interests of the creditors or shareholders.[87] The court can appoint an observer to monitor the preparation process and will probably do so if it orders a general stay.[88] The court can also appoint a restructuring expert to take over the preparations for a plan.[89]

3.3.3. The continued disposal of encumbered assets and adequate protection

If the debtor had the right to use, expend or dispose of encumbered assets before the stay, article 377 provides that the debtor keeps this right during the stay, insofar as it is necessary for the debtor's ordinary course of business:

> *Article 377 Continued use of encumbered property in the ordinary course of business*

[83] For the treatment of executory contracts in insolvency, see D Faber and N Vermunt, 'National Report for the Netherlands' in D Faber, N Vermunt, J Kilborn and K van der Linde, *Treatment of Contracts in Insolvency* (Oxford International and Comparative Insolvency Law Series 2013) 287-330.

[84] Article 376 (1) WHOA. See for an elaborate analysis of the WHOA's stay: FMJ Verstijlen, 'Flankerende voorzieningen in de Wet homologatie onderhands akkoord ter voorkoming van faillissement' in *Het dwangakkoord buiten faillissement - Beschouwingen over het Voorontwerp Wet homologatie onderhands akkoord ter voorkoming van faillissement* (Preadvies van de Vereeniging 'Handelsrecht' 2017) 99-116.

[85] Article 373 (4) WHOA. Cf. FMJ Verstijlen, 'Flankerende voorzieningen in de Wet homologatie onderhands akkoord ter voorkoming van faillissement' in *Het dwangakkoord buiten faillissement - Beschouwingen over het Voorontwerp Wet homologatie onderhands akkoord ter voorkoming van faillissement* (Preadvies van de Vereeniging 'Handelsrecht' 2017) 113-115.

[86] Article 376 (4) WHOA.

[87] Article 376 (9) WHOA.

[88] Article 380 (1) WHOA.

[89] Article 380 (2) WHOA.

> 1. A debtor who had the right to use, expend or dispose of property or to collect claims prior to the ordering of the stay as meant in Article 376 shall retain this right during the stay, provided this falls within the debtor's ordinary course of business.
>
> 2. The debtor may exercise the right described in Article 377(1) only if the interests of the third parties affected are adequately protected.
>
> 3. If the requirement of Article 377(2) is no longer satisfied, the court shall revoke or limit the exercise of the right referred to in Article 377(1) at the request of one or more affected third parties. Before taking its decision, the court shall offer the third parties affected, the debtor, the restructuring expert as meant in Article 371, if appointed, and the observer as meant in Article 380, if appointed, an opportunity to express their views in a manner and within a period determined by the court.[90]

The Dutch Minister of Justice has explained that a debtor must be able to expend and dispose of stock, use business resources and collect claims against their customers so that their business can continue. He added:

> "This also applies to property or claims that are encumbered with third party rights. They might include stocks or company resources that are delivered subject to retention of title and claims that are encumbered with a security right. What is important is that the debtor may only exercise this right if the interests of the parties that derive rights in any way from the said property or claims are adequately protected (Article 377(2) and (3)). For example, by offering replacement security."[91]

According to the legislative explanatory notes, article 377 also relates to a situation where the debtor has had a right of use of the collateral but was deprived of that right shortly (for example, two weeks) before the order of stay.[92] As soon as the court orders the stay, the debtor can invoke Article 377 and reinstate their right of use.

If the debtor disposes of encumbered assets, he needs to provide the secured creditors with adequate protection. The explanatory notes state:

> "Essentially, the latter condition implies the following. Where the debtor expends or disposes of property, the third party's right to that property would typically also be extinguished. To ensure that the interests of secured creditors are not harmed by this, the debtor is required to provide the affected creditors with replacement security."[93]

If the debtor cannot offer adequate protection, the secured creditor can ask the court to end or limit the debtor's right of use, as article 377 (3) provides.

The Dutch Minister of Justice expressly mentioned replacement security as adequate protection. In many cases in which restructuring is required, however, the debtor is over-indebted and many of its assets are already encumbered in favour of other secured creditors. Various questions remain unanswered.[94] For example, what will replacement security mean for a supplier with a retention of title? Will he be paid for deliveries prior to the stay and what will happen to the 'old' non-cash encumbered assets during the stay? As pointed out above, a creditor's security right will **not** automatically extend to the

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[90] English translation of the bill and the legislative explanatory notes by RESOR: url: https://www.resor.nl/files/WHOA_ENG.pdf/at_download/file. Cf. AM Mennens, *Het dwangakkoord buiten surseance en faillissement* (Wolter Kluwer 2020) nr. 287-290.

[91] Memorie van Toelichting 23Previous suggestions to introduce such a right were not followed by the legislator. Cf. Art. 3.6.4 Voorontwerp Insolventiewet 2007; MJ van der AA, *De afkoelingsperiode in faillissement* (2007) 123-128.

[92] Memorie van Toelichting 63. 'Artikel 377 ziet ook op de situatie waarin de schuldenaar een gebruiksrecht heeft gehad, maar dit recht hem kort (bijvoorbeeld twee weken) voor de afkondiging van de afkoelingsperiode wordt ontnomen. Zodra de rechtbank de afkoelingsperiode heeft afgekondigd, kan de schuldenaar zich beroepen op artikel 377 en zorgen dat zijn gebruiksrecht herleeft.'

[93] Memorie van Toelichting 63. 'De laatste voorwaarde komt neer op het volgende. Als de schuldenaar de goederen verbruikt of vervreemdt, vervalt daarmee doorgaans ook het recht van de derde op die goederen. Om ervoor te zorgen dat zekerheidsgerechtigde schuldeisers hierdoor niet in hun belangen worden geschaad, zal de schuldenaar de betreffende schuldeisers vervangende zekerheid moet verschaffen.'

[94] Cf. AM Mennens, *Het dwangakkoord buiten surseance en faillissement* (Wolter Kluwer 2020) nr. 287-290.

receivable that replaces the asset if it has been sold by the debtor.

When it comes to the interpretation of the Directive´s unfair prejudice and appropriate safeguards or the Dutch WHOA's adequate protection, legislators and legal practitioners will probably look for more particularised guidance in UNCITRAL's Legislative Guide on Insolvency Law or the US Bankruptcy code.[95]

4. The continued use and disposal of assets and adequate protection in UNCITRAL's Legislative Guide on Insolvency Law

The continued use and disposal of encumbered assets in the ordinary course of business is not only consistent with the Creditor's Bargain Theory, but also with recommendation 52 of the UNCITRAL Legislative Guide on Insolvency Law (hereafter: the Guide). The Guide recognises the need to use or sell encumbered assets during insolvency proceedings.[96] The disposal of third-party-owned assets in the ordinary course of business is, however, not recommended by the Guide. It only recommends a right of *use* of third-party-owned assets in the ordinary course of business.[97]

Both the Dutch approach and the Guide's approach progress from the notion that the continued use or disposal of assets charged with security interests in the ordinary course of business could benefit all creditors. However, the continued use and disposal of encumbered assets is only deemed justifiable if the secured creditors are adequately protected.

The Guide remarks that secured creditors could be protected by receiving substitute equivalent security interests, such as a replacement security right over other assets or the proceeds of the sale of the encumbered asset or receiving payment of the full amount of the value of the assets that secure the secured claim either immediately or through an agreed payment plan.[98] With regard to the *use* of third-party assets, the Guide states that the owner of the assets, such as a supplier who stipulated a retention of title, should be protected against diminution in the value of the asset.[99] Furthermore, the costs under the contract of continued performance of the contract and use of the asset will be paid as an administrative expense.[100] Only if encumbered assets or assets subject to other interests are sold outside the ordinary course of business, does the Guide recommend that the priority of interests in the proceeds of sale of the asset is preserved.[101]

The Guide distinguishes between two types of adequate protection: (1) the protection of the value of the encumbered asset and (2) the protection of the value of the secured portion of the claim. In the first approach, the secured creditor is protected against the diminution in value of the encumbered assets during a stay, if that value is less than the amount of the secured claim.[102] The protection could entail additional or substitute assets or periodic cash payments corresponding to the amount of the diminution in value. If the value of the encumbered assets exceeds the value of the secured claim, the payment of interest could be considered during the period of the stay to compensate for delay imposed by the proceedings.

The Guide's second approach is the protection of the value of the secured portion of the claim. This means that the encumbered asset is valued immediately upon commencement and, based on that valuation, 'the amount of the secured portion of the creditor's claim is determined. This amount remains fixed throughout the proceedings and, upon distribution following liquidation, the secured creditor receives a first-priority claim to the extent of that amount. During the proceedings, the secured creditor could also receive the contractual rate of interest on the secured portion of the claim to compensate for delay imposed by the proceedings. This approach avoids some of the complexities associated with ongoing valuation of

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[95] Cf. GD Hoekstra, *De positie van de pandhouder in het faillissementsrecht* (Bju 2007) 195-215.
[96] UNCITRAL Legislative Guide on Insolvency Law, para 74.
[97] Recommendation 54.
[98] UNCITRAL Legislative Guide on Insolvency Law, para 68.
[99] Recommendation 54.
[100] Recommendation 54.
[101] Recommendations 52 and 58.
[102] UNCITRAL Legislative Guide on Insolvency Law, para 64-65.

the encumbered assets that may be required under the first approach noted above.'[103]

The Guide and the Dutch WHOA clearly echo § 361 (*Adequate protection*) of Chapter 11 of the United States Bankruptcy Code, which permits reorganisation under the bankruptcy laws of the United States. § 361 states that adequate protection may be provided by making a cash payment or periodic cash payments to secured creditors (1), by providing additional or replacement security (2), or by granting other relief (3).

Time will tell what Member States (and national judges) will consider unfair prejudice to secured creditors and if they will require appropriate safeguards or adequate protection for secured creditors affected by the stay. Whether protection is adequate, is directly linked to the valuation of the encumbered assets. In the United States, valuation of assets is often determined 'through either litigation or bargaining in the shadow of litigation'.[104] The Guide allows for parties to agree on the modalities of a valuation, such as the basis of the valuation (e.g., going concern value or liquidation value), the party undertaking the valuation, the moment of valuation, and the party bearing the costs of the valuation.[105] National legislators could also confer a role on the courts or restructuring representative.

5. Concluding remarks

The way in which Member States address the deployment of encumbered assets during the Directive's stay will have an impact on the effectiveness of the restructuring procedure. During the Directive's stay, secured creditors cannot enforce their security rights and are at risk of depreciation and value fluctuation of the encumbered assets and the time value cost of delay. Secured creditors will want these risks mitigated by adequate protection. The Directive only requires Member States to provide that the judicial or administrative authorities get to lift a stay if creditors are unfairly prejudiced by it. It does not, however, make the protection of secured creditors during the stay compulsory. If the debtor is able to dispose of encumbered assets during the stay but the secured creditor gets nothing in return, there is no adequate protection. This increases the risk that secured creditors will strive to safeguard their interest by seeking to lift the stay and/or trying to terminate the continued use and disposal of encumbered assets in the debtor's ordinary course of business.

This in itself is not a new problem since it often occurs in Member States' current formal insolvency procedures. For example, if secured creditors lose access to out-of-court enforcement of their security rights under national formal insolvency procedures they can also be incentivized to exercise their rights prior to insolvency. Member States are free to address this problem as they see fit in their national insolvency legislation, regardless of whether effective restructuring can be achieved. However, when it comes to addressing this problem in the Directive's pre-insolvency procedure, Member States are required to put in place preventive restructuring procedures which comply with certain minimum principles of effectiveness.[106]

The Directive itself ignores asset deployment by focussing on the effects of the stay on the enforcement of security rights. The impact of the Directive on secured creditors' contractual powers (and obligations) under the security agreement is unclear, since the Directive does not clarify how the security agreement relates to the provisions on executory contracts. A security agreement usually contains more than just clauses on the (out-of-court) enforcement of the security rights. It often contains clauses that grant powers to the debtor or creditor, such as the provision that the debtor has power/permission to dispose of encumbered assets free of security rights in the debtor's ordinary course of business. This is often accompanied by provisions on termination/revocation of this power/permission. As the Directive does not clarify whether and to what extent these powers are affected by the provisions on executory contracts, Member States

[103] UNCITRAL Legislative Guide on Insolvency Law, para 69.
[104] L Arye Bebchuk and JM Fried, 'Secured Claims in Bankruptcy' (2011) 114 *Harvard Law Review* 8, 2390.
[105] UNCITRAL Legislative Guide on Insolvency Law, para 66-7.
[106] Preamble to the Restructuring Directive, para 1 and 13.

have leeway in applying the provisions on executory contracts to security agreements.

The present Austrian restructuring procedure illustrates how a broad definition of executory contracts could prevent some secured creditors from exercising their contractual power under the security agreement. For example, contracts of sale with retention of title are treated as executory contracts and cannot be terminated because of unpaid deliveries prior to the opening of the procedure. This means that the debtor will still be able to dispose of encumbered assets in the ordinary course of business during the stay. If, however, no adequate protection is offered to the creditor, he may still be able to terminate the contract if its continuation leads to severe personal or economic damages to the creditor. The Belgian legislation approaches asset deployment in a different way by enabling creditors to revoke the permission given to the debtor to sell the assets free of security rights in their ordinary course of business. However, it reduces the incentive for secured creditors to do so. The secured creditor is protected against the continued disposal of encumbered assets during the stay, since the security right automatically passes into the receivable that replaces the asset. However, this protection is lost once the money is paid by the third party-buyer to the seller as the security right will only exist as long as the 'proceeds' are identifiable in the estate of the debtor. The proposed Dutch act on restructuring, the WHOA, bypasses secured creditors by providing for the continued use of encumbered property in the ordinary course of business, if the interests of the affected secured creditors are adequately protected.

These national approaches illustrate how Member States could deal with asset deployment during the stay, regardless of whether or not the underlying contract or security agreement is executory. The bottom line is that Member States are required to introduce a pre-insolvency procedure that enables effective restructuring. This means that if asset deployment is problematic for effective restructuring in Member States' formal insolvency procedures, Member States could be required to provide a more effective solution to that problem in a pre-insolvency procedure. Article 5 of the Directive requires that the debtor remains in control of their assets and day-to-day operation of business. Member States must eliminate the secured creditor's right to prevent the debtor from disposing of encumbered assets or the incentive for a secured creditor to exercise this right to ensure the continued deployment of encumbered assets during the stay. The best way to do this is to provide secured creditors with adequate protection. This is consistent with prevailing bankruptcy theory, international standards, and the aim of the Directive to enable the debtor to continue operating or at least to preserve the value of its estate during the negotiations.[107]

[107] Preamble to the Restructuring Directive, para 32.