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Corporate and Insolvency Law Legal Update

April 2020

Corporate Governance and Insolvency Law amid the Coronavirus Crisis

Dear Clients and Colleagues,

Among its other consequences, the ongoing global outbreak of Novel Coronavirus 2019 (COVID-19) has resulted in an economic crisis. In this legal update we present insolvency law issues which may arise during the crisis and we also propose practical solutions for dealing with challenges that companies may face.

1. Background – Insolvency and the Coronavirus Crisis

The crisis has shaken the stability of many companies, especially companies that were leveraged immediately before the crisis began. In view of liquidity problems and the higher cost of debt, even companies that were healthy before the crisis began may now have difficulties refinancing existing debts or raising credit that is essential for their operations. Accordingly, a strong company may find itself in the "insolvency zone" or insolvent.

On the other hand, the crisis has also created business opportunities. For example, the precipitous drops in the stock markets may present opportunities for companies to effect buybacks of their securities which can result in capital gains. In addition, companies may be presented with opportunities to purchase businesses or assets at very low cost from distressed entities.

The crisis first and foremost has created unprecedented uncertainty, and already at present two immediate effects of the crisis have emerged. First, many companies that never expected to be in these positions now find that they are in (or will be in) the insolvency zone or that they are insolvent. Second, CEOs and directors are forced to make decisions under conditions of tremendous uncertainty in a new environment applying laws with which they are not familiar.

In this context, in September 2019, the new Insolvency and Rehabilitation Law 2018 (the "Law") came into force. The Law inaugurated a new legal regime for insolvency proceedings, including with respect to the liability of CEOs and directors. This recent major legislative change increases the already existing uncertainty mainly because the courts have not yet had occasion to interpret the Law.

In addition to the uncertainty arising from the crisis and the new Law, the basic question of determining when a company becomes insolvent also creates uncertainty. Determining whether a company is insolvent has important implications: on the scope of the discretion conferred on the CEO and the directors in their management of the company; on defining whose interest the CEO and the directors serve (the shareholders or the creditors); on determining the types of payments which can be made; and on deciding which transactions can be consummated.

In this legal update, we survey two issues which may arise during the crisis and we propose practical solutions to deal with them.

1. Claims brought against the CEO and directors for not preventing or exacerbating the insolvency.
2. Voiding of transactions in future insolvency proceedings.

2. The CEO's and the Director's Liability for Failure to Narrow the Scope of the Insolvency

The Law imposes liability on CEOs and the directors of companies which are under insolvency proceedings on three principal grounds: failure to narrow the scope of the insolvency (section 288); managing the company in a manner that breaches their duties towards the company (section 289); and fraudulent management (section 290). Below we focus on the cause of action which alleges the failure to narrow the scope of the insolvency of the company – which is also one of the principal amendments that the Law introduced compared to the previous insolvency law.

The Applicable Obligation

Under Section 288 of the Law, a CEO or director who knew or should have known that the company was insolvent and did not take reasonable measures to narrow the scope of the insolvency may, in certain circumstances, be liable for damages caused to the company's creditors for this failure to mitigate the insolvency.

There are two components of this liability: (a) knowledge of the insolvency (actual or imputed); and (b) failure to take reasonable measures to narrow the scope of the insolvency.

Defenses

The Law also establishes defenses to claims of this type of liability:

First, the Law establishes the presumption that the CEO or the director took reasonable measures to narrow the insolvency if the following two conditions are both satisfied:

(i) Measures were taken to determine the Company's financial state – *i.e.* the CEO or the director himself or through others conducted an economic evaluation of the company;

(ii) The CEO or the director carried out one (or more) of the following:

- Received assistance from an entity which specializes in the rehabilitation of companies.
- Engaged in debt restructuring negotiations with the creditors.
- Initiated insolvency proceedings in court.

A second defense under the Law is that liability cannot be imposed on a CEO or a director who can prove that he reasonably relied in good faith on information establishing that the company was not insolvent.

One of the main objectives of these principles is to prevent a situation in which a company that is in the insolvency zone or that is insolvent disregards reality and continues with business as usual or even increases the company's assumption of risk (asset sales at distressed sale prices, raising expensive debt, etc.), all while this increased risk is in practice "outsourced" to the company's creditors.

Operative Suggestions

Below we provide compliance suggestions on two different planes – (i) ongoing corporate decision making, and (ii) limiting the exposure of the CEO or the directors when the company enters insolvency proceedings and a claim is brought against them alleging this cause of action.

At this juncture, it is important to note that aside from repayment of debt to a company's creditors, one of the principal aims of the Law is the rehabilitation of the company to the extent possible. This is particularly relevant to corporate decision-making regarding the level of risk which companies that are in the insolvency zone or are actually insolvent can assume.

Ongoing Decision Making

In day-to-day decision making during the crisis the CEO or the directors can limit their potential liability by managing the Company in an informed and rational manner:

(a) It is important to make rational decisions which are based on relevant and complete factual foundations, which to the extent possible are made in an organized and documented manner, following appropriate deliberations which include, among other things, an evaluation of anticipated cash-flow, and a discussion of available alternatives and consequences.

(b) To the extent possible and as necessary, independent professionals – such as economists, valuators, and appraisers -- should be included in the decision-making process. This assistance can help to support the argument that a director or CEO acted in good faith reliance on professional advice.

(c) The assumption of legitimate business risk is not prohibited in and of itself, provided that the company carries out an evaluation based on relevant information concluding that the risk is reasonable under the circumstances both for the company and for its creditors.

(d) The board of directors must be especially cautious with respect to the company's public reporting, and in particular with respect to sensitive indicators such as the question of whether to publish a going concern notice, or the publication of a projected cash-flow statement.

(e) The board of directors must be responsive to the inherent tension between the shareholders' interest in general (and the controlling shareholders' interest in particular) and the creditors' interest, and it must exercise its independent and critical discretion when balancing these two interests.

(f) It is important to remain diligent and to regularly monitor at scheduled intervals the developments of the crisis, including continually evaluating the company's ability to repay its debts.

(g) The CEO and directors should remain focused on evaluating how to reduce the risk of falling into insolvency. The company will need to assess its ability to adjust its cash-flow needs and financing structure, enter into potential transactions, implement short-term and long-term plans, and undertake efficiency measures.

(h) An additional dilemma is whether to continue the company's activities as a going concern (which may involve certain risks), or to cease the company's activities and to petition the court or enter negotiations with the creditors for a restructuring plan. The company's continuation of its activities as a going concern may be the alternative that will reduce the risk of insolvency -- or that may exacerbate the risk.

(i) The board of directors must be familiar with the rules and regulations that apply to the actions it is considering, as whatever actions it takes will be closely scrutinized. Decisions most likely to attract review include preferential debt repayment for the benefit of certain creditors, assuming new undertakings where there is no certainty that these can be carried out, asset sales at distressed sale prices, and actions which benefit interested parties.

<u>Steps to Reduce the Insolvency Risk</u>

The Law establishes that a CEO or a director could benefit from a presumption that he acted reasonably to narrow the insolvency risk if he acted according to one of the three following alternatives:

(i) He took measures to determine the Company's financial state **and received assistance from an entity which specializes in corporate rehabilitation.**

(ii) He took measures to determine the Company's financial state **and received assistance in conducting debt restructuring negotiations with creditors.**

(iii) He took measures to determine the Company's financial state **and they received assistance to initiate insolvency proceedings in court.**

Of course, a decision to act (or not to act) according to one of the three above alternatives should involve the exercise of discretion in consideration of all of the circumstances based on a complete and well-established factual foundation and an assessment of all three options.

Nonetheless, a premature petition to the court or the premature initiation of negotiations with creditors (especially lenders) may be harmful to the company and serve as self-fulfilling prophecies.

With respect to the option of receiving assistance from a specialist in the rehabilitation of companies – the "expert" can be from a wide variety of fields – economics, management, law, etc.

A CEO or a director who acts in accordance with one of the above alternatives can benefit from the presumption that he acted to narrow the scope of the company's insolvency, thereby decreasing his personal liability exposure.

3. **Voiding Transactions**

The current crisis creates numerous business opportunities for companies both for the repurchase of securities and the acquisition of other assets (including other companies). If, however, the seller ultimately commences insolvency proceedings, the court may, under specific circumstances, rescind the transactions that were carried out before the proceedings were initiated. It is, therefore, important to be familiar with the legal provisions in relation to this prospect – not only from the side of the company which is experiencing difficulties but also from the side of the other negotiating party.

The rationale of the Law in this regard is based on the principle that distressed companies in the insolvency zone may make decisions which harm their creditors -- decisions that would not have been taken had the company begun insolvency proceedings earlier.

In general, under the Law four types of transactions carried out prior to the initiation of the insolvency proceedings can be voided:

1. A transaction which results in the **preference of specific creditors**.
2. A transaction carried out for **inadequate or no consideration**.
3. A transaction intended to **conceal assets**.
4. A transaction (ongoing or completed) whose voidance will result in increased **value for the creditors**.

Below we focus on the voiding or rescission of transactions which were carried out for inadequate or for no consideration and transactions which result in a preference for creditors. We focus on these types of transactions because during the crisis these types of transactions are more likely to be voided than during ordinary times.

Voiding transactions which prefer particular creditors (section 219 of the Law)

This provision of the Law deals with the situation where a company experiencing difficulties repays debts of some creditors before the commencement of the insolvency proceedings, thereby improving the situation of these creditors.

(i) **The voidable transaction**: Repayment of a debt where the creditor received more than what he would have received in insolvency proceedings in accordance with the payment priorities. Under the Law the principal test to determine whether a creditor was preferred is to determine whether under insolvency proceedings the creditor would have received less than what he received under the transaction being challenged. This objective test replaces the "fraud" element which existed under the preceding insolvency law regime.

(ii) **Timing of voidable transaction**: Transactions can be voided if they were carried out in the three-month period (one year, in the case of payment to a relative) before the filing of the motion to initiate insolvency proceedings.

(iii) **The company was insolvent on the date of the voidable transaction**: In light of difficulties to prove this condition, a rebuttable presumption was established under the Law which provides that the company was insolvent during the 3 month period (1 year for relatives) before the motion was filed.

The Law establishes that a **transaction cannot be voided** if one of the following conditions is satisfied:

(i) On or near the date of execution of the transaction the company received "adequate consideration under the circumstances". The repayment of the loan in and of itself will not be considered to be adequate consideration for this purpose.

(ii) The transaction was carried out in the company's ordinary course of business, and the debt which was repaid in the transaction was created during the company's ordinary course of business.

These defenses mainly cover debt refinancing transactions and repayment of ordinary commercial debts.

Voiding transactions carried out for inadequate consideration (section 220 of the Law)

The court may order the voiding of a transaction effected before the order initiating insolvency proceedings was made, which resulted in the reducing the assets available for satisfying creditors, if the following conditions are fulfilled:

Consideration – The voidable transaction was carried out for no consideration or "inappropriate consideration under the circumstances".

Time Period – The action was carried out in the two-year period (4 years for relatives) preceding the submission of the motion requesting to initiate the insolvency proceedings.

Insolvency – On the date of the act the company was insolvent, or the action caused it to be insolvent. The Law establishes a rebuttable presumption which provides that the company was insolvent during the 2-year time period (4 years for relatives).

If these conditions are satisfied, the court can either: order the cancellation of the transaction (and even though the Law is not explicit on this point, we believe that this means that – except under extraordinary circumstances – in parallel with the return of the asset to the company the buyer will receive a refund of the consideration that it paid), or order the buyer to pay the difference between the price that it paid and between the appropriate price that it should have paid.

The main difficulty these provisions raise is determining the definition of "appropriate consideration under the circumstances". We expect that the courts will have to grapple with this issue at length.

Operative Suggestions

While the principal exposure rests with the CEO and the directors to narrow the scope of insolvency, the counterparty has the greater risk in regard to voiding of a transaction. Nonetheless, a CEO or board members may also be held liable for voided transactions, for example if there was creditor preference, as it may not be possible to collect from the creditor the amount that it should have returned to the liquidation fund.

In light of the authority which the courts have under the Law to void transactions carried out where inappropriate consideration is paid, or where creditors are preferred, or based on the other relevant legal provisions, we make the following suggestions for compliance with these principles:

(i) Companies in the insolvency zone must consider the adequacy of consideration which they receive in every transaction, and for this purpose must seek the assistance of external and independent professionals who can support the logic and the economic justification of the transaction. This recommendation is equally applicable to both sellers and buyers.

(ii) Transactions at "liquidation prices", and the repayment of debts to company creditors which are not in the ordinary course of business, should raise red flags for the CEO, directors and third parties that their actions should be carefully considered.

Lawyers in our firm have extensive and varied experience in insolvency matters and decision-making in the insolvency zone and have extensive bankruptcy and corporate bankruptcy litigation experience. Our firm has provided counsel on many debt restructurings, including some of the largest arrangements reached in Israel with an aggregate value in the billions of shekels. We also advise boards of directors facing complex problems, and we represent financing entities, creditors, bondholders.

Sincerely,

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