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Client Update – April 13, 2020

Corporate Conduct and Creditor Preference during the Corona Crisis in light of the Insolvency and Economic Rehabilitation Law, 8758 -2018

Many clients are turning to our office with practical questions regarding that actions that are expected of them as corporate executives, during the time when the corporation's cash fund is thinning out and the debts are accumulating, especially when the end of this current crisis is not yet on the horizon.

This update is intended to offer companies and their executives practical tools for conduct during the Corona crisis based on the Insolvency and Economic Rehabilitations Law, 8758 – 2018. However, it is understandable that there are a variety of possible solutions that may fit the legal principles and that one cannot point to a solution that fits the wide spectrum of scenarios. For the sake of good order, we clarify that this update is intended for merely informational purposes and should not be considered as a substitute for legal advice or opinion of any kind regarding the issues hereinafter.

The starting point of this update, is that as a result of the imposing of restrictions and guidelines for prohibiting different types of businesses, many corporations experience **income cessation**, which does not allow them, or at very least creates a **real fear**, that as the situation continues they will not be able to fulfill their financial obligations in a timely manner. Consequently, the corporation's financial situation allegedly fulfils the **cash flow test** stated in clause 2 of the Insolvency Law, which is used as one of the two tests needed in order to deem a corporation as insolvent and as a **condition for opening insolvency proceedings**. On the other hand, there is a possibility, that already has somewhat of a presence in government programs and statements, that the government will provide assistance to businesses through various tools ranging from state guaranteed loans, various grants, waivers of compulsory payments such as property taxes and VAT, and even regulatory intervention in contractual relationships such as lease agreements and the determination of risk distribution in circumstances where government instructions were given to stop the activities of businesses.

In the situation we are currently experiencing, **company executives are asking themselves how they should be managing their currently slim funds in a way that will allow them to "keep their heads above water" and wait "until the rage passes", and on the other hand be prepared to continue operations and enable a quick recovery as soon as the crisis unfolds.**

In this situation, executives may find (after examining the risks and odds), that the right move for the company's survival is paying part of the suppliers and creditors, while negotiating payment deferral and debt distribution with the others. But that raises the question of **if the move constitutes creditor preference** and if the move fails, and insolvency proceedings will be issued against the company, **will these actions expose the executive to personal liability**.

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Continuing Conduct During the Crisis

Allegedly, when a company suffers from a cash crunch and meets the conditions of an insolvent company as defined in clause 2 of the Insolvency Law, the company will be subject to an order of opening proceedings. In this situation, both the corporation and its creditor (under the conditions specified within the law) may apply to the court and request such an order. At the same time, the **law does not impose an obligation to turn to the court and does not see it as an exclusive alternative when coping with the situation**. In such a situation, the law imposes **a duty on the executives to reduce the scope and outcomes of the insolvency**.

Along with the option of turning to the courts, the law offers an option of **consulting with a corporate restoration expert** (who will recommend tailor-made streamlining actions to assist with the restoration of the corporation) as well as **negotiate a settlement with company's creditors**. It must be noted, that the alternatives specified in the law are not defined as a closed list and the corporation and its executives **may turn to other ways** in order to reduce the insolvency. Past experience, based on the previous insolvency laws that used to be in effect before the new law came (in September 2019), teaches us that the **cash flow test is not foolproof** and the courts tend to enable the Company to continue its operations when there is an economic horizon for its survival and overcoming the temporary crunch. This starting point also guides us when examining the provisions of the law during the situation described.

Creditor Preference

Does an informed decision made by the directors and executives of the company, after the consideration of the available options, to deliver part of the corporation's suppliers payment **on time**, while negotiating with the other suppliers payment deferral and debt distribution, constitute a preference of creditors which would need to be cancelled?

The cancellation of a transaction that gives priority to certain creditors is stated in section 219 of the new law whereby the court **may** order the cancellation of the transaction which results in the repayment or advancement of debt to a creditor, if the following conditions prescribed by law are met: (A) the date of execution of the transaction falls within the 3 month period prior to the date of filing a request for an opening of proceedings; (B) the company was insolvent at the time the transaction was executed; (C) due to the transaction, the creditor will receive a larger portion of the debt compared to the portion he would have received during an insolvency proceeding within the order of creditors.

The explanatory notes to the bill indicate a significant change regarding the topic compared to the old law (section 98 of the bankruptcy order), where the **requirement for the intention to prefer a creditor has been eliminated**. The main reason for the provision is to promote the equal distribution between creditors and not to prevent the debtor from executing unfair transactions. Therefore, the new law sets an **objective consequential test -- a transaction which results in debt repayment or getting moved up the order of creditors – is deemed void.**

Section 219(B) sets out the exceptions to the cancellation rule and allows the court not to cancel a transaction that gives priority to creditors when one of the following exists:

1. "At the time or near the time of the transaction, the debtor received an appropriate remuneration under the circumstances of the executed transaction…"

This is the "new value rule" intended to apply in a case where it is economically wrong to look at the transaction as a past debt preference but rather as a new transaction for which the debtor receives new value.

2. "The execution of the transaction was within the ordinary course of business of the debtor and the debt was repaid due to the execution of the debtor's ordinary business…"

On the surface, the consequential test as adopted in section 219(A) **could have led to the cancellation of all payments** made by the debtor during the 3-month period prior to filing of an opening of proceedings order (inter alia, because of the presumption of insolvency that is applied to it during this period under section 219(A)(2)). Except, that the legislature's intention **was not to cause the debtor's premature implosion**, but rather try and allow it to progress during the difficult period while imposing the sanction and cancellation only specific transactions. Hence, there is the exception allowing the making of payments during the debtor's usual course of business. In the same way, the explanatory notes to the law make it clear that the exception is intended precisely for day to day situations, assuring suppliers, credit providers, and other entities operating with the debtor in the ordinary course of business that the payments which are transmitted to them are certain and final.

In the classic situations intended by the law, we shall distinguish between payments within the ordinary course of business and exceptional payments or other unusual transactions (such as strengthening collateral) -- the regular payments should continue to be paid in a timely manner as much as possible, while early payments or other unusual transactions will be more exposed to the option of cancellation due to creditor preference. **However, the current crisis requires more transversal and holistic solutions that will delay some of the affiliate payments and not just handle exceptional events. In such a situation, the execution of regular payments is possibly exposed to the preference claim. Executives should prepare and justify such conduct (assuming it is the case) when executing actions intended to minimize the insolvency as required by law**.

The Responsibility of Executives and Board Members During the Crisis

In light of the law, a transaction that in retrospect (when issued an opening of proceedings order against the corporation) led to the repayment of a larger portion of the debt in comparison to the portion that would have been given during the insolvency proceedings, and the conditions under section 219(A) cancelling the transaction are met, the executives of the corporation might hold personal responsibility for carrying out the transaction. However, the executive's responsibility must be examined in accordance to sections of the new law imposing personal responsibility, and in particular section 288 of the law. It should be asked if at the time of the action's approval, did the executives know, or should they have known that the company was insolvent **and did not take reasonable measures to reduce its scope**.

In certain situations, under the subjective facts and with the individual circumstances of each case, after weighing the information and the data before them, the executives may conclude that the payment that appears to favor a certain creditor might rather constitute reasonable means of reducing the extent of insolvency and preparing for "the day after" the crisis in which the corporation will need the same creditor in order to continue its operations and avoid the pit.

One of the steps that executives are expected to take in order to reduce the extent of insolvency is **negotiation with the creditors of the corporation to reach a debt settlement.** A debt settlement can be **unique** for each creditor (it might be more appropriate with one to reach a payment settlement arrangement, with another a deferral of payment solution, and the third actually changing the payment terms and separating the interest rate from the principal) or a **collective** debt arrangement offering the same plan to all of the creditors who are ranked similarly in the credit line (in accordance with the provisions of chapter 10 of the law referring to a settlement without the opening of proceedings). The instructions of section 288(B)(2) of the law indicate that negotiations with creditors to lessen insolvency "corresponds" with the second part of the correct action and offers a more holistic alternative in any case. In the first part as described above, if after considering the risks, the executives concluded that they intend to pay only some of its current corporate obligations, the second part shall be attempting to reach different arrangements in relation to the other debts in order to allow for breathing space until the crisis passes.

Ending Note

We found it appropriate to emphasize that the provisions of the Insolvency and Economic Rehabilitation Law, 2018 – 5779, which took effect in September 2019, this client update describes a series of provisions from within the law above and the possible implications that could be drawn from the interpretation also given in the context of the legal situation prior to the entry of the new law and in the explanatory notes to the law. Naturally, and in the absence of up-to-date case law, the interpretation and application of law above is expected to develop gradually future case law. It should also be emphasized, that the possible interpretations described above, as well as conduct that should be considered, are expected to be updated in tandem with the development of case law and practice.

Moreover, as it appears the Corona crisis is already affecting the global economy and extensive sectors in Israel in a significant way. Of course, we cannot anticipate in advance the way the crisis will end, and its implications will be examined only in retrospect. Therefore, it is important to note that the law is not intended or designed to respond to transverse stress situations as we now experience and therefore requires creative and "out of the box" thinking that is adapted to the circumstances of each case in order to properly apply the principles of the law.

Contact

We will be happy to stand at your disposal,

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