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Principles of Israel's insolvency regime and changes ahead

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Over the past few years, there has been an increase in corporate entities in Israel facing a financial crisis leading them either into liquidation or forcing them into a recovery process. Israeli law provides various tools with which to handle such situations. This article provides an outline of the key principles of insolvency proceedings in Israel, the legal tools available to Israeli corporations in financial crisis, creditor rights in such proceedings, and the legislative changes expected in this area. By Yuval Bargil, partner and Gil Oren, partner at Yigal Arnon & Co.

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Generally, insolvency proceedings are governed by three main pieces of legislation, including the Bankruptcy Ordinance; the Companies Ordinance; and the Companies Law. Insolvency principles are based on two tenets: the public nature of the procedure and parity among same-class creditors. The Knesset (the Israeli parliament) is now working on a substantial legislative change, with a new statute (the Insolvency and financial recovery Law) which is designed to replace all three pieces of legislation mentioned above. The principles underlying the new law are basically the same as the ones on which the existing statutes are based. The new law is intended to integrate the rules governing insolvency of individuals and corporate entities, with a focus on the debtor's financial recovery and of the rights of unsecured creditors.

What constitutes insolvency?

Israeli law and the principles developed by case law recognise both cash-flow insolvency; that is, where the corporation is unable to satisfy its current obligations as they fall due, and accounting insolvency (where the value of a company's liabilities exceeds its assets). The new bill focuses on the cash-flow elements.

According to current law, an Israeli corporation in financial difficulty does not have to instigate any legal proceedings, however, the Companies Law stipulates that where a company that has issued securities seeks to enter into a debt settlement with the security holders, it must apply to the court to appoint a court-appointed expert to examine the settlement. The new bill proposes various rules that impose personal liability upon the directors of an insolvent corporation, if they did not take appropriate action to minimise the scope of insolvency.

Liquidation processes

A corporation that is in financial distress and becomes insolvent, is entitled to court protection, through one of two avenues: liquidation or recovery. Under Israeli law, a company can also be liquidated voluntarily, without court intervention; but this process is more suitable for solvent companies.

The insolvency application is published in the Official Gazette and in a daily newspaper in Israel. Once all parties involved have been given the opportunity to state their position on the application, the court issues an insolvency order. Since the Justice Ministry is responsible for all insolvency proceedings, the order appoints the Official Receiver, which is the executive arm of the Justice Ministry, to serve as liquidator, until the creditors' meeting, in which the liquidator will be appointed.

When the creditors appoint the liquidator, this appointment is subject to court approval. The liquidator is considered an officer of the court, and is subject to court instructions. On their appointment, the liquidator serves as the only organ of the company for all intents and purposes. The Official Receiver oversees the liquidator and represents the interests of the company's creditors.

The liquidator's job is to liquidate all the company's assets, examine the creditors' claims and the circumstances that led to the company's collapse, and distribute the company's assets among the creditors on an equal footing. In most cases, the liquidator does not operate the company but endeavors to sell its assets in a public process, but they may, subject to court consent, continue operating the company to maximize the value of its distributable assets, for the benefit of all creditors. The liquidation order halts all action against the company to guarantee parity among creditors.

Recovery procedures

The Companies Law stipulates a mechanism that is designed to enable a company that is facing difficulties, to enter into an arrangement with its creditors and shareholders.

For this purpose, the court may issue an order protecting the company against legal action. Such orders have a limited timeframe, during which the company is supposed to propose a settlement to be approved by the various classes of creditors. In general, a settlement with creditors is initiated by the company, however, under Israeli law, creditors may also initiate such process. The protection against creditors may not, by law, exceed nine months, but where the circumstances justify this, the court may extend this term. During the protection period, the court appoints a trustee, who serves as an officer of the court and follows the court's instructions.

To gain approval for a settlement with creditors, the trustee must convene creditor meetings. Creditors are classified according to their rights – secured, preferential and unsecured. A majority of creditors representing at least 75% of the debt in each creditor meeting is required for a settlement to be approved.

However, the court may approve a creditor settlement that has not gained approval of all creditor classes, if creditors holding a majority of the debt in each of the classes supported the settlement, and provided that No class of creditors receives inferior rights under the settlement as compared to the rights they would have received if the company were to be liquidated.

Creditor rights

Israeli law recognises three main classes of creditors: secured creditors, those who hold a security; their rights rank higher with respect to the assets secured in their favour; preferential creditors, which are those creditors provided preference by law over the company's unsecured creditors. This is a finite list, including employees, the tax authorities and property lessors. Their preference is not absolute; it has an amount cap or time limit, as prescribed by law; and uunsecured creditors.

This breakdown is not exclusive. In effect, Israeli law also recognises setoff rights, creditors by virtue of a retention-of-title agreement, for example. As mentioned, the main principle of insolvency law is parity among creditors. This means primarily that creditors of the same class will be treated in the same way, and in effect translates into pro rata distribution among same-class creditors.

Secured creditors

Israeli law distinguishes between two kinds of securities: fixed charges and floating charges.

Charges over the rights of a corporation must be registered with the Companies Registrar or in any other specific register that may exist for the specific category of assets. In some cases, registration in several registers is required.

In insolvency proceedings, the holder of a fixed charge may require liquidation of the collateral and appointment of an officer to implement such liquidation. However, the court may preclude the holder of a fixed charge from exercising their right, if the secured asset is necessary for the company's recovery, and provided that another suitable security is granted.

A floating charge crystalises when the insolvency proceeding is commenced, or in other circumstances as stipulated in the debenture that created the charge. The floating charge catches all the assets in the hands of the company at such time, all except those that serve as collateral for fixed charges.

Floating charges also rank after preferential creditors, such that in effect, the proceeds on liquidation of the assets that served as the security for the floating charge will first be distributed among preferential creditors and only then to the holder of the floating charged.

The bill proposes, on the one hand, to substantially limit the rights of preferential creditors, and on the other, to stipulate that holders of floating charges will not be entitled to more than 75% of the proceeds, to assure that in the insolvency proceeding, unsecured creditors also recover at least some of their debt.

A floating charge can only be enforced through the court, which appoints an officer who serves as the long arm of the court and liquidates the asset. The secured creditor has rights in the proceeds of liquidation, and not in the collateral itself.

Preferential creditors

As mentioned, the Israeli legislator grants priority to several kinds of creditors in insolvency. This priority is not absolute. There is a cap on the secured amount, which also depends on when the debt that is alleged to be preferential has accrued.

Under the law as currently in effect, employees' preferential rights are limited by an amount that is updated from time to time, and as of now stands at approximately 11,000 NIS per employee.

The tax authorities and any lessor letting an asset to the insolvent company, also have preference, but this preference is not absolute either and is limited to a certain period during which the debt has accrued.

The new bill proposes to limit the number of preferential creditors, in effect almost completely eliminating the preference granted to the tax authorities and to lessors.

Unsecured creditors

All other creditors are in fact unsecured, and in insolvency, they rank after secured and preferential creditors. They are entitled to the proceeds after satisfaction of the secured and preferential debts as described above.

Shareholders

The shareholders are not, by virtue of their shareholding alone, entitled to any money of the insolvent company. Where the shareholder has also provided a shareholder loan prior to the company's entering into the insolvency proceeding, their rights arise from their status as a creditor. Israeli law treats this debt as any other of the company's debts.

However, in certain circumstances the court may withhold the rights of a shareholder to be counted among the company's creditors, where it transpires that the company was managed in a deceitful manner, in a way that was unfair to one or more of the company's creditors, or in a way that conflicts with the purposes of the company and while assuming an unreasonable risk with respect to its ability to satisfy its debts.

Conclusion

Insolvency proceedings in Israel are based on the open-court principle and on the principle of parity among same-class creditors.

The legislative process currently underway is intended to integrate the different insolvency statutes, with a focus on the financial recovery of the debtor and on protecting the rights of unsecured creditors. This change is likely to impact the behaviour of companies facing financial difficulties and that of lenders, with regard to their reliance on floating charges etc. That said, we believe that this is not a revolutionary reform, because most of the changes mentioned above reflect the position of the courts as already implemented in insolvencies in the last few years.

The online link to the article can be found here.