The Formative Decade of Israel's Reorganization Law: 1995–2004

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Abstract

The article analyses closely the major developments that took place between 1995 and 2002, both as a result of legislation and judicial law making. In 1995, the Knesset, the Israeli legislature, enacted a moratorium statute. This statute stays all pending proceedings against a financially distressed corporation which has applied to the court requesting its reorganization through a compromise or arrangement scheme. The moratorium statute influenced significantly this scheme and effectively reshaped it in a reorganization-friendly manner. The article submits that the moratorium statute has effectively transformed the nature of secured creditors' rights from rights-in-kind to rights-in-value. In addition, the article will demonstrate the relative contribution of both the Supreme Court and the district courts to reorganization law's development. The Supreme Court established the grand premises for judicial law making in corporate reorganization by holding that the statutory substantive norms which apply in corporate liquidation apply in reorganization as well *mutatis mutandis*. For their part, the district courts contributed to the law making in two primary aspects of corporate reorganizations: First, by requiring that in reorganization cases a court-appointed trustee shall manage the corporation and negotiate on its behalf with the creditors. Secondly, the courts developed the practice of auctioning the firms undergoing reorganizations as a means for maximizing the return to the creditors. Copyright © 2005 John Wiley & Sons, Ltd.

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*I wish to thank Odellia Minnes and Nir Friedman for their diligent assistance in researching this article.
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Int. Insolv. Rev., Vol. 14: 121–170 (2005)
Published online in Wiley InterScience (www.interscience.wiley.com). DOI: 10.1002/iir.129

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I. Introduction

Insolvency laws dealing with the human debtor are concerned with the realization of the debtor's property in order to allow him to pay his debts to his creditors,[1] as well as with discharging the debtor in respect of his unpaid debts and enabling him to open a new page in his economic life.[2] In contrast, Israeli law's treatment of *corporate* insolvency has traditionally been one-dimensional. Until recent years, Israeli insolvency law focused exclusively on corporate liquidation. Indeed, insolvency is one of the statutory grounds for corporate liquidation.[3] Yet Israeli law did not regard the liquidation process as just one of the possible methods of legally confronting corporate insolvency; rather, it saw it as *the principal*, if not exclusive, method for doing so. The legislature did not address the possibility of corporate reorganization as an alternative legal procedure to corporate liquidation. The courts followed in this legislative path invariably, ordering the liquidation of corporations on grounds of their insolvency. On the other hand, the courts played an

1. See Bankruptcy Ordinance (New Version) 5740–1980, *Laws of State of Israel* 639 (hereinafter- "Bankruptcy Ordinance"), Section 56(c) (the debtor's duty to aid in the realization of his assets among his creditors), Section 67 (debtor's obligation to assist in realization and distribution, even if he has received a discharge). *See also* C.A 2629/92 *Abu Shadid v. Official Receiver*, 47(1) P.D. 388, 390–391.

2. See Sections 61, 62 and 69 of the Bankruptcy Ordinance (regarding discharge), Sections 85(1A)-(1C), 86 and 86A (regarding bankrupt's assets which cannot be distributed) and Section 127 (payments to the bankrupt). *See* B.F. (T.A) 466/93 *Garbash v. Trustee for Yechiel Garbash, in Bankruptcy*, Pador 2000 (5) 437 (the goal of the debtor's payment of debts is to create a situation in which the debtor may be granted a discharge from his debts); K. Gross, FAILURE AND FORGIVENESS (1997) 14–19, 91–103.

3. Section 257(4) of the Companies Ordinance (New Version)—1983, Laws of State of Israel 761 (hereinafter—"Companies Ordinance"). The term "insolvency" is defined in Section 258(3) of the Companies Ordinance as follows: "It is proven to the court's satisfaction, having considered the company's pending and future debts, that the company is incapable of paying its debts".

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important balancing role by frequently exercising their judicial discretion in order to avoid giving liquidation orders. This occurred in cases where it was clear that liquidation would have far-reaching economic consequences for those connected with the insolvent firm.[4] Lacking appropriate statutory tools, the courts utilized existing legal procedures in attempts to achieve corporate reorganization of insolvent corporations,[5] even though the original purpose of such legislation was entirely different. Nonetheless, these attempts were exceptions that attested to the rule. The rule reflected the dominant legal perception in Israel, namely, that insolvent companies ought to be liquidated.[6]

The statutory framework changed when in 1995 Israel's legislature, the Knesset, adopted for the first time a statute expressly intended to promote corporate reorganization and recovery instead of liquidation. The Companies Ordinance Amendment Act (Amendment No. 10) 1995,[7] amended Section 233 into the Companies Ordinance. Section 233 deals with a settlement or compromise between the corporation and its shareholders or creditors. The amendment inserted subsection (a1), which authorizes the court to order a stay [freeze] of all proceedings against the corporation.[8] Despite its limited scope, comprising one subsection only, the amendment triggered a conceptual and practical revolution in commercial insolvency in Israel. Conceptually, the Moratorium Statute blazed a new legal trail for dealing with financially distressed corporations. It was a radical departure from accepted doctrine, which automatically sentenced the financially distressed company to liquidation as its sole recourse. The modern doctrine is more varied and more complex, as the insolvent corporation can now opt for one of two legal avenues possessing equal status: reorganization or liquidation.[9] Analytically, the

4. L.C.A 6422, 6418/93, *Bank Leumi LeYisrael Ltd. v. Receiver and Corporations Manager*, 49 (2) P.D. 685, 697 (hereinafter—*"Carmel Carpets"*); C.A. 359/88 *Sollel Boneh Ltd. v. Receiver and Liquidator of Cochav HaShomron Emanuel Ltd. (in liquidation) and of Cochav HaShomron Emanuel (1982) Ltd. (in liquidation)*, 45 (3) P.D. 862, 864–865, 873 (hereinafter— *"Cochav HaShomron"*). T.A. (M.A.) 148/90 *re Yuval Gad Ltd. (in interim liquidation)* Tak-Dis. 96 (1) 1661, paras. 4 and 19; Z. Cohen, Israel Bar, Tel Aviv, LIQUIDATION OF CORPORATIONS, (2000) 11 (Hebrew).

5. On the use of the interim trustee for an attempted reorganization, *see* C.A. 272/83 *Maof Airways Ltd. et al v. State of Israel, Ministry of Transport*, 39(3) P.D. 561, 564–565; *Yuval Gad Ltd, id.* para. 4; Y. Kantor, "Secured Creditors in the Light of Corporate Collapse and Corporate Reorganization: Permanent Solution—And the Need for an Interim Solution", 29 BANKING QUARTERLY (1991) 85, 91–94 (Hebrew).

6. For a criticism of this tendency, *see* Z. Cohen, "Corporate Liquidation at the Creditor's Request—Guidelines for Exercise of Judicial Discretion", 12 BAR-ILAN LAW STUDIES, (1995) 37; M. Mautner, "The Bankruptcy Act—Thinking Before Acting?" LUVENBERG BOOK (1908) 108, 121–124 (Hebrew). It should be noted that the courts gave the term 'insolvency" a strict and limited interpretation, and were not prepared to order the liquidation of a company in cases which did not satisfy all of the provisions of the Companies Ordinance, *see, for example*, Motion (J-lem) 129/97 *Danya Sybus—Building Company Ltd v. Or Habira Electricity Ltd*, Dinim-Dist. 32 (1) 904; *see also* CM (Haifa) 13321/01 *D.A. Alit Apartments Ltd. v. Israel Football Association*, Takd-Dist. 2001 (3) 3947.

7. S.H. 204.

8. For the purposes of this discussion, this law, like its successor—Section 350 of the Companies Act—1999, S.H. 189, will hereinafter be referred to as "The Moratorium Statute".

9. *See, for example*, the comments of Levin J. in *Carmel Carpets, supra* note 4, at 695–696; C.A. 673/87 *Salach v. Liquidator of Peretz & Isser, Building and Investments Company Ltd (in liquidation)*, 43 (3) P.D. 57, 68; *Cochav Hashomron, supra* note 4, at 869, in which Levin J. stated that "a settlement arrangement which is reasonable and balanced and acceptable to the majority of the creditors, is generally preferable to forced liquidation"; C.A. 4316/90 *Haspaka Chevra Mercazit Lechaklaim Ltd. (in liquidation) v. Agra–Eben Yehuda Aguda Chaklait Shitufit Ltd*, 49(2) P.D. 133, 168. *See also* comments of Judge Gilor regarding the preference of the reorganization process over the receivership process, B.F (Haifa) 274/01, MA 7933/01 *Hapoalim Bank Ltd v. Taal Industries Etz Levud Mishmarot Group Ltd.*, Takd—Dist. 2001 (2) 7462.

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Moratorium Statute increased the affinity between companies dealing with insolvency and individuals dealing with their insolvency.[10] In both cases the creditors' interests in maximizing repayments from the debtor are weighed against the debtor's separate interests.[11] The debtor's best interests include the benefit which the corporation's continued existence accords to its shareholders, its employees, its suppliers, consumers and the community as a whole.[12] The District Court[13] is charged with deciding on the corporation's fate and in that capacity it confronts a range of considerations. The court must draw a balance between considerations of benefit to creditors and considerations of benefit to other groups or communities connected to the company, which may well entail the continued existence of the company. Quite often these interests are not expressible in terms of financial return alone but also anticipate future benefits, such as ensuring the continuance of a place of work for employees, or ensuring the survival of the corporation as a central customer of the supplier and the like.[14] Indeed, on a theoretical level, these communities are distinct from the corporation,[15] which is the debtor. Nonetheless, as these

10. In this sense the law brings Israeli law one step closer to a standard unified law applying to both individual and corporate debtors. In another context, I expressed my view in support of the integration of insolvency law and its coherent general application, irrespective of the particular legal identity of the debtor. *See* D. Hahn, "Book Review: 'Corporate Liquidation', by Zipora Cohen, 16 BAR-ILAN LAW STUDIES, (2001) 487.

11. *See* Regulation 45(a) of the Companies Regulations (Application for Settlement or Arrangement) 2002, K.T. 868. For the dispute over the purpose of corporate insolvency law, and specifically the question of whether it should also include considerations of the *debtor's* best interests, *see* I. Haviv-Segal, INSOLVENCY LAW: INTRODUCTION TO THE LAW OF ISRAEL (Deventer: Kluwer, 1995) 327, 328. In the United States this issue is heavily disputed by bankruptcy law scholars. This dispute is the "Great Divide" between two principle streams. S. Block-Lieb, "The Logic and Limits of Contract Bankruptcy", 2001 U. ILL. L. REV. 503. On the one hand there is the classic stream, contending that insolvency law has an additional purpose, apart from the distribution of proceeds between creditors in the most efficient manner. *See, for example*, E. Warren, "The Untenable Case for Repeal of Chapter 11", 102 YALE L.J. (1992) 437, 467; D.R. Korobkin, "Value and Rationality in Bankruptcy Decision Making", 33 WM. & MARY L. REV. (1992) 333, 334–338; D.R. Korobkin, "Rehabilitating Values: A Jurisprudence of Bankruptcy", 91 COLUM. L. REV. (1991) 717, 766; J.W. Bowers, "Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure", 88 MICH. L. REV. (1990) 2097, 2111–2113; E. Warren, "Bankruptcy Policy" 54 U. CHI. L. REV. (1987) 775, 777–778, 795–797. On the other hand, there is the law and economics approach that contends that the insolvency laws are intended exclusively to solve the creditors' collection problems. *See* T.H. Jackson, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986) 1–6; D.G. Baird, "Loss Distribution, Forum Shopping, and Bankruptcy: A reply to Warren", 54 U. CHI. L. REV. (1987) 815; D.G. Baird & T.H. Jackson, "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy", 51 U. CHI. L. REV. (1984) 97, 102–110; B.E. Adler, "Financial and Political Theories of American Corporate Bankruptcy", 45 STAN. L. REV. (1993) 311, 312–315; M. Bradley & M. Rosenzweig, "The Untenable Case for Chapter 11", 101 YALE L.J. (1992) 1043–1044.

12. *See* Cohen *supra* note 6.

13. The substantive jurisdiction of the District Court is established in Section 256 of the Companies Ordinance. As for reorganization cases, Section 1 of the Companies Act defines "the court" as the District Court, and it is therefore the authorized court for purposes of Section 350 of this act, which provides for reorganization.

14. For creditors whose interest is survival, as opposed to purely financial interests, *see* A. Chaver & J.M. Fried, "Managers' Fiduciary Duty upon the Firm's Insolvency: Accounting for Performance Creditors", 55 VAND. L. REV. (2002) 1813.

15. Baird's claim has always been that there is no "debtor" in corporate insolvency. Rather, there are only the conflicting interests between investors. D.G. Baird, "A World without Bankruptcy", 50 LAW AND CONTEMPORARY PROBLEMS, (1987) 173. For the opposing approach, positing that the corporation is most certainly a "debtor", except that one cannot identify the interests of its different target communities as its own independent interest, *see*: Y.Z. Stern, "The Company as an Ownerless Legal Entity: Theory, Law and Reality", 21 BAR-ILAN LAW STUDIES (2004) 245.

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communities have an interest in the survival of the debtor, even if this may involve impairment of claims, their interests are somewhat analogous to those of an individual debtor. Both are interested in economic continuity, which is not necessarily compatible with the interests of the debtor's creditors. The declared goal of the Moratorium Statute, namely, to provide a legal mechanism for accommodating corporate recovery instead of liquidation,[16] also legitimized the interests of the corporate debtor. This was the basis of the conceptual revolution which it provoked.

The practical revolution triggered by the Moratorium Statute found expression in daily practice, both inside and outside the District Court. Prior to its enactment, the debtor-corporation lacked effective legal tools to promote reorganization measures in order to extricate itself from financial crisis. Acting on its own initiative, there was but one option for the financially distressed company attempting to avoid liquidation and take the path of recovery. It would have to attain the consent of all its creditors, particularly its secured creditors,[17] to temporarily forego liquidation measures and begin negotiations towards a compromise or settlement between the corporation and its creditors.[18] The shortcoming, however, was that there was no legal framework that obliged the creditors to act, even if only temporarily, in accordance with the criteria governing the promotion of reorganization procedures. Each creditor was free to defect and operate individually in order to give effect to his rights, whether by imposition of a garnishment, foreclosure on

16. *See* Explanatory Note of Companies Act Amendment (No.12) 1995, H.H. 405.

17. Section 1 of the Bankruptcy Ordinance defines a "secured creditor" as "a person holding a charge or lien on the property of the debtor or any part thereof as security for a debt due to him from the debtor".

18. For out of court arrangements, *see* G.K. Smith, "Conflicts of Interest in Workouts and Bankruptcy Reorganization Cases", 48 S. C. L. REV. (1997) 798, 852–876; C.B. Duberstein, "Out-of-Court Workouts", 1 AM. BANKR. INST. L. REV. (1993) 347; A. Schwartz, "Bankruptcy Workouts and Debt Contracts" 36 J. L. & ECON. (1993) 595; L. Lin "The Information Content of a Bank's Involvement in Private Workouts" 3 GEO. MASON L. REV. (1994) 97, 98–101; R.E. Mendales, "We Can Work it Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context" 46 RUTGERS L. REV. (1994) 1213, 1221–1245; S. Abe, "Recent Developments of Insolvency Law and Cross-Border Practices in the United States and Japan", 10 AM. BANKR. INST. L. REV, 47, 49–58 For the general tendency of Israeli courts to prefer out-of-court settlements to litigation in court, *see* Y.Z. Stern, "Resolution of Disputes Based on Corporate Law: The Choice Between Litigation and Settlement", 17 TEL AVIV U. LAW REVIEW, [1993] 323. It is clear that even in the era of the Moratorium Statute, a corporation and its creditors can agree to a reorganization attempt in the form of an out-of-court arrangement. This tendency is both meritorious and desirable. Even so, even a company that succeeds in formulating a voluntary arrangement may choose to enter the legal framework for purposes of confirming the arrangement or settlement. This generally occurs at the stage at which the corporation and its primary creditors have already formulated the arrangement. Entering the legal framework at this stage is done in order to exploit the advantages of flexibility provided by the law, which gives legal and binding effect to an arrangement that received majority approval. Without the arrangements provided by the insolvency law, any consensual arrangement would require the approval of each creditor. Needless to say, as a matter of practice, receiving such approval is a formidable task. The practice of formulating voluntary arrangements outside the courts with the subsequent resort to the legal framework of Chapter 11 at the voting stage, when the arrangement is confirmed, is referred to in the United States as "pre-packed reorganization plans". In England too, where there is statutory reorganization, there are many corporations that cooperate with creditors in the initiation of a voluntary out of court arrangement. This approach is referred to as the "London Approach". *See* J. Armour & S. Deakin, "Norms in Private Insolvency: The London Approach to the Resolution of Financial Distress" 1 J. CORP. L. STUD. (2001) 21; J. Armour, B.R. Cheffins & D.A. Skeel Jr., "Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom", 55 VAND. L. REV. (2002) 1699, 1754–1762.

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collateral or the filing of an application for liquidation. These measures frustrated out-of-court collective efforts aimed at corporate reorganization and at rescuing the corporation from its financial difficulties. Further, with the deepening of the financial crisis, any initiative taken by an independent creditor to effectuate his rights would effectively force the remaining creditors, who were generally weaker and slower in terms of their capacity to realize their rights, to adopt the only legal tool at their disposal: putting the corporation into liquidation. The liquidation files dominated the legal arena. But this is no longer the case. The adoption of the Moratorium Statute heralded a new era and alongside the liquidation files, the District Courts now receive many—according to some critics too many[19]—reorganization files. Applications for staying orders have become widespread, and today, as opposed to the past, the reorganization track is the track first adopted by corporations attempting to diffuse a financial crisis and it is one pursued on their own initiative. It is only when the court concludes that the corporation lacks the potential to reorganize,[20] or if the reorganization attempt fails,[21] that the corporation's life is terminated by liquidation. This is the practical revolution that was instigated by the Moratorium Statute in Israel.

This article will survey the development of corporate reorganization law in Israel in recent years. In this framework, it will review trends in developing Israeli law in this area as reflected in legislation and case law. The review of the change in the law and its development is presented in two parts. The first part deals with the legislative initiatives in the realm of reorganization. It will show that the primary developments in reorganization law in particular, and insolvency law in general, originated in the legislature. Quite frequently, these developments were the fruit of legislative innovation that was not preceded by judicial trail blazing. The second part deals with the courts' role in the practical development of corporate reorganization law. This section will stress the Supreme Court's contribution to the practical development of corporate reorganization in Israel. It will show that the while generally Supreme Court's treatment of the concrete aspects of corporate reorganization was sporadic, it did contribute to the development of the rules in one particular area, namely, the question of priority between pre-reorganization creditors of the corporation and creditors whose claims arose as a result of the reorganization case itself. Furthermore, the Supreme Court recently made a significant step, by apparently unifying reorganization law with corporate liquidation law, at least on a practical level. Not surprisingly, judicial activity in this realm has taken place primarily in the District Courts. In fact, the District Courts have supplemented the legislative initiatives in the entrenchment of reorganization law in Israel. A

19. *See, for example*, the comments of Judge Dovrat in B.F (B.S.) 6289/01 *Mega Progressive Building and Mobile Structures Ltd. v. A.D.P.A Ltd.* Tak-Dist 2001(3) 6744, para.3 (hereinafter—*Mega*).

20. *See, for example*, the comments of Judge Bein in TA (Haifa) 679/01 *Formica Mekor Ltd v. Minister of Industry and Trade*, Pador 01 (4) 791, paras. 4 and 16.

21. For examples of failed attempts at reorganization which ended in liquidation, *see* C.A. 6010/99 *Special Manager of Tabor Marble Industries Ltd v. Official Receiver*, 56 (1) P.D 385 (hereinafter—*Tabor Marble Industries*); C.M. (Haifa) 1148/01 *Chevrat Mifalei Plada Meuchadim Ltd. v. Koor Industries Ltd*, Tak-Dist. 2001 (3), 21402, 21404.

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District Court handling an insolvency case, whether on the liquidation track or on the reorganization track, is a central player, deeply involved in all the aspects of the case. In doing so the court makes use of the legal tools placed at its disposal by the legislature, giving them concrete content. In this context this article will review the two central tendencies that have developed in the District Courts. The first concerns the establishment of a format of corporate control of the reorganizing firm, in the image of a special manager appointed by the court. The second concerns the formulation of procedures for confirmation of reorganization plans, with preference being given to auctioning processes as a tool for maximizing the value of the corporation for distribution among its creditors.

II. The Legislation

A. Historical background

1. British mandate legislation

The insolvency legislation in Israel is not originally Israeli. The two central pillars of insolvency law in Israel are mandatory ordinances. Bankruptcy of individuals, as well as of partnerships, is regulated primarily in the Bankruptcy Ordinance. In addition, the Companies Ordinance deals with corporate liquidations.[22] These ordinances were amended a number of times, but fundamentally, both in terms of their formats and primarily in terms of their scope, the ordinances remain faithful to the legal approach prevailing in England during the first third of the 20th century when they were promulgated in Mandate Eretz-Yisrael.[23] The traditional English approach to insolvency was, and some say still is, essentially creditor-biased.[24] In other words, the English approach was basically that the goal of insolvency law is to maximize the repayment of creditors.[25] The basic problem of insolvency is that economic resources are insufficient to pay the debts of all the creditors. Consequently, the law is primarily concerned with the establishment of rules for the distribution of the remaining resources for the (partial) repayment of debt claims and its emphasis was therefore on extracting maximum repayment for the creditors under the circumstances. The approach derives from the fundamental perception that debts must be paid. As long as the creditors have not been repaid in full, the

22. The Companies Act did not repeal the chapters of the Companies Ordinance that dealt with the collateralization of corporate assets (Chapter 8) and corporate liquidation (Chapters 11–17), leaving them intact, in line with the declared policy of the drafters of the legislation whereby these chapters would be replaced in the future within the framework of the reform of secured transations law and insolvency law. *See* Hahn, *supra* note 10, at 495–498. For the initiative to reform the laws of insolvency, *see infra* Chapter II, A(2).

23. I dealt with the basic conceptions of the Mandate Period regarding insolvency in another context. *See* D. Hahn, "A Security Interest as 'Property'", WEISMAN BOOK, (2002) 43.

24. F. Tolmie, INTRODUCTION TO CORPORATE AND PERSONAL INSOLVENCY LAW (London, Sweet & Maxwell, 1998) ch. 5; I.F. Fletcher, THE LAW OF INSOLVENCY (London, Sweet & Maxwell, 3rd ed., 2002) 21–23.

25. V.M. Lester, VICTORIAN INSOLVENCY, BANKRUPTCY, IMPRISONMENT FOR DEBT, AND COMPANY WINDING UP IN NINETEENTH-CENTURY ENGLAND (Oxford, Clarendon Press, 1995) 1–6, 222–239; P.R. Wood, PRINCIPLES OF INTERNATIONAL INSOLVENCY (London, Sweet & Maxwell, 1995) 2–9.

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debtor cannot benefit from its economic resources. The practical application of this view in the corporate context is that when the company is insolvent, *i.e.* its assets are insufficient to cover its debts to the creditors, then the remaining equityholders in the company are no longer entitled to benefit from its resources and the corporation must liquidate.[26] And in fact, as a result of this perception the Companies Ordinance extensively regulates the liquidation process, while not offering any alternative that enables the continued existence of the corporation as a going business concern, despite its financial difficulties. Reorganization laws had not yet been adopted. But while reorganization laws had yet to be passed, the prospect of economic destruction that would have been wrought by the collapse of certain Israeli corporations created the practical need for legal solutions to enable the continued operation of the corporation as a going concern. Accordingly, Israeli courts adopted innovative judicial approaches that formulated reorganization alternatives for commercial corporations. These initiatives included both the creation of innovative procedural avenues such as the appointment of a pre-liquidation trustee,[27] and the utilization of existing procedures for different purposes, for example, temporary liquidation and receivership.[28] The courts guided the various appointees in the corporation to manage it in an attempt to find a way that would enable its continued existence as a going concern. Nonetheless these initiatives constituted a 'welcome improvisation'[29] of an *ad hoc* character. A structured and systematic legal response for corporate reorganization was still lacking.

2. The late eighties: The Levin Committee

In December 1986, the Minister of Justice appointed a public committee chaired by Supreme Court Justice Shlomo Levin 'to examine the need for a reform in the laws

26. Tolmie, *supra* note 24, at 166–169; Fletcher, *supra* note 24, at 570–572.

27. S. Levin, "The Wizard of Oz: Can the Court Create Something from Nothing?", LUVENBERG BOOK, (1988) 3; C. Avnor, "The Temporary Liquidator", LUVENBERG BOOK, (1988) 199, 204–205.

28. According to Section 194 of the Companies Ordinance, and as indicated by its title, the goal of receivership is the enforcement of the secured creditor's right under a floating charge. *See* A.Wolovsky, RECEIVERSHIP IN CORPORATE LAW (Jerusalem, Tapuz, 1992) 123–126. C.A. 522/72 *State of Israel v. Receiver for Voltex Tzimron Ltd.*, 27 (2) P.D. 393, 398, 405. Even though the court demanded that the receiver conduct himself in good faith and fairly for the benefit of all the creditors (*see*, *for example*, BF (T.A. 165/96 *Moriah Mines Ltd*, Pador 01 (3) 433), conceptually, the receivership process is intended to further the debt collection of *one particular creditor*, regardless of its importance. Receivership does not deal with the provision of a legal tool for the collective payment problems of a corporation *vis-à-vis* its various creditors. Receivership is intended to realize the creditor's security, guaranteed by a floating charge. In most cases, this charge applies to all the corporate assets. Consequently, the receivership process has broad economic implications and will immediately impact on the standing of the corporation's remaining creditors. It is for this reason that the courts are prepared to use the receivership process as a legal device for furthering an economic process of rehabilitation of the corporate affairs. For more about receivership as a procedure for reorganization, *see* J. Armour & S. Frisby, "Rethinking Receivership", 21 OXFORD J. LEG. STUD. (2001) 73.

29. Using the terminology of D. Levin J. in *Carmel Carpets*, *supra* note 4, at 697: "Had the court at its disposal more appropriate and organized tools for pursuing this path, had we been in a position in which we already possessed the important, necessary up-to-date and modern tools which the legislature must establish for use by those dealing in the field, then the procedure with which we are dealing would have been simpler and without obstacles and pitfalls. However, the procedure is still being conducted on unpaved paths, involving a great deal of the desirable and welcome judicial improvisation, and so one may still stumble . . . ".

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of bankruptcy and corporate liquidations, with the aim of adapting and updating the existing law in these areas'.[30] In its letter of appointment and as a first priority, the Committee was requested to deal with the adoption of legal arrangements to be utilized by corporations in financial difficulties which would provide an alternative to liquidation. In other words, the Committee initially focused on formulating an arrangement for corporate reorganization. At the beginning of 1990, the Committee submitted its recommendations to the Ministry of Justice regarding the laws of corporate reorganization in Israel. The Levin Committee report was less concerned with the concrete arrangements governing the interim period of corporate management, from the commencement of a case until the approval of the reorganization plan,[31] and focused primarily on the requirements for the commencement of a case and the procedure for a plan's approval.[32] With regard to the form of corporate management during the interim period, the Levin Committee report adopted existing framework arrangements governing corporate liquidation.[33] An important working assumption of the Committee was that there would be a restricted number of judges in Israel dealing in this field. The small group of judges would specialize in the field and its experience would ensure its professionalism and expertise. 'This obviates the need for highly detailed and articulated arrangements, and it is sufficient to establish fundamental principles and the organizational structure for rehabilitation procedures, while simultaneously granting the court the discretionary powers necessary for adjustment of the law to the circumstances of the particular company slated for reorganization.'[34]

B. 1995: The Moratorium Statute

A number of years have lapsed since the submission of the Levin Committee recommendations for legislation pertaining to corporate reorganization, and still the Government has yet to promote the legislation itself. The Committee's recommendations have remained recommendations alone and there have been no follow up activities towards their translation into legislative acts. One of the reasons was the restriction on resources in the Legislation Department of the Justice Ministry. This department is charged with advancing legislative initiatives, and at the time was heavily involved in the legislation of the reformed Israel Companies Act, that would replace the Companies Ordinance of the Mandate Period. This legislative initiative was lead by Justice Aharon Barak during the 1980's, and, in its final stages, commanded almost the complete attention of the Legislation Department of the

30. The Public Committee for Examination of the Necessity of Reform in the Laws of Bankruptcy and Corporate Liquidation, Report No.1—Corporate Recovery (hereinafter-Levin Committee Report), at 1 (dated 22 January 1990).

31. The focus of reorganization laws on this interim period is dealt with *infra* Chap. II. B.

32. *See* Levin Committee Report, Introduction, para. 7 sub-paras. a-c (synopsis of report regarding competency for reorganization procedure), g-h (synopsis of report regarding the reorganization plan and process and its conversion into a liquidation process).

33. *Id.* Paras. d-f (synopsis of report regarding corporate management by a functionary known as the ''rehabilitator'' and adoption of the legislative arrangements pertaining to a liquidation case).

34. *Id.* para.6.

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Ministry. The extensive time invested in the emergent Companies Act temporarily forestalled the parallel promotion of a general insolvency law, or even the full implementation of the Levin Committee's recommendations in the area of corporate reorganization. At the same time, the Justice Ministry succeeded in spearheading a brief and focused legislative process designed to provide the Israeli market with a legal tool that would facilitate corporate reorganizations. In 1995 the Knesset enacted an amendment to the Companies Ordinance (Amendment No. 10), today, the Moratorium Statute. This law introduced the moratorium order to Israel. It stipulated that the District Court was entitled to grant a stay when a settlement or compromise was proposed between the company and its creditors or shareholders, and the court was satisfied that granting the order would assist in the crystallization or endorsement of the plan for corporate reorganization.[35] The drafters of this amendment made it clear that they had never regarded it as a comprehensive corporate reorganization law. Nor did it purport to give legislative expression to the Levin Committee recommendations. The law was enacted as an auxiliary measure and solution to an acute problem arising in every reorganization initiative even when consensual. The absence of any legal mechanism preventing an individual creditor from pursuing individual collection measures impairs collective proceedings aimed at a compromise or arrangement and the reorganization of corporate capital.[36] The Moratorium Statute offered an injunctive type remedy as an incentive for both the corporation and its creditors to conclude reorganization initiatives. Conceivably, use of the word '*havra'ah*' (*a* Hebrew word meaning rehabilitation/ recovery) has amplified the general tendency in the field of corporate reorganization to describe these proceedings in medical terms.[37] The corporation is 'sick' and the interim manager is the 'doctor' (and presumably the court is the hospital) and the legal arrangements for capital reorganization are perceived to be an 'operation'. In the spirit of these descriptions a proceedings moratorium is regarded as nothing more than 'first aid' for the corporation, in other words a temporary measure in anticipation of more substantive treatment awaiting the corporation.[38] Needless to say, the law does *not* exhaust corporate reorganization law in Israel. The law is perceived as a significant step in the direction of institutionalization of reorganization although ultimately it is only a first step.[39] The delay in the

35. See Section 233 (1A)(1) of the Companies Ordinance, now Section 350(b) of the Companies Act.

36. For an analysis of the problems that still remain following the amendment, *see* Y. Bahat "Reorganization Procedures after the Amendment of the Companies Ordinance" 34 BANKING QUARTERLY, (1996) 13 (Hebrew); L.C.A 7125/00 *Receiver of Asphalt Group Ltd v. Shalbana*, Tak-Supr. 2002 (1) 858 at para.5 of Levin J's judgment (hereinafter—*Asphalt Group*); C.A. 3254, 3225/99 *Shikun Ovdim Ltd v. Teshet Building Contractors Company Ltd.* 53 (5) P.D. 97, 113–116 (hereinafter—*Teshet*).

37. Finance Minister Benjamin Nethanyahu recently expressed himself in a similar vein when referring to the state of the Israeli economy and the kind of treatment it requires. The Finance Minister referred to the Israeli economy as a "patient" and viewed the economic programme that he was presenting as a means of "recovery" which would "stop the bleeding". *See* N. Cohen "Nethanyahu at the Press Conference 'The Economy is Sick; the Fund is Empty'", http://www.nfc.co.il/archive/001-D-21412–00.html?tag, (18-03-03).

38. D. Lahman, "Principles of the Memorandum of the Corporate Recovery Law", 34 BANKING QUARTERLY, (1996) 24, 24–25.

39. For a description of the legislative matters that were and have remained absent, even after the Moratorium Statute, *see infra* Ch. II. B(3).

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legislation made it clear that the stop-gap enactment of a measure allowing stay of proceedings was preferable to complete inaction regarding corporate reorganization. There were already a number of precedents for the courts being requested to issue a proceedings moratorium on creditors' debt enforcement measures in order to expedite a practical feasibility examination of the reorganization option. This would occasionally compel the courts to utilize their "inherent power" to award any legal remedy.[40] However, the courts of a developed country cannot invoke their inherent power as a matter of course.[41] Staying proceedings required legislation and the Moratorium Statute was the legislative response to the need of the hour.[42] As it transpired, reality and legal practice had their own dynamic.

Despite its piecemeal nature, since its adoption in 1995, the Moratorium Statute has become a central tool in the treatment of financially distressed corporations.[43] As will be later observed, practices developed in the case law supplemented the statute and channelled the reorganization process in appropriate directions, taking into consideration the interests of both the creditors and the debtor.[44] The Moratorium Statute effected a significant change in the law's approach to corporate insolvency. On the other hand, as stated, the law does not constitute a comprehensive corporate reorganization law, and many elements are still missing.[45] In the following examination we will survey the direct implications of the Moratorium Statute for corporate insolvency in Israel.

1. *Reorganization as an alternative to liquidation*

While the stay of proceedings measure was exclusively structured to enable temporary industrial peace for the corporation, its practical implications were considerably broader. The Moratorium Statute triggered a conceptual revolution.

40. Motion (T.A) 947/97 *Raviv Emek Hefer—Infrastructure and Construction (1982) Ltd*, Pador 99(4)162, para.6 (hereinafter—*Raviv Emek Chefer*); Motion (Jer) 4870/97 *Rahiti Avgi Morris Ltd v. Acc.Dror Mizaref (Temporary Receiver)*, Tak-Dist. 98 (2) 1991, 1992; CF (T.A) 2630, 2629/86 *Ganei Aviv Engineering and Construction Ltd (in Liquidation) v. Paritzky*, PSM 1990 (1) 177. Section 75 of the Courts Act [Consolidated Version], 5744–1984, S.H. 198, authorizes the court to grant any remedy in a civil case, as deemed necessary in the circumstances.

41. *See, for example*, C.App (Nazareth) 1955/98 *Teiba Municipality v. Trustee General*, Tak-Dist. 98 (4)178, para. 5.

42. It is somewhat paradoxical that the Moratorium Statute was adopted in the middle of the 1990s at the beginning of the blossoming of high-tech and communications technology sectors. Even though there were companies that encountered financial straits at that time they were immeasurably less in number than the companies in financial straits today at a time when the economic depression has become more acute than ever. It thus emerges that it was in the years of plenty that the legislature empowered the courts to deal with the famine that would confront us in the ensuing years. This situation is different from the one which the Japanese were forced to confront at the end of the nineties. The global depression did not pass over the empire of the rising sun finding its victims there too. Japan was not prepared to legally confront the problem of enforcement and individual collection and had no legal tools for effectively promoting reorganizations. The result of all was that under the pressure of the deteriorating financial crisis the Japanese were forced to adopt a hasty rehabilitation law, relying on the outstanding example of the American Chapter 11 process. *See* S. Walker, "Asian Insolvency Regimes Feel Strain", THE NATIONAL LAW JOURNAL (4.5.1998).

43. C.App (T.A) 19229/01 *Elrod Enterprises and Property Ltd v. Securities Authority*, Din-Dist. 33(5) 837, para. 21 (hereinafter—*Elrod)*.

44. For this development in the court case law, *see infra*, Ch. III. B.

45. *See* comments of Englard J. in *Teshet, supra* note 36, at 112.

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Following its adoption, Israeli corporations, creditors, legal advisors and the courts too, all began taking reorganization law seriously. Since the statute was enacted in 1995, ailing corporations have been confronted with two options: liquidation and dissolution of the corporation or reorganization. Suddenly, the notion of a corporation negotiating with its creditors and concluding a reorganization plan became a feasible option. The rules of the legal game changed. Prior to the Moratorium Statute, the formulation of an arrangement or compromise was exclusively dependent on all the creditors having consented to temporarily suspend execution measures against the corporation. Notably, the negotiating period was still entirely subject to individual based rules of commercial-civil law. In other words, any creditor who broke ranks in order to implement independent execution measures was liable to derail the crystallization of the reorganization plan. This weakness of the legal system impaired the effective consummation of any reorganization arrangement. In this situation it was only natural that the liquidation option held the field, for in fact it was the only collective regime for creditors in Israel. The Moratorium Statute introduced another collective action option into Israeli law, with a slightly different end-goal. It was no longer the inevitable dissolution of the corporation, but rather an attempt to revive it. Even though the stay of proceedings is certainly not the purpose of these laws, its role is more than simply auxiliary. It is a central tool in the achievement of the reorganization goal, namely, the reorganization plan. It is the remedy that constitutes the legal regime necessary for the intermediate period, leading to the reorganization plan. If the reorganization plan is the chamber, the stay of proceedings is the corridor leading thereto.

Legal practitioners were quick to endorse this conceptual turnabout, and it has now become standard practice to file for a stay of proceedings prior to filing for liquidation. Reorganization has become a real option, enjoying the same status as liquidation. It is no longer regarded as the exception but rather as an accepted mode of action for a corporation in financial difficulties.[46] The law constituted a clear legislative pronouncement of the desirable trend regarding the stay of proceedings and it impacted upon court rulings too. First, courts internalized the fact that corporate reorganization was now a central legal procedure for corporations in financial strife and toeing the line, they grant the stay orders and open the avenue for many corporations to attempt reorganization prior to being exposed to the liquidation guillotine.[47] Secondly, the courts appropriately interpreted the law as intended to implement a collective regime for the purpose of the creditors' settlement. This meant that as opposed to the legal position that obtained before the law, the opposition of one or more individual creditors to the stay of proceedings no longer necessarily spelt the death-knell on the corporation's path to reorganization.

46. *See* C.App (Haifa) 2413/03, *Hai v. Ness* Tak-Dist 2003 (1) 2287, para. 9 ("...it is generally agreed that the reorganization procedure carries distinct advantages over the liquidation and bankruptcy procedures"); BF (T.A)1048/02 *Trustee for Performance of Settlement v. Midreshet Ruppin, Institute for Higher Learning*, Tak-Dist 2002 (3) 6478, para.16.

47. For rhetoric in this vein, *see* BF (T.A) 1896/02 *Special Manager of Grouper Koren Ltd v Ministry of Defense—Financial Department*, Tak-Dist 2003 (1) 3519, para. 5; BF (T.A) 1361/02 *Hotel.Com Ltd v. Trustee and Special Manager of Tevel International Transmission to Israel Ltd and Gevannim and Cable Television Ltd*, Tak-Dist 2003(1) para.36.

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The court will order a stay of proceedings, in compliance with the legislation, despite the creditor's opposition.[48] Furthermore, and as we will elaborate below, since the Moratorium Statute the courts have consistently attempted to harmonize the liquidation law with reorganization law, gradually broadening the scope of liquidation laws so that they also apply to corporations currently under a stay of proceedings.[49] The attempt to achieve legislative harmony between the two alternatives seeks to predicate them on a common normative basis.[50] The standardization of the systems also neutralizes either party's attempts to exploit the alternative procedures in a strategic, manipulative manner that works to its own benefit only.[51]

2. *Ramifications for secured creditors*

A major innovation of the Moratorium Statute in terms of its affect on the legal environment of Israeli creditors and debtors relates to the position of secured creditors. A secured creditor is someone holding a lien on one of the debtor's assets.[52] The traditional position of Israeli law was that the secured creditor benefits from a special treatment even when the debtor is insolvent. Whereas the other creditors are subject to the collective regime, the secured creditor was entitled to continue individual collective procedures as if there was no collective regime at all.[53] This privilege is rooted in the tradition of the common law of England and its colonies,[54]

48. Where the majority of the secured creditors support the stay of proceedings, the court will order the stay despite the opposition of a lone secured creditor. *See* BF (T.A.) 1242/02 *Shbiro Glass Industries Ltd v. Kamil, Accountant. (the Trustee)*, Tak-Dist. 2002 (2) 2971; *Raviv Emek Hefer, supra* note 40, at 18–19.

49. *See, for example*, C.A. 3911/01 *Caspi v. Nes*, Tak-Supr. 2002 (3) 2721, para.8 (hereinafter—*Diur LeOleh*); L.C.A 292/99 *Shikun Ovdim Ltd v. Teshet Construction Company Ltd (Under Special Management)*, 55(2) P.D.56, 61–63; BF (T.A) 1664/00 *Oceanus Holiday Services Ltd (in Receivership and Liquidation) v. Bank Leumi Le-Israel Ltd*, Dinim-Dist. 33 (7) 64, paras. 37–39. *See also* BF (T.A) 11448/02 *Special Manager of Rondoplass Ltd (In Stay of Proceedings) v. Cargo Amerford International (1980) Ltd.*, Tak-Dist. 2002 (2) 4906, para. 25 (hereinafter—*Rondoplas*); C.App. (Haifa) 14032, 15074/00 *United Iron Industries Ltd v. Kaduri*, Pador 2000 (5) 752, para. 5.

50. For the importance of legislative harmony, and primarily in branches of law that are substantively and conceptually similar, *see* J. RAZ, THE CONCEPT OF A LEGAL SYSTEM: AN INTRODUCTION TO THE THEORY OF THE LEGAL SYSTEM, (Oxford, Clarendon Press, 1970) 78, 172.

51. For the problem of maneuvering and its solution by way of harmonization of the law, *see* J.E. Moliterno, "Why Formalism?", 49 KAN. L. REV. (2000), 135, 142–143. In the past Yedidyah Stern expressed concern regarding manipulation processes which exploit merger transactions as a way of circumventing the requirement for a special majority at the general assembly in order to amend the corporate regulations. *See* Y. Stern, PURCHASE OF CORPORATIONS, (Jerusalem, Hebrew University Press, 1990) 558–559. This concern no longer exists in the era of the Companies Act, because the law is satisfied with a regular majority in the general meeting in order to change the corporate by laws and in order to approve a merger. *See* Sections 20(a), 85 and 320(a) of the Companies Act.

52. Section 1 of the Bankruptcy Ordinance; C.A.261/88, 558, 793 *Itung Ltd v. Levi David and Sons Ltd (in liquidation)*, 48 (2) P.D. 102.

53. The legal basis for this privilege of the secured creditor is found in Section 20 (b) of the Bankruptcy Ordinance, which states: "The provisions of this section [*i.e.* Section 20(a) which states that once the receiving order is made, no creditor can institute legal proceedings against a debtor save with the court's permission-D.H.] shall not derogate from the power of a secured creditor to realize or otherwise deal with its security". The provision of Section 20(b) of the Bankruptcy Ordinance was also applied to corporations in liquidation, by virtue of the incorporating provision of Section 353 of the Companies Ordinance. *See* C.A. 5821/92 *Huri, Adv. v. Fishler*, 49(5) P.D. 833.

54. *See* in England, Insolvency Act, 1986 §130 (2); in Australia, Corporations Law §471B; Canada, Bankruptcy and Insolvency Act § 69(1).

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but has no application in the United States.[55] In Israel, in both bankruptcy and liquidation, the secured creditor is free to foreclose on its security in accordance with the foreclosure rules established for a security interest in the Security Interest Act, 1967[56] or in the Companies Ordinance.[57] In explaining the rationale underlying this exception to the general rule applying to a stay of proceedings, the courts generally adopted the property rhetoric. As a matter of case law, neither bankruptcy nor liquidation detract from the secured creditor's right to realize its security, given that the lien confers on the creditor a right *in rem*. Being the creditor's property, the charge withdraws the security from the pool of assets available for distribution.[58] In my view, however, one need not invoke the property rhetoric to explain the rationale for the secured creditor exception.[59] Instead, recourse may be made to the basic principles controlling the distribution of assets among the debtor's creditors. In bankruptcy and corporate liquidation, the stay of proceedings is intended to accommodate the statutorily determined order of distribution. Subjecting the parties to the collective regime prevents any possibility of an individual creditor enforcing its right against the debtor and thereby receiving 100% of its debt while the remaining creditors are left with a lower rate of distribution.[60] Staying proceedings enables the collective distribution to be conducted by a court appointed officer, who distributes the proceeds of the assets among all the creditors in an orderly

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55. Bankruptcy Code § 362(a). Under this section the automatic stay, which also binds secured creditors, applies at all stages of insolvency dealt with by the Code: liquidation (chapter 7), adjustment of debts of a municipality (chapter 9), reorganization (chapter 11), adjustment of debts of a family farmer with regular annual income (chapter 12), adjustment of debts of an individual with regular annual income (chapter 13). *See* Bankruptcy Code §§ 103(a) & 901(a). For the approach in the U.S. to the automatic stay and its treatment of secured debtors in the United States *see*, G.R. Warner, "The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy", 9 AM. BANKR. INST. L. REV. (2001) 3, 61–62; T.J. Holthus, "A Debtor as a "Creditor" and the Automatic Stay", 62 AM. BANKR. L. J. (1988) 377, 377–378; J.B. Johnston, "The Bankruptcy Bargain" 65 AM. BANKR. L. J. (1991) 213, 259–266.

56. Section 17(2) of this act provides that a security interest that was pledged with a creditor or filed, in the case of an individual debtor in the Security Interests Registrar or in the case of a corporate debtor with the Companies Registrar, may be foreclosed on by the Execution Office.

57. In relation to a floating charge the Companies Ordinance provides a mechanism for specific realization. Section 194 of the Companies Ordinance provides that the enforcement of the right of a secured creditor (secured by a floating charge) shall be effected through a receiver appointed by the District Court. About receivership, *see supra* note 28.

58. *See* Itung, *Supra* note 52, at 122–125.

59. In my opinion, deviation from the property rhetoric enables us to refer in an untainted manner to the laws of insolvency and to weigh factors such as the rationale for protecting additional communities and groups connected to the insolvent.

60. *See* C.A. 400/88 *Sokol v. Kalanit Management and Holdings Ltd (in liquidation)*, 45 (2) P.D 866, 869–870 ("the rationale behind this provision [stay of proceedings in Section 267 of the Companies Ordinance—D.H.] is the desire to protect the creditors of the corporation in liquidation, so that the interests of all the creditors are examined in the framework of one procedure (before the liquidator or the liquidation court), and in doing so to prevent a situation in which an ugly battle is conducted between the claimants, in which there is a danger that particular creditors will seize the property of the dissolving corporation"); C.A. 2643/99 *Keren Investments Company (Segel-Frankel) v. Discount Mercantile Bank ltd*, 55 (2) P.D 441, 445–446. This, in fact, is the essence of the concept of insolvency law as collective law. The first generation of the economic approach to insolvency law endorsed the concept of insolvency law as a collective law that was geared to providing a collective response to the inefficient competition that was likely to ensue between competitors in their attempts to realize the debtor's assets, presenting the problem as the classic prisoner's dilemma. *See* T.H. Jackson, "Bankruptcy, Non-Bankruptcy Entitlements and the Creditors Bargain", 91 YALE L.J. (1982) 857, 864–865; W.E. Williams, GAMES CREDITORS PLAY, (Durham, NC, Carolina Academic Press, 1998) 73–84.

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manner and in accordance with the statutory sequence of priorities. Subjecting the unsecured creditors to the stay of proceedings is the only possible method of channelling them into the statutory *pro rata* distribution.[61] On the other hand, from here it also follows that there is no reason for delaying a creditor who in any case has priority in distribution over the other creditors. Subjecting such a creditor to a stay of proceedings is pointless given that there is no other creditor whose right is prejudiced by its own realization of its security.[62] As such, permitting the secured creditor to deviate from the stay of proceedings provision is dictated by the fact that the stay of proceedings provision is a means of effectuating the goal of assets distribution in accordance with the order of priorities. In view of its statutory priority, the goal of an orderly distribution cannot be frustrated and there is therefore no reason for placing an artificial obstacle (the stay of proceedings) in the path of the secured creditor.

In the Moratorium Statute, the legislature subjected the secured creditors to an emerging collective procedure for the first time. While the law refrained from expressly providing for the stay of proceedings in respect of secured creditors, as an affirmative act, Section 350 of the Companies Act states unequivocally and explicitly that a relief from the stay of proceedings will only be granted if a secured creditor's right in the collateral is not adequately protected.[63] For as long as the rights of the secured creditor in the collateral are adequately protected, that creditor is subject to the stay of proceedings.[64]

The Moratorium Statute thereby created a new balance. On the one hand, for the very first time, the secured creditor was prevented from realizing a security and was subjected to collective insolvency procedures. On the other hand, the law demands assurance that the creditor's right in the secured assets

61. *See* BF (T.A.) 1361/02 *Special Manager and Trustee of Tevel International Transmission to Israel Ltd v. Warner Bros, International Television Distribution*, PSM 2002 (2) 19, para. 6b.

62. However, where there is an expectation that the asset will appreciate in value by the distribution stage, then there may still be a purpose in also staying proceedings against the secured creditor. *See* L.A. Bebchuk & J M. Fried, ''A New Approach to Valuing Secured Claims in Bankruptcy'', 114 HARVARD L.R. (2001) 2386, 2398; Johnston, *supra* note 55. This is a particular instance of the more general problem of a conflict of interests between the secured creditor and the other creditors. Private realization by a secured creditor may be inefficient, because the secured creditor does not maximize the efficient value of the collateral, in view of its private interest which extends no further than the sum of its debt against the debtor, even if the collateral itself is worth more. Judge Alsheich was aware of this problem. Consequently, in a bankruptcy case in which the circumstances indicated the risk of inefficient realization by a secured creditor, she subjected the procedure of private collection adopted by the secured creditor to the ongoing inspection by the court, in order to protect the interests of the junior creditors, and the debtor's interest in maximizing the value received from the realization of the collateral. *See Garbash supra* note 2.

63. In the original Moratorium Statute, this provision appeared in Section 233(a2) of the Companies Ordinance.

64. This protective measure was imported into Israeli law from American Law. Even the name of the remedy is a literal translation of the measure of ''adequate protection'' provided in Bankruptcy Code § 361. For an analysis of the remedy of adequate protection in the United States and its position as a central hinge of insolvency law, *see* L.P. King, ''An Overview of Recent Developments and Future Prospects in the United States'' in CURRENT DEVELOPMENTS IN INTERNATIONAL COMPARATIVE CORPORATE INSOLVENCY LAW (J.S. Ziegel ed., Oxford, Oxford University Press, 1994) 29, 31; R.T. Nimmer, ''Secured Creditors and the Automatic Stay: Variable Bargain Models of Fairness'' 68 MINN. L. REV. (1983) 1, 3–4.

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will not be impaired.[65] The question is why the legislature chose to place secured creditors together with unsecured creditors and subject them all to the stay of proceedings. In the alternative collective legal regimes—bankruptcy and liquidation—the secured creditor was released from the burden of a stay of proceedings, and we explained this as the result of his existing priority over the other creditors in the distribution process. In answering this question attention must be given to the differences in the role played by the stay of proceedings in the respective regimes. In bankruptcy, in liquidation and in reorganization, the stay of proceedings serves as a *means* for the implementation of a collective regime, a regime that is necessary in order to realize the goal of the proceeding. Reorganization, however, is distinct from bankruptcy and liquidation both *in its goal and in the manner of its achievement*. The liquidation and bankruptcy procedure both culminate in the actual accumulation of the debtor's assets, their conversion into *cash money*, and its payment to creditors. In reorganization, on the other hand, the process terminates with the reorganization of the corporate capital and payment to creditors by way of deferred payments from future corporate cash flow or the issuing of new equity securities against the old debts.[66] From a commercial perspective, corporate rehabilitation is predicated on the continued financial existence of the corporation. As such, the retention of corporate assets is vital to its continued operation. Any divestment of corporate assets jeopardizes its economic capacity for reorganization. Consequently, given that the manner of achieving reorganization differs from the manner of achieving liquidation, the two regimes must also differ in the scope of the respective ancillary measures that they adopt in order to achieve their diverse goals. Where the law is exclusively concerned with the manner of allocating the cash proceeds received from the sale of corporate assets, the stay of proceedings measure can be limited, and be applied exclusively to unsecured creditors.[67] On the other hand, the legal horizons can be expanded to include both the prioritizing of distribution between creditors and the practical ability of effecting such distribution in a manner that exploits the corporate cash flow instead of realizing corporate

65. The main commercial context in which the need arises to ensure adequate protection is where there is a concern for the devaluation of the collateral during the stay of proceedings period. Another variant discussed in the context of adequate protection is the status of the secured creditor when the corporation is financed by new credit while in reorganization, even though in essence this is an expression of the competition between creditors. *See* D. Hahn, "Adequate Protection for Secured Claims in Corporate Reorganizations" 32 MISHPATIM (2002) 247, 287–292.

66. *See* C.App (Haifa) 5617/00 *Neeman Mifalei Plada Meuchadim Ltd et al (in Stay of Proceedings) v. Akko Municipality*, Tak-Dist. 2000 (3) 987, 990. The distinction between the liquidation of a corporation and its reorganization can be likened to the alternative methods of deriving economic benefit from a cow. The liquidation of a corporation can be liked to carving the cow up and allocating its parts to the creditors. On the other hand, reorganization of the corporation is comparable to keeping the cow alive for milking purposes. The creditors can receive the milk extracted from the live cow, instead of receiving pieces of the dead cow's corpse.

67. More precisely, the stay of proceedings in bankruptcy and in liquidation applies to debt with priority status, and unsecured debts. *See* S. Levin & A. Grunis, BANKRUPTCY LAW, (2nd ed., Jerusalem, Israeli Corp. for Professional Preparation, 2001) 114–117. The stay of proceedings under Section 20 of the Bankruptcy Ordinance does not apply to a secured creditor as defined in Section 1 of the Bankruptcy Ordinance. In other words, debts with priority status are not included in this exception. Even so, in traditional legal literature, the priority debts are identified with unsecured debts, except that the legislature gave them preference over unsecured debts. *See* Z. Cohen, *supra* note 4, at 604–606.

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assets. In the latter scenario, the stay of proceedings must be broader and more comprehensive. Its scope must be commensurate with the final goal of reorganization, which eschews any realization of corporate assets, be it by an unsecured creditor or by a secured creditor.[68] This explains the legislative extension of the stay of proceedings measure. The private interests of the secured creditors retreat when confronted with the broader goal of corporate reorganization.[69] On the other hand, the Moratorium Statute provides the secured creditors with a protective measure in order to preserve the value of their rights in the collateral.[70]

3. Partial nature of the legislation

The Moratorium Statute was adopted as a concrete response to an existing need, but this single provision of the law, regardless of its centrality, does not purport to encompass the entire complex of reorganization law. Following the legislative adoption of the stay of proceedings order Israeli legislation dealing with reorganization comprises two subjects only. The first is the stay of proceedings order and its counterpart, adequate protection provision for secured creditors. The second is the framework for voting on the reorganization plan at the creditors' meeting.[71] Not surprisingly, since 1995 case law has repeatedly and correctly stressed that the existing arrangement for corporate reorganization is "largely the product of *ad hoc* improvisation".[72] There are a number of substantive matters in corporate reorganization

68. Indeed, the tests established by the legislature for the removal of the stay of proceedings order are compatible with this approach. Where the asset charged is not essential from a business point of view for the purpose of conducting the business of the corporation, there is in any event no additional rehabilitation value in the liquidation. Likewise, in these circumstances, the court will order the removal of the stay of proceedings order in relation to the asset and will permit it to be realized by the secured creditor. *See* Section 233(A2) of the Companies Ordinance; B.F. (Haifa) 438/02 *Tfahot Mortgages Bank v. Chayil Holdings (1965) Ltd.*, Tak-Dist. 2002(3) 2878. *See also* the provisions of the Bankruptcy Code § 362(d)(2)(b) as well as *In re Bonner Mall Partnership* 2 F.3d 899, 902, 917 (9th Cir., 1993); *Empire Enters., Inc. v. Koopmans* 22 B.R. 395, 396–398 (Bankr. D. Utah 1982); D.A. O'Connor, "Application of the "Feasibility" Test Under Section 362(d)(2): Did Timbers Really Change Anything?" 9 BANKR. DEV. J. (1992) 133; D.J. Warren, "Relief from the Automatic Stay: Section 362(d)" 3 BANKR. DEV. J., (1986) 199, 210–215.

69. The tendency to qualify individual rights for societal reasons was analysed at length in H. Dagan, "Property, Social Responsibility and Distributive Justice", published in DISTRIBUTIVE JUSTICE IN ISRAEL, (Tel Aviv, Ramot, 2001) 97, 104–116 (Hebrew). *Cf.* H. Dagan, RESTITUTION AND BANKRUPTCY: ON CONSTRUCTIVE TRUSTS, RATABLE DISTRIBUTION, AND INVOLUNTARY CREDITORS (78 Am. Bankr. LJ. (2004) 247). For the tension between the individual and public realms in this context, *see* the highly instructive discussion in C.A. 6339/97 *Rocker v. Solomon*, 55 (1) P.D. 199, 275–281.

70. For the distinction between protection of the right to an asset's value and the right to the asset itself, *see* Hahn, *supra* note 65, 254–256. The language of the law supports the interpretation of adequate protection as the protection of the value of the asset. Section 350(g) of the Companies Act confers the secured creditor with adequate protection of creditor's rights in the asset. In other words, the protection is not given to the creditor and his rights as such, but rather specifically to his rights as they relate to a particular secured asset. This literal interpretation is also consistent with the purpose of the adequate protection remedy, *id.* at 270–271.

71. The provision regarding the convening of meeting of creditors and shareholders and the majority required in each meeting for the approval of an arrangement, was part of the Companies Ordinance since its inception, and as mentioned, it serves as a catch-all provision in the Companies Act, *see* Y. Bahat, "Reorganization of Corporations in Difficulties with the Banks' Assistance—Out-of-Court Workouts as an Alternative to Formal Procedure" 30 BANKING QUARTERLY (1992) 60; Y. Bahat, IN AND OUT OF COURT REORGANIZATION WORKOUTS, (Tel Aviv, Bursi, 1996) chapter 14; L.C.B. Gower, GOWER'S PRINCIPLES OF MODERN COMPANY LAW, 762–762 (London, Sweet & Maxwell, 6th ed., 1997).

72. See Teshet, supra note 36, para. 23. For citations in the same vein in another paragraph, *see Carmel Carpets, supra* note 4, para. 23; *Raviv Emek Hefer, supra* note 40, para. D.

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that still require legislative regulation, as well as various procedural matters that are essential for the conduct of an insolvency proceeding. The first matter awaiting legislative attention is the status in distribution of the creditor extending new credit to finance the reorganization process.[73] Quite frequently new credit is essential in order to jump-start a financially ailing company during the interim period of the stay of proceedings. Having already collapsed financially, a new financier will be doubly careful before extending credit to the corporation, and in that context one of its primary concerns will be its distributive status in relation to the other corporate creditors (prebankruptcy creditors), particularly in the eventuality of a failed reorganization process, subsequently converted into a liquidation. The second matter still requiring legislative attention concerns the identity of the entity controlling the reorganization process. Prior to the Moratorium Statute, an application was filed with the courts to convene a creditors' meeting to confirm the reorganization plan. However, as already noted, the creditors' meeting occurs at the end of reorganization. As such, there was no interim period during which the corporation confronted its creditors as a collective. One of the practical implications of the Moratorium Statute though was the creation of an interim period during which the corporation is collectively managed, and subjected to reorganization law. In as much as the creditors' interests are at the forefront of a corporation's considerations, the question arises as to whether the old incumbent management should continue controlling the corporation, even during the reorganization.[74] The alternative option is the appointment of an external trustee.[75] Israeli primary legislation has yet to address the matter even though District Courts have developed a procedure by which they appoint an external trustee to manage reorganization procedures.[76] The third matter requiring legislative regulation is the status of the corporations' existing contractual engagements. The question is whether the corporation remains bound by contracts the conditions of which it has breached, thus becoming exposed to rescission by the aggrieved party, or does the right of rescission recede in view of reorganization considerations and the best interests of the

73. This matter was discussed in *Carmel Carpets, supra* note 4, para. 27. In this case the Supreme Court ruled that the new financier has no priority over the prior, secured creditor, unless the creditor agreed to a deferral of its entitlement to collect or if 75% of all the creditors agreed thereto. Even so, in that case the court stressed, *id*, at 697 that its ruling was temporary. The court anticipated that the entire subject would soon be regulated in legislation. "If the court had at its disposal more appropriate and organized tools for pursuing this path, if we were in a position in which we already had the important, necessary up-to-date and modern tools that the legislator must establish in order to be used by those dealing in the field, then the procedure we are dealing with would be simpler and without the obstacles and pitfalls. However, the procedure is still conducted on unpaved paths, involving a great deal of desirable and meritorious judicial improvisation, and so one may still stumble . . . ". The *Carmel Carpets* ruling is further dealt with below, *infra* Chapter III.A(1).

74. This is the rule applying to reorganization under Chapter 11 of the American Bankruptcy Code, *see* Bankruptcy Code §1107.

75. This is the rule applying to reorganization in England and in numerous other countries, *see*, *for example*, the Insolvency Act 1986, § 8 (2); Sch. B1–10; the Japanese Corporate Reorganization Law (Kaisha Kosei Ho).

76. See infra Chapter III.B(1). The Department of Justice recently joined forces with the courts, by promulgating the Companies Rules (Application for Arrangement or Settlement), 2002, K.T. 868 (hereinafter—the Reorganization Rules). Rule 14 thereto provides that at any time after the filing of an application for a stay of proceedings order, the court is empowered to appoint a trustee for the corporation . . . The Regulations are dealt with at length below in Ch. II.C.

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remaining creditors.[77] Furthermore, even where the corporation desires to reject a binding executory contract, in the performance of which the other side is interested,[78] the precise conditions of the rejection must still be determined. True, the subject is officially regulated in liquidation law under the legal rubric of 'onerous property',[79] but legislative clarification of the matter is still required in the context of reorganization. Given that the reorganization procedure anticipates the continued operation of the corporation, the question of the continued validity of the contracts or their expiry is of far greater importance than in the liquidation context. It cannot be taken for granted that the standards for releasing from contractual

77. From a broader perspective this question indicates the intensity of the dilemma facing insolvency law regarding the applicability of principles of classic civil law in the situation of insolvency. In the concrete context this invites a confrontation between the purposes of reorganization on the one hand and the principle of freedom of contract on the other hand. Notably, there is a distinction between the classical breach of contract, in other words the corporation's failure to discharge its undertakings (in an insolvent corporation, the most common form of breach is arrears in payments), and a breach deriving from the corporation's actual entry into legal proceedings that treat insolvency (liquidation, temporary liquidation, reorganization or receivership). Indeed, it is most common for business contracts to include clauses providing that the very institution of such proceedings constitutes a fundamental breach entitling the solvent party to rescind the contract. These clauses are recognized as *ipso facto* clauses. Despite their wording as clauses of breach, in essence they are comparable to a conditional clause, which terminates the contractual relations upon the commencement of one of the insolvency proceedings. In the United States whereas a breach anchored in non-payment exposes the contract to rescission, even when based upon insolvency (even though the insolvent has the opportunity of curing its breach, *see* Bankruptcy Code §365(b)), the legislature invalidated *ipso facto* breach clauses in as much as they undermine the policy of reorganization, and cause damage to creditors who stand to benefit from reorganization. *See* Bankruptcy Code §365 (e). For a criticism of this statutory provision, *see* A. Schwartz, "A Contract Theory Approach to Business Bankruptcy", 107 YALE L.J. (1998) 1807, 1844, 1847. In Israel the District Court addressed the question of rescission of contract by the solvent party in the cases of *Home Mart* (Motion (T.A.) 6483/97 *Home Mart Ltd. v. Official Receiver*, Tak-Dist. 97 (2) 124, 127–131) and *Nur* (Motion (Tel-Aviv) 1446/97, 1761 *Nur Pirsum Chutzot (Yitzur veHafaka) Ltd v. Aviv and Co. Contracting Company for Public Works*, Tak-Dist. 97 (2) 469). In the case of *Home Mart*, Judge Alsheich approved the rescission of a lease by the owners of a shopping mall due to the payment arrears on the part of the lessee. Furthermore, in a short *obiter dictum* Judge Alsheich stated that the lessor definitely had a right of rescission in view of the *ipso facto* clause included in the lease. However, *c.f.* recently C.App (T.A.) 9258/01 *Bezek Israel Communications Company Ltd v. Tevel Israel International Communications Ltd*, Tak-Dist. 2002 (2) 3334, paras. 40–49. A substantive evaluation of the question of the status of a breached contract exceeds the scope of this article and will be discussed in another forum.

78. In a case in which the trustee is entitled to reject a contract, it is excused only from the *performance* of the contract but the contract is not cancelled. In other words, the rejection is understood as a legal licence to breach the contract, but its significance is only to permit the breach without the party in breach exposing itself to actual performance. The other contractual party can still be regarded as an aggrieved party, who is relegated to damages alone. *See* Sections 363 and 365 of the Companies Ordinance. However, the damages claim will constitute an unsecured claim against the insolvent debtor. *See* Bankruptcy Code §365 (g). American law does not have a definition for an executory contract, and the accepted definition was worded in the article of V. Countryman, "Executory Contracts in Bankruptcy: Part 1", MINN.L.REV. (1973) 439: 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 material breach excusing the performance of the other party". This kind of contractual release (rejection of an executory contract) would entitle the aggrieved party to indemnification only. As mentioned, such indemnification would be in respect of an unsecured debt. *See In re Metro Transp. CO.*, 87 BANKR. 338, 344–345 (Bankr. E.D. Pa. 1988); M.T. Andrew, "Executory Contracts in Bankruptcy: Understanding 'Rejection'", 59 U. COLO. L. REV. (1988) 845, 900–901; L.B. Bartell, "Revisiting Rejection: Secured Party Interests in Leases and Executory Contracts" 103 DICK. L. REV. (1999) 497; J.L. Westbrook, "A Functional Analysis of Executory Contracts", 74 MINN. L. REV. (1989) 227, 252–257.

79. The definition of "Onerous Property" in Section 360 of the Companies Ordinance includes "non-profitable contract".

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performance in liquidation are also those that would apply in reorganization. Executory contracts in reorganization are a crucial issue that requires urgent legislative attention. The fourth matter in which the law is deficient, concerns the application of the laws of avoidance of transactions in corporate reorganization. I am referring here to the avoidance of preferences, transfers of corporate assets at undervalue, as well as a provision regarding the avoidance of transactions conducted in corporate assets after the filing of an application for stay of proceedings,[80] all of which still lack statutory regulation in Israeli law. To some extent, however, judicial rulings have apparently supplemented the legislative omission with respect to this fourth matter.[81] Finally, although the subject of corporate reorganization has surfaced on the legislative agenda in Israel, the legislature has yet to address the matter of creditor classification into groups of identical interests and the effective ability to confirm reorganization plans when a plan is supported by some of the creditors' groups but rejected by others. Israeli law's inability to enforce a plan on a dissenting class of creditors, led the courts to classify creditors in the broadest possible categories.[82] By reducing the number of groups, the courts effectively limited the likelihood of a narrow interest group neutralizing the plan and imposing an effective veto upon it.[83]

Summing up the subject of the partial nature of the legislation it should be stressed that some of the *lacunae* left by the legislature have not been neglected but rather have been supplemented by case law, as mandated by the Israeli legislature.[84]

80. In the liquidation context, the avoidance of post-filing transactions is provided in Section 268 of the Companies Ordinance. For the purpose of this provision, *see* C.A. 126/89 *Receiver of Koppel Tours Ltd. v. Dan Hotels Company Ltd.* 46 (3) P.D. 441, 451–452 ("... Inevitably, there is always a period of time from the filing of the liquidation application until the entry of a judicial decision ordering such liquidation. Experience indicates that under these circumstances ... pressure is exerted by various bodies connected to the corporation, intended to retrieve whatever can be retrieved in order to satisfy the corporation's debt to them, all prior to the appointment of a liquidator entrusted with the distribution of the corporate assets in a manner that benefits the creditors as a group. Furthermore, during this interim period there is often a situation of administrative disorder, which can be exploited by creditors for the conclusion of transactions which benefit them, but which prejudice the positions of the other corporate creditors ... the need for Section 268 arises precisely in those cases in which a transaction may be valid under the regular law and, as explained above, this section is designed to prevent them, in order to save the company from being emptied out by various elements therein ... ").

81. *See* Chapter III. A(2) *infra*.

82. *See* Y. Bahat, "Coercion of Group Opposing Arrangement under Section 233 of the Companies Ordinance", 17 TEL AVIV UNI. LAW REVIEW, (1993) 445, 457–459.

83. The absence of a mechanism for enforcing a plan upon an dissenting class creates a direct link between the manner of classifying groups and the possibility of approving the reorganization plan. This connection was also analysed by Englard J. in *Teshet, supra* note 36, para. 27, where he wrote: "It should be stressed that numerous creditor groups convening in separate forums confer inordinate power upon the individual creditor, who grows more powerful as the size of the group decreases. For the rule is that the required majority for approval of the arrangement must be attained specifically in each class. The result is that if a particular class consists of one, individual creditor, that creditor has veto power over the entire arrangement ... such power may confer upon the individual creditor extensive bargaining power, to the extent of 'blackmailing' power." Further on, at para.28, Englard J. notes that the court has two ways of toning down the exaggerated bargaining power of the individual creditor: "First, by preventing proliferation of classes of creditors, and secondly, by application of the principle of good faith, in cases in which the refusal of a particular creditor appears, in all the circumstances, *prima facie* to be absolutely unjust".

84. The Foundations of Law Act, 1980, S.H. 163; A. Barak, PURPOSIVE INTERPRETATION IN LAW (Jerusalem, Nevo, 2003) 106–111 (Hebrew).

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Moreover, as shall be discussed in the following paragraph, the secondary legislature recently promulgated regulations to supplement the Moratorium Statute.[85]

C. 2002: The Reorganization Rules

The economic recession that struck the entire economy over the last few years resulted in an unprecedented growth in the number of corporations in conditions of financial stress. Consequently, there was an exceptional increase in numbers of companies having recourse to insolvency proceedings generally, and particularly reorganization. This phenomenon focused legal attention on the laws of corporate reorganization, exposing both practitioners and judges to their deficiencies and their limitations. The protracted duration of legislative reforms in Israel compelled the secondary legislature to address the matter, for the benefit of all those engaged in corporate reorganization, practitioners and judges alike. In 2002, the secondary legislature attempted to provide practical working tools that answered the problems occasioned by the *lacunae* in the Moratorium Statute. The result of this initiative was the promulgation of the Reorganization Rules[86] by the Ministry of Justice. The rules are highly detailed, and cover the myriad of connected issues. The rules cover both the procedural and the substantive aspects of corporate reorganization.

1. The procedural provisions

The procedural aspects encompass the following matters: the contents of an application for an arrangement or compromise and the information to be included therein;[87] additional elements required in an application for a stay of proceedings order;[88] publication of the application for an arrangement by the applicant and service of copies thereof to interested parties;[89] reporting to the Companies Registrar of the filing of an application;[90] provisions regulating the filing of proofs of claims by creditors, their review and their approval;[91] provisions regulating the convening of creditors meetings;[92] provisions regulating the manner of filing the plans for confirmation in court (after voting in creditors meetings),[93]and the filing of a secured debtor's application for foreclosure on collateral.[94] Unquestionably, the actual

85. Reorganization Rules. These regulations are analysed below, Chapter II. C.

86. According to their official title and content, the Reorganization Rules are not limited to procedures for settlement or arrangement in the framework of corporate reorganization. They regulate the procedural matters for any application for a settlement or arrangement filed under Section 350 of the Companies Act. As stated above in notes 57 and 58, and the accompanying text, these applications may be filed for a number of commercially based reasons, such as consolidation of share capital in anticipation of a public issue of shares. In this sense, referring to the regulations as the "Reorganization Rules" is somewhat imprecise. Even so, applications for an arrangement or a settlement against a background of an attempt at corporate reorganization, accompanied by an application for a stay of proceedings order, occupy a central position in the regulations. Furthermore, in practice the settlement and arrangement mechanism is used mainly in the context of corporate reorganizations. This explains the licence I took in referring to these regulations as the Reorganization Rules.

87. Rules 7 and 38 of the Reorganization Rules.

88. Rule 41 of the Reorganization Rules.

89. Rules 2–5 of the Reorganization Rules.

90. Rule 9 of the Reorganization Rules.

91. Chapter C (Rules 15–24) of the Reorganization Rules.

92. Rule 25 of the Reorganization Rules.

93. Rules 32–35 of the Reorganization Rules.

94. Rule 51 of the Reorganization Rules.

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regulation of these matters in organized legislation is commendable. The initiative purported to introduce a modicum of order into the system as a whole, to stabilize and standardize the overall management of reorganization cases and ensure that all parties involved are apprized in advance of their procedural rights and obligations, thus enabling them to plan accordingly and intelligently. Nonetheless, in my view, the procedural provisions are deficient in two central aspects. First, the regulations do not establish the date for filing proofs of debt, their review and their approval.[95] This impairs the principle of certainty, a principle which was supposed to have been one of the main benefits of the Reorganization Rules.[96] Secondly, by all standards, the Reorganization Rules are inflated in their requirements of reporting and specification in order to support an application to commence reorganization procedures. The central provision in this context is Rule 41 (a) of the Reorganization Rules that provides as follows:

> An application for a stay of proceedings filed in court shall be authenticated by an affidavit and, subject to Rule 42 shall be filed together with an application for a settlement or arrangement for the reorganization of the corporation and its appendices, as specified in Rules 7 and 38.

This regulation incorporates the reporting particulars of no less than three regulations governing the filing of an application for stay of proceedings. Rule 41 of the Reorganization Rules itself requires the itemization of the following matters:

(1) All of the facts pertaining to the application for a stay of proceedings, the requested duration of the stay of proceedings and the reasons supporting the grant of a stay of proceedings order;
(2) *Specification of cash flow, production scope and expenses, marketing scope and expenses and organizational changes during the period of stayed proceedings*;
(3) The position of the substantive creditors, to the extent known to the applicant.

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95. Regulation 15 of the Reorganization Rules provides: "At any time after the commencement of proceedings under these regulations the court may, if it deems it necessary, determine a date for filing of claims of debt". In addition, Regulation 24 (a) provides: "The trustee will review each claim and decide, within the time set by the court, whether to approve it or reject it, in full or in part". It would seem that the secondary legislature's failure to determine dates for filing proofs of claims and their review was the result of uncertainty regarding the stay of proceedings period. In other words, since the length of the stay of proceedings period is determined by the court, the legislature left it for the court to determine the period for filing and review of proofs of claims. Even so, in my opinion, the law should have determined a maximum period for filing a proof of claim, combined with a provision allowing the shortening of the period in cases in which the stay of proceedings was established for a shorter time period. In a corporate liquidation a proof of claim can be filed within six months of the liquidation order, Rule 53 of the Companies Rules (Liquidation), 1987, K.T. 884, and Rule 76(a) of the Bankruptcy Rules, 1985, K.T. 1072.

96. See comments of Englard J in *Teshet*, cited in note 83 *supra*.

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Moreover, Rule 7 of the Reorganization Rules requires the itemization of the following matters:

[a] . . .

(1) *Description of the corporation and its dealings*, relating to the activities reflected in its consolidated financial reports, including, *inter alia*, the specification of the following matters:

(a) The sectors in which the corporation is engaged, features of licensing, taxation and government supervision thereof, to the extent that they are unique to the corporation;

(b) Characteristics of the corporation's clients and degree of dependence on them, description of substantive engagements with clients the scope of which exceeds 10% of aggregate annual sales during the year preceding the date of the application; engagements may be specified without stating clients' names;

(c) Degree of dependence on suppliers, including marketers or dependence on sources of raw materials;

(d) Unique characteristics and risk factors in the activities of the corporation in every sector in which it operates.

(2) *Proposal for settlement or arrangement* and its reasons;

(3) Name of receiver or liquidator if appointed to the corporation or for its assets pursuant to a court decision, or a decision of the execution office, and whose appointment is in effect on the date of application.

(4) Description of advantages to be gained from settlement or arrangement for corporate executives, including payments, whether in his capacity as corporate executive, or in his capacity as a shareholder or a creditor.

(5) Name of the individual controlling the corporation directly or indirectly, the extent of his equity in the corporation, categories of securities in his possession and his main occupation, including specification of the corporations through which he holds shares in the corporation, the extent of their equity in the corporation, the categories of the securities they hold and their main occupation. . .;

(6) The various categories of shares, *indicating what the settlement or arrangement offers to the shareholders and the affect of the settlement or arrangement on their existing rights*, including the waivers to be required of them and the description of the rights offered in consideration thereof;

(7) Substantive creditors of the corporation, the aggregate debt owed to them, securities for their debts, aggregate debt to non-substantive creditors of the corporation;

(8) *Guarantees, collaterals or other securities given or proposed to be given to the corporation for purposes of the settlement or arrangement*, indicating the complete identifying particulars of the provider;

(9) Specification of the sums to be paid for services and costs and estimated cost of services and expenses required due to the proposal for settlement or arrangement;

(10) Where a trustee was proposed to oversee the compromise or arrangement—his particulars, his consent to serve as trustee, his proposed powers and functions, the sum proposed in payment for his activities and actions for which he is entitled to

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reimbursement of expenses, and if he is an interested party in the corporation or connected to an interested party or substantive creditor, his connection must be specified;

(11) Any other substantial information of any kind that is required for a reasonable creditor or reasonable shareholder to reach a decision whether to agree to the proposed settlement or arrangement.

(b) The following documents shall be appended to an application for compromise or settlement filed in court:

(1) *Report on the corporation's assets and debts*, updated to the date of filing the application, set out in accordance with form 4 of the schedule;

(2) *Detailed list of substantive agreements to which the corporation is a party*, updated to date of filing the application, set out according to form 5 of the schedule;.

(3) *List of substantive legal proceedings in which the corporation is a party*, set out according to form 6 of the schedule;

(4) Detailed list of position holders in the corporation on the date of filing the application and of position holders in the corporation who left during the year preceding the filing of the application, set out according to form 7 of the schedule;

(5) The registers of shareholders and of substantive shareholders updated to the date of filing the application;

(6) *Annual financial reports of the corporation, including consolidated reports for the two years that preceded the year in which the application was filed, having been legally audited by an accountant*;

If the date of the balance sheet included in the last annual financial report was more than six months earlier than the filing date of the application, the most recently reviewed reports shall also be appended, provided that the date of the balance reviewed in the report shall not be more than five months before the dates of filing the application for a settlement or arrangement.'

In addition, Rule 38 of the Reorganization Rules requires the specification of the following matters:

(1) The number of employees in the corporation on the date which is one year before the filing of the application and immediately before the date of filing the application;

(2) *Description of what is being offered to the various classes of creditors in the proposal for a settlement or arrangement and the affect of the settlement or arrangement on their rights including waivers of their rights that may be required of them, and a description of the rights being offered in their stead*;

(3) *The proposed plan for corporate reorganization, the methods of execution, including sources of financing for the proposed plan, financing costs, anticipated cash flow, scope and costs of anticipated production, scope and expenses of anticipated marketing, anticipated profit and loss, anticipated organizational changes, dates on which substantive events will occur required for execution of the plan, the assumptions and data on which the plan and assessments are based and data supporting the conclusion that the plan is preferable to the existing situation (hereinafter—the reorganization plan); all with an indication of the period to which the assessment relates, the economic model on which it is based, and specification of the facts, the presumptions, the calculations and the expectations upon which the assessment is based.*

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(4) *The anticipated amounts that the creditors and shareholders would have received had the corporation been in liquidation at that time*, including the assessments and data on which the specification is based.
(5) Substantial assets of the corporation that were transferred during the six months that preceded the filing date of the application for the settlement or arrangement, their description, value, the consideration paid, and the identity of the recipient;
(6) Where corporate shareholders are also included among the creditors, this fact shall be specified together with itemization of their holdings;
(7) *Identifying particulars of any candidate for service as an office holder in the corporation following confirmation of the settlement or arrangement proposal*, and if he is an interested party or has a connection to an interested party or to a substantive creditor, his connection must be specified including specification of the conditions of service, his salary and remuneration including securities and any other direct or indirect consideration.
(8) Particulars regarding creditors who are connected to the corporation.
(9) List of 'legal proceedings to which the corporation is a party.' (The emphases in all of the citations were added—D.H.).

It is indisputable that Rules 7 and 38 of the Reorganization Rules established a fully blown disclosure statement, intended to present the creditors and shareholders about to vote on the proposed reorganization plan with all the information required to reach their decision.[97] The information provides an extensive review of the structure of the corporation, a description of its business, its controlling parties and, most importantly, the details of the reorganization plan. Indeed, in order to formulate a position regarding the proposed reorganization plan, information must be furnished concerning the future financial plans of the corporation, the manner of financing its business and obviously, an itemization of the allocation of new rights in the corporation to the various classes of creditors and shareholders.[98] *However this information is required at the stage of approving the reorganization plan and not upon the commencement of reorganization procedures.* In this context, the Reorganization Rules suffer from the basic problem of confusion of realms, which is clearly the result of the piecemeal legislation in the field. Indeed, the law of corporate reorganization deals exclusively with the interim period, beginning with the grant of the stay order and terminating with the confirmation of the reorganization plan. In this vein, the stay of proceedings order was intended primarily to obtain industrial peace for the corporation which would enable it to negotiate with its creditors in a

97. This is particularly obvious in Regulations 7(a)(2), (6), (8), (11) and 38(2), (3) (4) and (7) of the Reorganization Rules.

98. For the disclosure required prior to the confirmation of a reorganization plan in the United States, *see* Bankruptcy Code §1125.

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relaxed atmosphere, with relative immunity from the threats of individual collection. This negotiating framework is essential for the formulation of a proposed reorganization plan. In other words, *the stay of proceedings order is a preparatory stage, facilitating the crystallization of a reorganization plan.* However, the Companies Act reverses this order and the provisions of the Reorganization Rules reflect the same mistaken perception. Hence, according to both the statute and the rules promulgated thereunder, the grant of a stay of proceedings order (*i.e.* receiving the remedy required in order to formulate a reorganization plan) is contingent upon the filing of a detailed reorganization plan (comprising all of the components of information specified in the law).[99] Indeed, reality has proven that negotiations with creditors and the formulation of a reorganization plan take time, and during that time any creditor is liable to undermine the entire procedure by enforcing his debt in individual execution proceedings. It was the desire to accommodate negotiations towards the crystallization of a reorganization plan that led to the addition of subsection (a1) to old Section 233 of the Companies Ordinance. This subsection empowered the court to order a stay of proceedings "if it is satisfied that it will assist in the crystallization or the confirmation of a plan to reorganize the corporation." The problem was that subsection (a1) was added without any amendment being made to subsection (a), which commences with the words "where a settlement or arrangement was proposed" [thus making the grant of the stay of proceedings contingent upon the prior filing of a settlement or arrangement]. In my view, this is the source of the circuitous logic of the provisions, which require that a settlement or arrangement be proposed (*i.e.* a reorganization plan) as a precondition for granting a stay of proceedings, which is intended to promote the formulation of the reorganization plan. Following the enactment of the Companies Act, Section 233 of the Companies Ordinance was copied verbatim and in its entirety, becoming Section 350 of the Companies Act and there was no attempt to resolve this logical flaw. As stated, the Reorganization Rules perpetuate the same logical failing. The disclosure requirements of Rules 7 and 38 are totally unrelated to the stage at which an application for a stay of proceedings is normally filed. The provisions themselves make it clear that disclosure is only required at the termination of the procedure, which anticipates the convening of the creditors' meeting in order to vote on the

99. For the court's request to be presented with the reorganization plan (or at least its basic outline) as a precondition for granting the stay of proceedings, *see Mega, supra* note 19, para.3; B.F. (T.A.) 2118/02 *Rubenenko Shmuel Holdings Ltd v. Official Receiver*, Tak-Dist. 2002 (4) 163, paras. 3–4. Even so, it should be noted that the court will examine the specific circumstances of each particular case, so that the circumstances may affect its decision regarding whether to order a stay of proceedings or to extend a stay of proceedings order that is about to expire. For complex cases, in which the court displayed relative flexibility regarding the presentation of a reorganization plan as a precondition, *see* B.F. (T.A.) 1896/02 *Noga Electrotechnica Ltd v. The Trustee*, 33 (5) Dinim Dist. 161; B.F. (T.A.) 1739/02 1734, 1764, *In re Feichtunger Industries Ltd.* Tak-Dist 2002 (3)1268, paras. 30–33 (hereinafter—*Feichtunger*).

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reorganization plan that was crystallized during the stay of proceedings. In contrast, at the first stage—when the application for a stay of proceedings order is filed—the plan has yet to be formulated and there are no details yet for presentation to creditors.

The rules also present a practical problem for debtor corporations. A corporation in a position requiring a stay of proceedings is generally insolvent. What this means is that the corporation lacks the cash flow needed to service ongoing debts, such as short-term loans, suppliers' credit and salaries.[100] Such financially ailing corporations may quite simply be incapable of bearing the tremendous financial burden involved in the extensive disclosure mandated by Rules 7 and 38 of the Reorganization Rules. The disclosure required under these rules is comparable to the level of disclosure required under the Securities Act. However, there are two significant differences between the two regimes. The first concerns the financial straits in which the corporation finds itself, rendering it incapable of employing the professional personnel and incurring the costs needed in order to compose this kind of disclosure statement. The second distinction is occasioned by the extensive scope of the Reorganization Rules that apply to *all* companies, including private ones. When receiving relief that is essentially injunctive, irrespective of its scope, there is no justification for subjecting a private company to a disclosure obligation equivalent to the disclosure imposed when offering securities to the public.[101] As such the extensive disclosure requirements of the Reorganization Rules are unreasonable. Consequently, the rules should be amended so that the extensive disclosure requirements pertaining to the substance of the reorganization plan will only apply as a preliminary condition for convening a meeting of creditors and shareholders, in which a vote will be conducted regarding a proposed plan. At the stage of application for a stay of proceedings the requirements should be far more simple and brief.[102]

100. *See, for example, Feichtunger, supra* note 99, at 1–4.

101. *See also* the criticism voiced by the President of the Tel-Aviv District Court, Judge Uri Goren, in *Elrod, supra* note 43, regarding the poor use of discretion of the Securities Authority when it attempted to take a particularly strict approach to the disclosure requirement in relation to a corporation undergoing reorganization, under Section 350 of the Companies Act. Judge Goren's criticism related to the disclosure requirement at the stage of the confirmation of the reorganization plan and is applicable even more so to the stage of the application for stay of proceedings.

102. I appreciate the concern that a vague, unarticulated application for stay of proceedings, absent any substantive details about the corporation and its plans within the framework of the reorganization, may well be exposed to exploitation of the reorganization process. However, in addressing this concern we should not throw out the baby with the bathwater. Only a small number of judges deal with liquidations and reorganizations, and they become experts in the field. As such, they can be relied upon not to grant a stay of proceedings should there be a suspicion of abusing the procedure, or at least to severely limit the stay period, and make its continuation contingent upon the presentation of details regarding progress towards the crystallization of a reorganization arrangement. This in fact is regular practice and in my view it constitutes an appropriate response to the problem of abuse of the proceeding.

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2. The substantive provisions

Apart from the procedural matters, the rules also include a host of substantive law provisions. First, the rules give legislative expression for the first time to what has become a traditional part of judge made law, by empowering the courts to appoint a trustee over a corporation in respect of which an application for settlement or arrangement was filed.[103] The trustee coordinates the management and control of the corporation for the duration of his appointment.[104] This legal provision effectively neutralizes the function of the corporate management that was appointed voluntarily by the shareholders, replacing it coercively by an appointed external trustee. Indeed, the question of the identity of the corporate controller is a major one, disputed among different legal systems[105] and in legal

103. Rule 14 of the Reorganization Rules.

104. Rule 14(a)(1) of the Reorganization Rules. It is interesting to compare between the provisions of the Reorganization Rules regarding the appointment of the trustee and the role of the corporate liquidator under the provisions of the Companies Ordinance and the Companies Rules (Rules for Appointment of Receivers and Liquidators and their Fees), 1981, K.T. 646 (hereinafter—"Rules for Appointment of Liquidators and their Fees"). *First*, the court is empowered to appoint a trustee upon application from the date of filing for a settlement or arrangement. In corporate reorganization this application will be appended to the application for a stay of proceedings. However, the trustee can be appointed even prior to the stay of proceedings order. This is probably a result of the fact that applications for a settlement or arrangement are generally filed at the corporation's initiative. Consequently, in the view of the secondary legislator, the relocation of corporate governance in the direction of a professional trustee may already be warranted at that early stage. In liquidation, on the other hand, the liquidator is only appointed for the corporation upon issuing a liquidation order (*see* Section 300 (a), (d) of the Companies Ordinance. (As an exception, the court may appoint a temporary liquidator upon the filing of the liquidation application; *see* Section 300 (b) of the Companies Ordinance).) The deferral of the liquidator's appointment to the date of the liquidation order derives from the fact that liquidation applications are generally filed by the creditors, despite the corporation's opposition. So long as the court is not convinced of the need to conduct collective proceedings there is no justification for replacement of the corporate management with the appointment of an external trustee. Nonetheless, in my view, in settlement and arrangement processes too, there is no justification for immediately and automatically appointing an external trustee the moment an application for a settlement or arrangement is filed. Rather, it would be preferable to determine, in a manner resembling the liquidation procedure, that the trustee will only be appointed upon the issuing of the stay of proceedings order, and not immediately upon filing the application for the order. Even applications filed by the corporation may well be contested by creditors. In view of their opposition, the court may very well decide not to grant the stay of proceedings. *See, for example*, B.F. (Haifa) 415/01 *Bank Leumi Ltd. v. Eltan Communication Services Haifa (1997) Ltd.*, PSM 2001(1) 944. This being so, in my view there is no need to immediately appoint a trustee prior to the court being satisfied that the time has come to commence collective proceedings. *Second*, the qualifications required of the trustee under the Reorganization Rules differ from those required under the Rules for Appointment of Liquidators and their Fees. Whereas the latter require the appointment of an advocate or an accountant to the role of liquidator, (Rule 2 (a)(1)), the Reorganization Rules do not limit the qualifying condition for candidates for these roles, specifically to members of those professions. In its stead, Rule 14 (a)(2) stipulates that: "The court will appoint a trustee after being satisfied that the candidate is suited to the job in view of his talents and experience in formulating settlement or compromise arrangements." *Third*, the fees of a trustee are not tied to the provisions of the Rules for Appointment of Liquidators and their Fees. Rule 14 (b) of the Reorganization Rules explicitly relates to the possibility that the sum of payment to the trustee may differ from the sum specified in the Rules for Appointment of Liquidators and their Fees.

105. *See supra* notes 74–75 and the accompanying text.

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academia.[106] It impacts directly upon the nature of reorganization and creditors' rights as well as on the number of reorganization applications that will be filed. The rule providing for the appointment of a trustee fills a major gap in the reorganization legislation. Secondly, the Reorganization Rules establish provisions regarding the debt amounts that may be claimed by creditors in proofs of claims. In this context, the Reorganization Rules provide that proofs of claims will be revaluated as of either the date of filing the application for a settlement of arrangement, or the date of the application for a stay of proceedings, whichever is earlier.[107] Thirdly, the rules establish the entitlement to vote on a proposed settlement or arrangement. They also deny voting rights to a creditor whose debt, in the trustee's opinion, cannot be fairly assessed.[108] In addition, they determine the manner in which the creditor votes. At the creditors meeting each creditor is entitled to vote by itself, by way of an agent, or by delivering a proxy vote.[109] The fourth issue of substantive law in the Reorganization Rules is the provision of Rule 45, which states:

> *In determining the duration of the stay of proceedings, the court will consider, inter alia, the benefit to be gained by the company during the stay of proceedings, as opposed to the possible damage to the corporation's creditors.*

Section 350 (b) of the Companies Act restricts duration of a judicial stay of proceedings to nine months.[110] Once the stay of proceedings period was "technically" demarcated by the primary legislature, it was for the secondary legislator to

106. D.A. Skeel, Jr., "An Evolutionary Theory of Corporate Law and Corporate Bankruptcy", 51 VAND. L. REV. (1998) 1325; Skeel, Jr., Armour & Cheffins, *supra* note 18. (The authors explain the difference between the American system in which the management oversees the reorganization process, and other legal systems in which an appointed trustee is in charge. The difference is explained against the background of evolutionary development both of the political structure and the capital market structures of the different countries.) *See further* D.G. Baird & R.K. Rasmussen, "Control Rights, Priority Rights and the Conceptual Foundations of Corporate Reorganizations", 87 VA. L. REV. (2001) 921 (who emphasize the primary importance of the issue of control in the reorganization process contrary to the prevailing view whereby the order of priorities in the distribution of resources is the more critical issue). For a sharp criticism concerning managerial control of the company undergoing reorganization under Chapter 11 in the United States, *see* Bradley & Rosenzweig, *supra* note 11. For the approach supporting control of the management in the reorganization of a public company in which the ownership is decentralized, but which calls for joint control of the management of corporation by the corporate management and the external trustee in a corporation in which the equity ownership is concentrated, *see* D. Hahn, "Concentrated Ownership and the Control of Corporate Reorganizations", 4 J. CORP. L. STUD. 117 (2004).

107. Regulation 20 of the Reorganization Rules.

108. Regulation 24 (b) of the Reorganization Rules. According to the language of the regulation, that class of creditor does not have voting rights. From this it may be inferred that his right to participate in the distribution of assets remains intact, which also accords with the specific wording of Regulation 24 (c) of the Reorganization Rules. The question which presents itself is how to relate to such a creditor. If the sum of his debt cannot be fairly assessed, then what is the basis of the debt which entitles him to distribution according to the settlement or arrangement? On the other hand, if his debt can be assessed for distribution purposes, then why should he be denied participation in the creditors' meeting which votes on the distribution proposed in the settlement or arrangement!? For criticism of the court's reluctance to apply the partnership presumption on the future income of a spouse due to the difficulties of income assessment, *see* S. Lipshitz, PAST AND FUTURE ASSETS AND THE PHILOSOPHY OF SPOUSAL PARTNERSHIP IN ISRAELI LAW (unpublished manuscript, on file with author).

109. Regulation 29 (a) of the Reorganization Rules.

110. For the extension of the stay of proceedings order, despite these statutory provisions, beyond 9 months, *see* B.F. (T.A.) 1361/02 *Tevel International Transmission to Israel Ltd* (*slip op.* 9.12.02); and B.F. (T.A.) 1361/02 *Tevel International Transmission to Israel Ltd v. Various Creditors*, Dinim-Dist. 33 (7) 435.

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substantively limit the judicial discretion to be exercised when ordering a stay of proceedings. Rule 45(a) of the Reorganization Rules instructs the court regarding the substantive considerations to be balanced when issuing a stay of proceedings order, *inter alia*, in the context of a corporate reorganization. This regulation posits considerations of damage to creditors against the corporate interests or benefits to the corporation provided by the stay of proceedings. Placing all the creditors of the corporation on one side of the scale and the "benefit to the corporation" on the other, the secondary legislature provided that the court must weigh the benefits accruing to additional constituencies connected to the corporation, apart from the creditors, by the conduct of reorganization proceedings. Such a determination unquestionably involves a major value judgment on the part of the secondary legislature regarding the substantive values and guidelines for the development of corporate reorganization law in Israel. The problem, however, is that the identity of the dominant values in corporate reorganization in Israel is sharply disputed in legal circles. On the one hand, there are those who argue that considerations of the creditors' best interests are the sole interests that are relevant in procedures concerning corporate insolvency, to the exclusion of considerations relating to the interests of the corporation and its other constituencies.[111] On the other hand, it is contended that the creditors' interests must be balanced against the interests of the corporation and its employees.[112] The question for which I have no answer is how the secondary legislature presumed to unilaterally resolve such a substantive issue instead of deferring it for the Knesset's independent resolution? Indeed, the parallel provision in corporate law, under the title—the "goal of the corporation" was not neglected as an afterthought to be dealt with by the secondary legislature, but rather merited a place of honour in the opening sections of the Companies Act in Section 11 thereof.

III. **Case Law Contributions**

A. The Supreme Court

There is a dearth of Supreme Court rulings regarding insolvency generally and particularly in the area of corporate reorganizations.[113] Nonetheless, the Supreme Court adjudicated a number of appeals in which it expressed its view of the spectrum of considerations that should inform the judicial decisions in this context. Since 1995, the period discussed in this article, the Supreme Court handed down significant decisions dealing with corporate reorganization in the cases of *Carmel Carpets*,[114] *Asphalt Group*[115] and *Diur LeOleh* [housing for immigrants].[116] The

111. See Baird *supra*, note 15. For the views contending that the only benefits to be considered are those of reducing credit costs *ex ant*, *see* Adler *supra* note 11, at 322–323; R.K. Rasmussen, "Debtor's Choice: A Menu Approach to Corporate Bankruptcy", 71 Tex. L. Rev. (1992) 51.

112. Warren & Korobkin, *supra* note 11.

113. For an analysis of the judicial passivity in the general corporate law over the past decades, *See* Y.Z. Stern, "Anatomy of Judicial Passivity in Corporate Law—The Deficiency of the Positive Norm", 17 TEL AVIVU. LAW REVIEW, (1993) 811.

114. Carmel Carpets, supra note 4.

115. Asphalt Group, supra note 36.

116. Diur LeOleh, supra note 49.

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decisions in *Asphalt Group* and *Diur LeOleh* attest to an apparent reversal in the Supreme Court's approach to corporate reorganization. The Supreme Court rejected its one-dimensional attitude, in which creditor's rights were the exclusive, all pervasive consideration, progressing gradually to a more complex and balanced approach, in the understanding that the judicial decision requires that a balance be struck between the conflicting interests of the creditors and the debtors. The court took a major step in the case of *Diur LeOleh*, when it progressed towards a synthesis between corporate reorganization law and liquidation law. This ruling institutionalized and firmly implanted in the Israeli judicature, the revolution that had begun with the adoption of the Moratorium Statute.

1. Financing reorganization proceedings: From Carmel Carpets to Asphalt Group

One of the most pressing needs of any corporation during reorganization is fresh financing. It was financial difficulties, and primarily the absence of available cash flow, that forced the corporation to commence reorganization in the first place. Indeed, without new financing most of the corporations in this position could not survive. This need presents the following legal dilemma: new financing can be provided in accordance with the existing rules, in other words: the corporation applies to potential lenders, who assess whether in view of the projected cash flow of the corporation it can be expected to repay the debt in accordance with the determined time schedule. In addition, the lenders will calculate a price for the risk involved in providing a loan and will demand collateral to minimize these risks. The loan will resemble all other loans to the extent that if reorganization fails, the debt created by the loan will be classified in accordance with the order of priorities applying to creditors in insolvency. The problem, however, is that at the planning stage, there are very few economic entities that are willing to provide additional financing under these rules to a corporation already in financial difficulties. As stated, in addition to profit considerations, the new financier will also consider the possibility that the dangers inherent in the failure of the reorganization attempts will actually materialize. From this perspective it must consider its position in the order of priorities *vis-à-vis* all the corporate existing creditors. A continually growing list of competing creditors would no doubt discourage any potential financier, especially since the list of creditors generally includes secured creditors to whom the corporate assets in their entirety are already charged. A legal policy that attempts to encourage reorganization initiatives must therefore consider the creation of exceptions to regular priority rules so that they would favour the financiers of the reorganization over the prior creditors. The dilemma of which creditor to prefer—the former or the latter—is therefore reflective of an ethical conflict between the value of honouring the creditors' rights on the one hand (preference of the former creditor) as opposed to the value of encouraging attempts to rehabilitate financially distressed corporations prior to their final demise, on the other hand.

This dilemma received expression in the cases of *Carmel Carpets* and the *Asphalt Group*. Both cases concerned corporations whose reorganization attempts

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had failed.[117] As a result of the failed attempts, entities which had contracted with the corporations in the framework of their dealings during the reorganization attempt, now had to compete for priority against secured creditors from the pre-reorganization stage. In *Carmel Carpets,* the Industrial Development Bank had financed the reorganization attempts of Carmel Carpets, and it found itself competing for priority against other banks holding pre-reorganization security interests. In *Asphalt Group* a group of contractor companies had executed works as secondary contractors for the Asphalt Group in the area of the German Colony in Haifa. They subsequently competed with the Leumi Bank that was secured by a pre-reorganization floating charge on all the corporate assets.

Prior to the adoption of the Moratorium Statute, the Supreme Court expressed its attitude to the priority competition in the *Carmel Carpets case* in the following way: first, the Court presented the purpose of reorganization proceedings. The court regarded these proceedings as intended first and foremost to assist the creditors, and primarily the secured creditors.[118] Indeed, in the paragraph in which the court relates to the values to be factored into the reorganization procedures it proclaims that the reorganization procedures are also intended for the corporate benefit. But this proclamation seems to have been somewhat half-hearted, without any independent analysis of this consideration on its merits.[119] The court ruling indicates that the interest in protecting the rights of secured creditors (despite the balancing values rhetoric) is basically the sole value it weighed. The court itself proceeded to point out that its starting point is that secured creditors have a protected property right. This is most certainly a value judgment,[120] one that served not only as a starting point but also as a termination point in the exercise of judicial discretion. In fact, the court ruled that in the priority competition between the

117. In both of these cases the attempts failed even before the creditors' confirmation of the arrangement. Indeed, this is the more frequent example of failed attempts at reorganization. For the less frequent type of case, in which the reorganization fails post-confirmation, *see Tabor Marble Industries, supra* note 21.

118. In the words of the court in *Carmel Carpets*, *supra* note 4, at 695: "The underlying purpose of the proceeding is to offer all possible assistance to the creditors, and *a fortiori* to the secured creditors. Nonetheless, in many of the cases it is a mistake to realize the corporate property and resources, when they are not utilized, frozen and of no value. It is in the interests of both the creditors and the failing corporation to be proactive and make the effort to revive the corporation to the extent possible, and at the very least to promote the liquidation process when the corporation is a going concern".

119. The absence of an ethical assessment of the slogan "the corporate benefit" is particularly conspicuous in the structure of the judgment. The subject of secured credit, *i.e.* the conglomeration of rights included therein and its constitutional power warrant an independent subchapter in the judgment, comprising six paragraphs (paras. 24–29) and numerous citations substantiating the status of the right. On the other hand, there is not even one paragraph, and certainly not a sub-chapter, which analyses the considerations pertaining to the corporate benefit, as distinct from the creditors' benefit (and particularly that of the secured creditors). Indeed, in paragraphs 22 and 23 of the judgment the court quotes from citations that are intended to indicate the priority attaching to the attempt to reactivate the corporation prior to its elimination, but the underlying goal of that policy is not expressed in those paragraphs.

120. M.D. Birnhauk, "Constitutional Engineering: The Methodology of the Supreme Court in Value Based Decisions", 19 BAR-ILAN U. LAW STUDIES, (2003) 591, 598–601, 610–611 (the choice (ostensibly technical) of a particular formula influences the result reached by the court).

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new financiers and the secured creditors from the pre- reorganization period, the secured creditors would have priority unless 75% or more of those creditors had explicitly waived their own priority for the benefit of the new financier.[121] This is certainly not expressive of a balance in which weight is according to the conflicting value, *i.e.* the interests of the other corporate constituencies. The court's reasoning is premised exclusively on the property right encapsulated in secured credit. In most corporations this means that the new financier is denied access to any of the corporate assets as all the corporate assets are already collateralized to prior bank creditors in the form of a floating charge. The result is that absent the consent of the prior creditors, it becomes impossible to obtain financing for reorganization procedures based on the secured corporate assets.[122]

The Moratorium Statute affected the rulings of the Supreme Court in the particular context of the priority competition between new elements contracting with the corporation within the framework of managing reorganization proceedings and the prior secured creditors. This influence was particularly pronounced in the *Asphalt Group case.* In that case the corporation engaged in a number of contracts for land development ventures in Haifa. The corporate assets in their entirety were subject to a floating charge held by the Leumi Bank. Prior to its completion of these ventures, the corporation ran into financial difficulties and a stay of proceedings order was granted for its protection. The special manager appointed for the corporation concluded agreements with a number of sub-contractors which completed the various ventures. With the completion of one of the ventures, in the German Colony, the corporation received a consideration totalling 1.5 million New Shekels. Based on the floating charge securing its credit, the Leumi Bank claimed priority to the funds received, over the sub-contractors which had completed the ventures. This time the Court ruled in favour of the sub-contractors. In other words, in favour of the entities that had contracted with the corporation during the reorganization as opposed to the prior secured creditor. In its ruling the

121. *Carmel Carpets*, *supra* note 4, paras. 27–28. Consistency with the court's ruling means that the priority accorded to the secured creditors is limited to the value in liquidation of their securities (*i.e.* the consideration received with a forced sale of the assets in the framework of the corporate liquidation), whereas the new financier would have priority in its rehabilitated value, or its value as a part of a going concern. *See id, id.*

122. *See Carmel Carpets, supra* note 4, at 698 ("the rule is that one cannot infringe the property right of the secured creditor without its express consent, and without good reasons for doing so on a constitutional level, and on the level of the relevant pragmatic considerations"), and at 699–700 ("in appropriate cases one can consider infringement of the property right of the secured creditor as part of the obtaining of new credit for a corporation in rehabilitation, if one of the following conditions is satisfied: (1) the secured creditors gave their explicit agreement; (2) if their consent was not received, the opponents must be a negligible minority (less than 25% of the value represented in the voting) and the continued cooperation is essential for the continuation of the rehabilitation, including the obtaining of credit; further more, "adequate protection must be provided for their secured right"). The second exception determined by the court also requires that the prior, secured creditors give their consent to the financier's priority. This exception is directed towards a situation in which there is an internal dispute among the prior secured creditors, and proposes subjecting them to the decision of a special majority, which will be able to impose its will on the minority.

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Court was aware that this result was not consistent with the result in *Carmel Carpets*. The Court had two options for reconciling the conflicting results. It could either distinguish the two cases or openly declare that its new ruling deviated from the previous ruling.[123] In the *Asphalt Group case* the Court chose the first option. When comparing the case before it to the *Carmel Carpets case,* the Court's justification for the preference of the secured creditor in the latter case was that the secured creditors had not agreed to the adoption of reorganization measures by the corporation, whereas in the case before it, the bank had consented to the stay of proceedings.[124] Furthermore, the court noted rather briefly, and without any elaboration, that in the *Carmel Carpets case* the connection between the financing of the reorganization proceedings and the benefit accruing to the secured creditor was tenuous at best and did not admit of objective measurement. As such, in the absence of any real benefit to the secured creditor as a result of the new financing, the new financier would not merit any priority over the prior secured debts. On the other hand, in *Asphalt Group* the court contended that in view of Leumi Bank's agreement to the granting of a stay of proceedings order, then "in the circumstances of this case the secured creditor derived (or was likely to derive) benefit from the creation of these [new—D.H.] debts."[125] As such the law should be that the new debts incurred to the secondary contractors should merit payment first, given that they were also intended to optimize the value of the secured creditor's debt.

As stated, the court made a distinction based on the Leumi Bank's consent to the proceedings stay. This was the only explicit consent that was given in the *Asphalt Group case*. There was no explicit consent to subordinate the bank's rights to those of the sub-contractors. The court inferred the existence of such consent from the bank's act of consent to the stay of proceedings.[126] But in fact this inference was not the only possibility. Conceivably, the bank might have agreed to stay proceedings in the sense of temporary non-realization of its security, but with the intention of retaining its absolute priority in the security in any future foreclosure. In other words, the consent of a prior creditor to withhold foreclosure proceedings on a security does not necessarily imply his additional consent to waive his priority in favour of a later creditor. The creditor's consent to the stay of proceedings provided

123. For an analysis of the Supreme Court rulings from the Mandate to the present regarding the unwillingness to deviate from a precedent, *see* Y. Shachar, "Unity and Inter-Generationalism in the Supreme Court—The Politics of the Precedent", 16 BAR-ILAN U. LAW STUDIES, (2001) 161.

124. *Asphalt Group, supra* note 36, para. 9.

125. *Id.* end of para. 6.

126. *Id*, para. 9 of Deputy President S. Levin's judgment: ("... In our case the bank was a full and active partner in the recovery process. It gave its consent to the granting of the stay order, and then continued to channel extensive funds to the corporate coffers. As such, they cannot now claim that actions done with its knowledge and cooperation were not intended for its benefit. The benefit anticipated by the bank is clear and quantifiable. *Under these circumstances*, in which expenses were made for the benefit of a secured creditor, with his knowledge and approval, *his explicit approval is not required in order to give priority to these expenses over the debt to him*") (emphasis mine—D.H.) Englard J. was even more forceful in his inference of the bank's consent, and almost ruled that there had been explicit approval on the bank's part to the priority of the secondary contractors. (*see id*, paras. 12–13 of Englard J's judgment).

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an opening for the corporation to continue operating, but to the extent that such operations involved contracting with other creditors, the latter have to be satisfied with a secondary level of priority, following the absolute priority of the pre-reorganization secured creditor. What emerges therefore is that legally, the court did not deviate from the legal parameters delineated in *Carmel Carpets.* The judicial policy was to define the priority of the prior creditor as a function of the liquidation value of its security at the stay of proceedings date, as would have been received from its forced sale at that time.[127] This legal determination enabled the court to factually distinguish between a prior creditor who consents to reorganization proceedings and a prior creditor who opposes them. The Court assumed that as a secured creditor, the Leumi Bank was aware of the *Carmel Carpets* ruling, which limits the prior creditor's rights to the liquidation value of the security. *Ipso facto,* any consent of the bank to reorganization proceedings also constituted an implied waiver of its absolute priority in relation to the additional value attained the managing of the corporation in the framework of reorganization proceedings.

A different interpretation that illuminates the difference in the results of *Carmel Carpets and Asphalt Group* can be offered. As stated, the Court's judicial policy was to limit the prior creditor's priority to the liquidation value of his security. The additional value, also referred to as the reorganization value or going concern value, is available for new creditors who enter into contractual engagements with the corporation.[128] The different result in the two cases therefore derives from the different identities of the creditors. In *Carmel Carpets,* the later creditor was a banking financier who extended credit to the corporation for purposes of its ongoing operation. This credit, *per se*, did not create any additional corporation value which it would not have had otherwise. Consequently, it comes as no surprise that once the reorganization failed the corporation had no additional going-concern value from which a later creditor could benefit.[129] On the other hand, in *Asphalt Group*, the later creditors were sub-contractors whose contribution to the corporate coffers consisted in the completion of the development ventures, with the resultant optimization of their value. This was a specific contribution that created an additional, identifiable, going-concern value. And hence, though ultimately the reorganization failed, there was nonetheless additional value for which the former and latter creditors could compete. In *Asphalt Group* it was the work of a group of sub-contractors that infused additional value into the collateral. Under these circumstances there is

127. *Asphalt Group*, *supra* note 36, para. 6: ("priority is conferred to secured creditors exclusively in relation to the sum of the secured debt on the date of granting the stay order").

128. For the distinction between liquidation value and going concern value *see* Hahn, *supra* note 65, at 266–271.

129. The point made here is the essence of my criticism of the impracticality that characterizes the Supreme Court's approach which divides the value of the security between its liquidation value and its going concern value, *see id*, 289–290.

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room for giving the sub-contractors priority with respect to the additional value that they created.[130]

The discussion so far indicates that *prima facie*, a direct and consistent judicial policy connects *Carmel Carpets* to *Asphalt Group*. The prior secured creditor retains its priority regarding the liquidation value of the security. However in a brief, but highly significant *obiter dictum* in *Asphalt Group*, the Supreme Court added a value-based determination that implements the fundamental rationale underlying the Moratorium Statute:

> In my view, the actual consent of the bank to the reorganization proceedings was not a precondition for the existence of the respondents' rights as determined in the judgment, because the bank could have rightly asserted that a distinction must be made between the reorganization proceeding and its rights as a secured creditor. For even absent the bank's consent, the court could still have ordered the conduct of a reorganization proceeding, while assuring adequate protection for the secured creditors.[131]

In this statement the Supreme Court revealed its policy that the secured creditor's consent is not required as a precondition for the conduct of reorganization proceedings. In its promotion of corporate reorganizations the Court's policy is that these proceedings can be conducted even absent the secured creditor's consent, and entities contracting with the corporation in that framework are conferred priority (in relation to the going-concern value) over the prior secured creditor. In my understanding, this policy is indicative of the Supreme Court's internalization of the underlying principles of the Moratorium Statute. In the *Carmel Carpets* ruling, which was delivered before the Moratorium Statute, the absolute status of the secured creditor was staunchly upheld, to the extent of almost neutralizing any possibility of conducing reorganization proceedings without the latter's support. On

130. The justification of the result in *Asphalt Group*, in my view, is compatible with the legal policy in Israel which gives priority to a right of lien on an asset to the contractor against an earlier security interest on the same asset, even if the right of lien accrued at a later stage. This rule too is based on the consideration of the appreciation of the asset in the hands of the holder of the lien. *See* C.A. 790/85 *Israeli Airports Authority v. Gross*, 44 (3) P.D.185, 212; N. Zaltzman, THE LIEN, (1999) 314–317; A. Hartman and D. Neuman, "Order of Priorities between Right of a Security Interest and the Right of a Lien" 10 MISHPATIM (2000) 535, 540. This kind of reasoning also appears in *Asphalt Group, supra* note 36, para. 6 (creditors who contract with a reorganizing corporation "are entitled to assume that they are contracting with a corporation in respect of which a stay order has been granted, and that they are not expected to throw their money to the winds, *and that funds received by virtue of the contract with them will* first and foremost serve for the repayment of their debt, and not the debts of others") (Emphasis added—D.H.). Another policy consideration supporting the priority of the lien is the consideration of market overt. In other words, as a matter of policy we are not interested in obliging an artisan who contracts with a client to examine the nature of the rights to which the asset is subject, and to have to decide whether to handle the asset or not in accordance with the legal rights applying to it. Releasing the artisan from this burden is effected by granting him priority over other holders of previous interests in the asset. This consideration is similarly valid with respect to contractors concluding agreements with a reorganizing corporation. For citations indicating that this is indeed the underlying policy of the market overt, *see* A. Zamir, SALE LAW—1968, (1987), 685–687, 695–696; A. Struzman, "Market Overt", 34 HAPRAKLIT, (1981) 353, 354; Y. Zigenlaub, "Market Overt: The Unfolding of the Market Overt and the Development of the Law", 31 MISHPATIM (2001) 837, 881–882.

131. *Asphalt Group, supra* note 36, end of para. 9.

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the other hand, in *Asphalt Group*, the court opened the door—though not totally—for the conduct of reorganization proceedings irrespective of opposition originating with the prior secured creditor and for the regulation of the order of priorities between the secured creditor and the new financier-creditor.[132] This certainly represented a change in judicial policy and while it would be incorrect to overstate its importance, it nonetheless gives authentic expression to the change heralded by the Moratorium Statute. Instead of a departure point conferring unfettered primacy to secured creditors for all intents and purposes, including a veto right regarding the actual conduct of reorganization proceedings, the Moratorium Statute now compels the courts to balance between the prioritized rights of the secured creditor and considerations of maximizing the value of corporate assets leading to increased payments of their own debts too, in addition to considerations of corporate rehabilitation for the benefit of additional constituencies.[133]

2. *Application of liquidation law to reorganization proceedings*

The analysis of *Asphalt Group* identified a change in the judicial policy regarding the managing of reorganization files, but was hesitant in overstating its importance. These reservations do not apply to the Supreme Court's ruling in the *Diur LeOleh case*, which is of unparalleled importance for the laws of corporate reorganization.[134] The Court addressed the subject of a potential avoidable preference immediately before the commencement of reorganization proceedings. The *Diur LeOleh*

132. The discerning reader will certainly have observed that the consent referred to in the *Carmel Carpets case* and the absence of agreement referred to in the *obiter dictum* of *Asphalt Group* are not of the same genre. In *Carmel Carpets* the court required the consent of the secured creditor to the subordination of its priority in the liquidation value to the rights of the new financier. However, the court did not require the secured creditor's consent to the actual conduct of reorganization proceedings, at least not in the overt, explicit level of the judgment. In contrast, in the *Asphalt Group case*, the court addressed, in an obiter dictum, the issue of the consent to the reorganization. Nonetheless, in my opinion, the transition between the two judgments requires examination. First, the judgment in *Carmel Carpets* displays an unreserved view of the elevated status of the secured creditor and the necessity for its support for all the stages of the reorganization process. On the other hand, the *Asphalt Group case* implements the legislature's position as reflected in the Moratorium Statue, whereby it is possible to replace the security of the prior creditor with appropriate protection, *i.e.* with a security of a different type, and to conduct the reorganization process even without its consent. In other words, in the *Asphalt Group case* the court applied rehabilitative considerations from a broad perspective, having at least the entire creditor constituency in mind, and rejecting the individualist perspective of the sole secured creditor. *See Asphalt Group supra* note 36 para. 6 of the judgment of Levin D.P. ("... There can be no doubt that rehabilitation or the reorganization of the corporation also involves a change in the status of the secured creditor. From hereon, it is unable to unreservedly realize its security immediately and in doing so frustrate the recovery program, and he will be subjected to the actions of the special manager, both with respect to the use of the secured asset and with respect to its replacement by another collateral"). Second, the court made it clear in the case of *Asphalt Group* that the later creditors would be granted priority even if the earlier creditor had not given any consent to the reorganization proceeding. On the other hand, as mentioned, this last point was not reflected in the *Carmel Carpets case*, given that there was no balance of any going-concern value for which there could have been competition for priority.

133. *Asphalt Group*, *supra* note 36, para. 8 of the judgment of Englard J. ("Generally, there is a substantive difference between liquidation proceedings, which are geared primarily to the realization of corporate assets for the payment of debts, and reorganization proceedings during the stay of proceedings, which are intended to preserve the corporation as a going concern").

134. *Diur LeOleh, supra* note 49.

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corporation encountered financial difficulties and just 11 days before filing an application for a stay order to protect it, the corporation sold one of its apartments to the Caspi couple.[135] The appeal focused on the two central elements of an avoidable preference. The first question was whether the transfer of the property had actually entitled the transferee (the Caspi couple) to a larger portion of the property than they would have received through insolvency proceedings in the absence of the transfer.[136] The second question was whether the corporation's act of transfer was accompanied by the debtor's intention to prefer Caspi over its other creditors.[137] The court's correct conclusion was that the requisite conditions for avoidance of a preference had indeed been satisfied, but the innovation and the importance of the case lay elsewhere. Its main innovation lay in the court's actual agreement to

135. The commercial background of the apartment's sale was a loan transaction conducted between the parties about one and a quarter years previously. In return for the loan from Caspi, the corporation provided various securities to ensure payment. One of the securities was a memorandum signed by the corporation, in which it gave Caspi the option to purchase the apartment from it in return for the sum of the loan. The court regarded the memorandum as a camouflaged security interest, by virtue of Section 2(b) of the Security Interest Act, 1967. Since the security was not registered in the Companies Registrar as required under Section 178 and 179 of the Companies Ordinance, the court ruled that the security interest was void. In view of this the court regarded the sale of the apartment prior to the reorganization proceedings as an independent transfer of value, which was intended as payment of the loan, and not as the realization of the security interest. In view of the avoidance of the security interest, the loan was an unsecured loan, and its payment by way of the apartment's sale fell into the category of preference of creditors. *See Diur leOleh, supra* note 49, para. 6. For conditional sale transactions of land as a camouflaged security interest for a loan, *see* C.A. 2328/97 *Cochavi v. Arenfeld*, 53 (2) P.D. 353; C.A. 196/87 *Shweiger v. Levi*, 46 (3) P.D. 2. According to another approach, a sale of this kind does not fall into matrix of the Security Interest Act, *see* recently L.C.A. 1690/00 *M.S. Northern Drillings Ltd. v. Temporary Liquidator and Special Manager of Labert A. Avgel Technology Ltd. (in Temporary Liquidation)*, 57 (4) P.D. 385. It should be noted that the contract for the sale of the apartment was concluded only 11 days before the commencement of the reorganization proceedings. The Court regarded it as a transfer to the creditor of all the rights in the apartment, and not just the obligatory stage. This also led to the need to analyse whether the transfer constituted preference. For had the sale contract only been regarded as the obligatory stage of the sale transaction, then it would not have benefited Caspi and would not have impaired the capacity of the other unsecured creditors to receive value from the apartment, of a relative portion equal to that of Caspi. The point however was that actual conclusion of the sale contract withdrew the apartment from the fund of corporate assets that were available for distribution among all of the creditors in accordance with the statutory order of priorities. The Court's starting point in its discussion relied on enhancement of the contractual stage of land transactions from the obligatory stage to the completed *in rem* stage, even before the registration of the transaction in the Land Registrar. This enhancement was established in the *Aharonov* ruling (*see* C.A. 189/95 *Bank Otzar Hachayal v. Aharonov*, 53 (4) P.D. 199). In the case of *Diur LeOleh* the court explicitly declared that its analysis was based on "the Aharonov transfer of right", from *Diur LeOleh* to Caspi. *See Diur LeOleh, supra* note 49, para. 7. In other words, the court broadened the application of the *Aharonov* ruling to the context of purchasing a land right from a transferor, who prior to the completion of the transaction in registration entered into bankruptcy or liquidation. *See also* B.F. (T.A.) 241/89, C.App 9849/01 *In re Yitzchak Bilu (Bankrupt)* (handed down 11.9.03).

136. *Diur LeOleh, supra* note 49, para.7. While this element is not explicitly mentioned in the language of the law, (*see* Section 98 of the Bankruptcy Ordinance) it is an essential precondition of an avoidable preference. In another place I described this element as the "preference effect", *see* D. Hahn, "Transfer of Value to a Creditor and Assignment of Right by a Creditor: On Preferences in Insolvency", 16 BAR-ILAN U. LAW STUDIES, (2001) 197, 209–210. This element is expressly anchored in the criteria concerning preferences of creditors in American law, *see* Bankruptcy Code § 547(b)(5).

137. *Diur LeOleh, supra* note 49, paras. 9–11. For a criticism of the criterion of a debtor's intention prefer the transferee-creditor and a proposal to replace it by alternative criteria, *see* Hahn, *supra* note 136, at 210–218 (proposal to adopt alternative criterion of the creditor's awareness of the debtor's insolvency). Cohen, *supra* note 4, at 418 (proposal to adopt an objective criterion, as in the United States, which disposes of any state of awareness or intention, whether of the debtor, or of the creditor-transferee).

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adjudicate the issue of avoidance of preferences and to apply it in the context of corporate reorganization. Some clarification is required here. Throughout this article, it has been made clear that to date in Israel the legislation in corporate reorganization is limited. It focuses on a limited number of subjects and contains no reference at all to issues such as the status of contracts during reorganization or the avoidance of transactions. This deficiency is particularly conspicuous in view of the abundance of statutory provisions regarding these matters in the parallel contexts of insolvency proceedings, namely bankruptcy and to a lesser extent even in corporate liquidation.[138] And here in one fell swoop, in a single ruling, the court decided in *Diur LeOleh*, to take the obvious step and by way of judicial interpretation it made the legislation pertaining to bankruptcy and liquidation also applicable to reorganization proceedings.[139] The Court identified the similarities between a reorganization case and a liquidation case. Accordingly it was appropriate to determine that the corporate liquidation law regarding avoidable preferences under Section 355 of the Companies Ordinance, should also apply to corporate reorganization. In practice, preference law impugns transfers to creditors made during the three months preceding the filing date of the liquidation application. As such its appropriateness for reorganization cases is evident and the period of three "suspicious" months will be traced back from the filing date of the application for a stay of proceedings order.

The court gave its ruling almost incidentally, without devoting substantive consideration to it, weighing up its pros and cons. In my own view, the case law application of statutory liquidation law to reorganization is almost trivial. Nonetheless, it is interesting to note that the court ruling deviates (by implication) from its entirely different long-standing policy. In 1989, following the economic collapse of the *Ganei Aviv* corporation (which belonged to the corporations group owned by

138. The qualification regarding liquidation is that many of the substantive provisions are actually imported from bankruptcy law. In this regard, *see* A. Procaccia, BANKRUPTCY LAW AND ISRAELI CIVIL LEGISLATION, (Jerusalem, Hebrew U. Press 1984) 245–255 n.10; Hahn *supra* note 10.

139. As the Court stated in the *Diur LeOleh case*, *supra* note 49, para. 8: "To the extent that the arrangement in Section 350 and the new rules is not complete, they can be supplemented from and with the inspiration of liquidation rules in the Companies Ordinance ... the reason for this supplementing is that there is a definite similarity between reorganization and liquidation. The purpose of reorganization proceedings is to save as much as possible of the corporate assets, primarily for the creditors. Occasionally, rehabilitative procedures undertaken within the framework of liquidation culminate with the reorganization of the corporation." In the text below I will clarify why I believe that the court's ruling was both correct and appropriate. However, I am unable to concur with the ruling's justification as just cited. The similarity that enables an analogy with the laws of liquidation and their application to corporate reorganization does not lie in the fact that liquidation proceedings sometimes culminate in corporate reorganization; this is to confuse the symptom with the cause. As explained above (*supra*, Ch II. A), from a historical perspective, liquidation proceedings, and primarily temporary liquidation proceedings, were often adopted for purposes of corporate reorganization in the *absence* of formal reorganization proceedings. In my view, therefore, the analogy is justified because of the substantive similarity between the proceedings. Bankruptcy, corporate liquidation and reorganization are all legal proceedings that are intended to deal with the same economic situation: the debtor's insolvency. The substantive law deals with the economic problem by way of the collective treatment of creditors and confronting the debtor with their rights. This is the factor that is common to all these legal proceedings. The existence of a shared legal structure justifies conducting the analogy between the proceedings and the application of the statutory provisions dealing with liquidation, in a uniform manner, to the other proceedings as well.

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Abraham Gindi) the District Court annulled a land transfer that the corporation had completed just 15 days before it filed for an arrangement under Section 233 of the Companies Ordinance but almost 4.5 months prior to its subsequent filing of the liquidation application.[140] However, the Supreme Court reversed the decision.[141] The formal reason given by the court was that it had not been proved that the transferee was indeed a corporate *creditor*, which by statute was an essential element of an avoidable preference.[142] Nonetheless, in an *obiter dictum* the court also expressed its reservation regarding the District Court ruling that any relation back should be from the date of application for an arrangement, and not from the date of filing for liquidation, as prescribed by the Companies Ordinance.[143] From this we can infer that the court's traditional position was that liquidation law *would not* be applied to alternative legal frameworks, exclusively in reliance on judicial law making. On the other hand, the *Ganei Aviv case* was adjudicated at the end of the 1980s, before the Moratorium Statute, and at that time arrangement or settlement proceedings had yet to receive their concrete statutory expression within the legal framework of reorganization law. It seems to me that in *Diur LeOleh*, the Supreme Court had internalized the legislature's (temporary?) initiative to rely upon the improved proceeding for an arrangement or settlement, *i.e.* supported by a stay of proceedings order, as the basis of all Israeli reorganization law, until the adoption of an original and comprehensive law on the subject. In its ruling in *Diur LeOleh*, the Supreme Court completed the legislative initiative, giving it additional substance in the form of case law. The Supreme Court's judgment represented a departure from its traditional, relatively passive approach in matters of insolvency. The court made the transition from the exclusively declaratory stage in which it extolled the importance of corporate reorganizations, to the stage of practical rulings, providing legal working tools for the management of reorganization files. It seems to me that the courts indeed instituted a revolution in reorganization law, even though rather oddly, it made no declaration to that effect so that one could almost say that it was unintended. Hence, it was the Moratorium Statute that paved the way to the formulation of Israeli corporate reorganization law. The initiative was perfected by the Court, after it had internalized the fact that the Moratorium Statute was not a law of localized scope and applicability but rather a law with a root concept that required an overall development in the laws of corporate reorganization.

The ramifications of the fundamental determination of the Supreme Court in *Diur LeOleh* are far-reaching. First of all, it had a practical affect on the framework

140. *See Ganei Aviv, supra* note 40.
141. *See* L.C.A. 86/89 *Paritzky v. Ganei Aviv Engineering and Construction Ltd (in Liquidation)*, P.D. 43(1) 424.
142. *Id.* at 426.
143. *Id.id.*("The learned judge may have been correct in his view that for purposes of the determining date, Section 98 of the Bankruptcy Ordinance [New Version] takes into account the appointment date of the preliminary liquidator and not the date of the liquidation application (*and regarding that decision, which is in itself problematic, I will not express an opinion*). However, the court was not presented with any evidence by the liquidators that could indicate that the requirements of Section 98 were actually satisfied, for example, that preference had been given to a particular creditor or a person who was a guarantor for his debt" (emphasis added—D.H.).

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of pending reorganization cases. Once the Supreme Court removed all the existing obstacles and extended the application of statutory liquidation laws to reorganization cases, a whole sleuth of technical problems, which had inefficiently drained judicial energy in the context of reorganization proceedings, now received prompt solutions. In other words, the judges are no longer required to waste judicial energy in deciding fundamental questions of whether a particular law or particular provision law rooted in the rules of liquidation is also applicable in reorganization cases. Simply and appropriately—the general answer appears to be yes. Accordingly, the set-off rules that apply in bankruptcy and liquidation would similarly be applicable to reorganization.[144] Yet, somewhat surprisingly, in a recent decision, the Supreme Court hesitated to follow up on *Diur LeOleh*, and held that applying set-off law to reorganization cases should be left to the legislature.[145] By the same token of *Diur LeOleh*, there no longer ought to be any problem in applying the laws of onerous property in reorganization proceedings.[146] This is a matter of particular importance because executory contracts binding the corporation may also fall within the category of onerous property. The assessment of the network of contractual connections binding a corporation in reorganization is of crucial importance. The network of a corporation's contractual relationships plays a decisive role in determining whether or not the corporation is capable of discharging its financial obligations from then on. Furthermore, the broad application of the *Caspi* ruling will enable the application of the ancillary laws in reorganization procedures too. Liquidation laws establish extensive investigative powers which enable the liquidator to ascertain and clarify the history of the corporation, and determine the reasons for its failure.[147] Should the investigations indicate that the corporate managers are responsible for various defects and that they are liable for mismanagement of the corporation, liquidation law enables him to file personal actions against the managers in addition to actions under general corporate law.[148]

144. See Oceanus supra, note 49, (Justice Alsheich ruled that the determinant date for application of special set off date in bankruptcy proceedings is the day of the stay of proceedings order). However, *c.f.* C.A (Naz.) 1095/02 *Dachpor Hagolan v. Pritzker Ventures Ltd*, Tak-Dist. 2002 (1) 1772 (the Stay of Proceedings order does not prevent the exercise of the extra judicial measure of set off in the framework of contracts law, because this order bars a "proceeding that only involves actions in which judicial intervention is required"). It should be noted that Judge Alsheich in the *Oceanus case*, gave a broad interpretation to the laws of corporate reorganization prescribed in Section 350 of the Companies Ordinance, in reliance on the interpretative policy adopted by the Supreme Court in the *Diur LeOleh case*. Judge Alsheich's interpretation constitutes a deviation from her previous interpretation of the Moratorium Statute. A few years ago, she gave the law a restricted interpretation. Adopting the same policy as the Nazareth District Court in *Dachpor HaGolan*, she was only prepared to apply it to proceedings requiring judicial intervention. *See Home Mart, supra* note 77.

145. See C.A. 1698/03 *In re Oceanus Holiday Services Ltd.*, www.court.gov.il (15.7.04).

146. The principal factor in the law of onerous property (Section 360–365 of the Companies Ordinance) allows the liquidator to waive that kind of asset. In the contractual sense, this waiver means "a judicially sanctioned breach". In order to protect the interest of the second party, the case law requires that the liquidator's waiver receive the advance approval of the court (C.A. 673/87 *Salach v. Liquidator Peretz and Issar, Construction and Investments Company Ltd (in liquidation)* 43 (3) P.D. 57). The party aggrieved by the waiver can file an action demanding damages for the breach (Section 365). However, this claim will be an unsecured claim, and the damaged creditor will have to share *pro rata* with the other unsecured creditors.

147. For the investigative powers in liquidation, *see* Sections 223–224, 228–230, 288, 298–299, 314(b) of the Companies Ordinance.

148. See Sections 373 and 374 of the Companies Ordinance.

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Examination of the commercial history of the corporation is an essential component of its reorganization. Absent an understanding of the causes of the corporate failure it is impossible to map out the correct path towards rehabilitation. As such it is appropriate to implement the *Diur LeOleh* ruling in the procedural context too, and to apply all of the auxiliary powers of the liquidator in reorganization procedures too.[149]

Even so it is clear that the unification of insolvency laws in case law does not obviate the need for future legislation in this area. It cannot be disputed that proper and orderly regulation of this broad legal area requires a comprehensive statute, intelligently structured in a way that contributes to legal clarity, certainty and consistency between its various branches.[150] The legislative reform in the area of insolvency is a need that the legislator cannot postpone for much longer.

A second important derivative of *Diur LeOleh* is that the case law largely neutralizes strategic considerations of creditors, debtors and their advocates regarding the case they will utilize. The question of whether to resort to liquidation or reorganization will be less influenced by legal loopholes whatever they may be, that result from the dearth or plethora of legal norms in a particular case. More than in the past, the choice of proceedings will be based on the meritorious considerations regarding the financial situation of the corporation and what the appropriate proceeding is for addressing the particular financial situation.[151]

B. The District Courts

While the problem of commercial insolvency has not been dealt with extensively by the Supreme Court, the District Courts are collapsing under masses of liquidation and reorganization cases. The financial crisis of the past years intensified this process. In reorganization cases judicial decisions require business expertise, the ability to respond promptly to a developing dynamic and extensive involvement in its management. Naturally, this leads to a significantly large number of judicial decisions. Even so, one must remember that a by-product of the nature of the numerous interim applications submitted in reorganization cases, and also of the necessity for a prompt response, is that many of the decisions are brief and unreasoned. However, the collection of reasoned decisions handed down by the District Court judges

149. With respect to *Diur LeOleh*, there is another possible implementation, also prescribed initially in liquidation law. In view of the Supreme Court ruling in *Diur LeOleh* that when the respective purposes of the insolvency procedures are similar they should also be governed by similar laws, I think that the path is clear for case law to deviate from the *ratio decidendi* of *Ganei Aviv*, and to apply the "frandulent conveyance" law prescribed by Section 96 of the Bankruptcy Ordinance to corporate liquidations as well. This would obviate the need to waste valuable judicial time on examining the conditions of "piercing the veil" in order to deal with the phenomenon of smuggling goods out of the insolvent corporation.

150. *See* L.C.A 3126/00 *State of Israel v. E.S.T Project Management and Personnel Ltd.*, Tak-Supr. 2003(2) 108, paras. 6 and 9 of the judgment of Beinish J. and para. 2 of the judgment of Englard J.

151. Even so, these tactical considerations will not totally disappear, even in the current situation. For example, there is a striking difference between application of the stay of proceedings on secured creditors during reorganization, and its non-application during liquidation.

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over the last few years in the area of corporate reorganization is steadily growing. This article is concerned with providing a systematic analysis, from a broad perspective, of the developmental trends in reorganization law in recent years. Accordingly, in that framework, it does not purport to address the specific contents of the many decisions handed down by the District Courts, but rather to point out the tendencies reflected by those decisions which are of fundamental importance in the area. By way of generalization, it would appear that one can identify two prominent trends which highlight the unique contribution of the District Courts to the development of an 'oral law' in Israeli corporate reorganization law during the last few years. The first trend is the formulation of control formats for corporate governance during reorganization, and the second trend is the formulation of new formats for the reorganization plans. Both of these trends will be briefly examined in the order in which they were mentioned.

1. Formats of corporate governance during reorganization: Appointment of a trustee

One of the most fiercely disputed questions in the theory of corporate reorganization concerns the identity of the controlling party in the reorganizing corporation.[152] One view is that the most efficient management of a distressed corporation is achieved if the incumbent management continues to manage the corporation's affairs. This prevents shocks, retains the commercial connections with the suppliers and customers and thereby saves the resources otherwise expended in the learning curve of an external trustee in connection with the reorganizing corporation.[153] The other view is that the incumbent management should be totally replaced during reorganization. This view relies on the following considerations: First, the incumbent management was involved in the corporation's commercial failure. As such it seems neither appropriate nor commercially logical for it to continue in its previous capacity, and it should make way for new leadership, untainted by failure.[154] Secondly there is the fear that the existing management will not manage the corporation and negotiations with creditors regarding the reorganization plan on the basis of relevant considerations, but rather on the basis of the self serving personal interests of the managers. For example, there is the fear that the managers will take actions and make proposals the main purpose of which is to conceal their own mistakes and to exempt them from responsibility for these mistakes.[155]

152. See supra, notes 74 and 75.

153. See P.F. Coogan, R. Broude & H. Glatt, "Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills" 30 BUS. LAW (1975), 1149, 1156; (The authors claim that generally the creditors will prefer the regular corporate governance to that of an external third party); G. G.Triantis, "A Theory of the Regulation of Debtor-in-Possession Financing" 46 VAND. L. REV. (1993) 901–918 (The author contends that the courts prefer the discretion of the management regarding financial decisions that affect the company, because the management has more information and experience). J.S. Bhandari & L.A. Weiss, CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES (Cambridge, Harvard U. Press 1996), in the Foreword by the Honourable Richard A. Posner, (according to Posner, this was the primary objective of the Bankruptcy Code when it prescribed that the management would remain in its position during the reorganization period).

154. Skeel, *supra* note 106.

155. Bradley & Rosenzweig, *supra* note 11; V.S. Armstrong & L.A. Riddick, "Evidence that Differences in Bankruptcy Laws among Countries Affect Equity Returns", available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id = 269709.

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The Moratorium Statute did not adopt a definite position on this issue. It will be recalled that at the outset the legislator adopted a localized initiative in the establishment of the stay order as a way of promoting negotiations towards a settlement or arrangement. The other matters related to the reorganization process were left pending by the legislation for a future and comprehensive reform. Even so, the law did create the 'reorganization period', commencing with the stay of proceedings, and terminating with the confirmation of the reorganization plan. The legislative silence on the question of corporate governance during that time left the matter open for judicial interpretation.[156] The District Court took a definite and uniform approach in the reorganization cases opened since the adoption of the Moratorium Statute. They were not prepared to leave the corporate control in the hands of the existing management. Instead, the courts appointed external managers for reorganizing corporations.[157] The special manager is really the non-twin brother of the trustee in bankruptcy or liquidator. As such the external manager too is a court appointed officer, serving as its extended arm[158] and taking the reigns of corporate control from the hands of the previous management. Even so the practical aspects of his role are broader than those of the trustee in bankruptcy or the average liquidator. The very nature of liquidation proceedings necessitates the continued operation of the corporation as a going concern. Accordingly, the special manager as opposed to the liquidator cannot allow himself to take "time out" from the ongoing management of the corporation. At the same time, concurrently with the ongoing commercial management, the special manager must also undertake special actions in respect of office holders in the insolvent company, *i.e.* he must consolidate the proofs of claims of the various creditors, approve them or reject them, and he must consolidate the estate of the corporate assets. [159] In addition, in contrast to the liquidator who focuses on the realization of assets, the special trustee is required to negotiate with creditors and to formulate a reorganization plan for the corporation. The reorganization plan will consist of the commercial aspects of operating the corporation along with the legal dimension which will deal with the structuring of the creditors' post reorganization rights. The task is thus a highly complex one. [160]

The formal source of the court's power to appoint a trustee has not been adequately clarified. Similarly, the courts have refrained from shedding light on the real motive for choosing the trustee as the preferable alternative to leaving the existing management in control. Even so, there is a possible explanation that provides

156. It will be recalled that this subject was eventually regulated only three years ago, in Rule 14 of the Reorganization Rules, which empowers the court adjudicating the application for a settlement or arrangement to appoint a "trustee" for the corporation.

157. C.App. (Jer) 3070/00 *Teshet—Contracting Building Company v. "Tefahot" Mortgages and Loans Bank Ltd*, Tak-Dist. 2000 (3) 10503, para. 16. (Justice Or presents the alternatives available to Teshet, the second of which is the grant of a stay of proceedings order and the appointment of a special manager); B.F. (Haifa) 486/99 *Shalbana v. Assets Receiver of Asphalt Group Ltd*, Tak-Dist. 2000 (3) 30722, 572; *Raviv Emek Chefer, supra* note 40; *Rondoplass, supra* note 49.

158. *See* B.F.(T.A.) 2043/01 *Peleg v. Gan Oranim Ltd. (in Liquidation)* Tak.-Dist. 2002 (2) 4796, para.11.

159. *See* Cohen, *supra* note 4, at 259–276, 288–294.

160. For a comparison between the qualifying conditions for an trustee, or special manager, and those of the liquidator or receiver, see *supra* notes 27 and 28.

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an answer to these two issues. The explanation is a historical-cultural one. Until the adoption of the Moratorium Statute there was no formal procedure in Israel for handling a financially distressed corporation in which the management would retain its previous functions. The legal order that commenced collective procedures for an insolvent corporation has always involved the replacement of the corporate controller. In liquidations, in receivership and in temporary liquidation, the management was required to vacate its position in favour of an external, court appointed trustee. This was the system with which Israeli judges were familiar. Time-worn work procedures are not "threatening" and are regarded as both appropriate and efficient. When the legislator paved a new path for the reorganization of insolvent corporations without indicating the format of corporate governance, it was only natural for the courts to interpret the vague statute as being consistent with the parallel, recognized insolvency procedures. [161] For as long as the legislator had not indicated that the reorganization proceedings would be subject to a different regime of corporate control, the court chose to adopt the existing control mode that was already accepted in liquidation law. The historical-cultural explanation was expressed in the case of TWA. [162] In that case, a US airline corporation had encountered financial difficulties. In order to solve its problems the corporation filed for Chapter 11 protection in the Delaware Bankruptcy Court. Within that framework the corporation conducted negotiations for its purchase by another American corporation: American Airlines. The acquisition plan that emerged was about to cancel certain TWA routes in different parts of the world, including Israel. This would mean firing the Israeli employees of TWA. The latter applied to the Tel-Aviv District Court and requested the appointment of a local trustee in Israel in order to protect their rights. Judge Alshiech granted their request. Among the considerations for the appointment of the local trustee, she cited the absence of any principal trustee in the main case being conducted in Delaware. In the words of the decision:

> Had a trustee been appointed for this case in the United States, the result might possibly have been different. For in that case this court would have had a counterpart to consult with, as was the case with Tower Air until the issuing of the liquidation order. However, in this case, the Delaware court in the United States (incidentally—in the Tower Air too, it was the Delaware court) granted the stay of proceedings order without appointing a trustee. It would appear that this says it all, or almost all.[163]

161. This note becomes even more interesting in view of the fact that over the years the Supreme Court never conducted a complete comparison between the various formats of insolvency proceedings. Prior to the *Diur leOleh* ruling, the Supreme Court was cautious and the intra-statutory application of insolvency proceedings was only done in accordance with explicit legislative authorization. *See* discussion, *supra* Ch. III.A(2).

162. B.F. (T.A.) 1225/01 *Berman v. Trans World Airlines, Inc.* Tak.Dist. 2001 (1) 29448.

163. *Id.* Further on, in its decision the court adds that in its view "Our concern is definitely not with a liquidation in the United States. This case also has repercussions and influence on the employees here in Israel. I would refer to the proceedings being conducted in the United States as negotiations under deluxe conditions. The American court allows the negotiations between the corporations in a quiet and relaxed environment, without disturbances and thereby allows it to arrive at a successful conclusion".

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In the United States, the standard practice in Chapter 11 proceedings is to leave corporate control in the hands of the existing management.[164] As distinct from liquidation proceedings, in the US courts do not require external trustees in reorganization cases. This represents a different conception of corporate governance. In the view of the Israeli courts on the other hand, a stay of proceedings without a parallel appointment of an external trustee is not a recognized insolvency proceedings, but rather a deluxe framework for conducting negotiations. This example gives paramount expression to the historical-cultural mindset, which took root in Israeli case law and led to the creation *ab initio* of the external trustee for reorganization proceedings.[165]

It thus emerges that District Courts created the management format for reorganization procedures in Israel. The format adopted ensured the conformity of liquidation cases and reorganization cases, and in creating this format the Israeli courts made Israeli reorganization law increasingly similar to the English system.[166] Both systems reject the American Chapter 11 conception of the professional corporate governance being exercised by the previous management.[167]

2. *Formats of reorganization plans: Auctioning the corporation*

The legal proceedings of corporate reorganization have a defined goal—effectuating a reorganization plan. The essence of the procedure is to enable the corporation and its creditors to conduct substantive negotiations, leading to the formulation of a reorganization plan that will be confirmed and binding upon all parties. However, the law does not relate to the contents of the reorganization plan or the question of who is entitled to propose it. Indeed the substance of a reorganization plan is flexible and does not admit of rigid rules and definitions. Its overall goal must be to map out the subsequent commercial activities of the corporation, and as such it will not necessarily be consistent with its commercial activities prior to reorganization. Even regarding its financial aspects, the corporation may outline a reorganization process which diverges significantly from past practice, and quite naturally, the reorganization plan can be formulated in accordance with a broad spectrum of commercial possibilities.[168] The plan may propose the merger of the reorganized corporation with another corporation; the purchase of control of the reorganized

164. *See* Bankruptcy Code § 1107. For the literature explaining this subject's fundamental importance in proceedings under Chapter 11, *see* R.T. Nimmer & R.B. Feinberg, "Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity", 6 BANK. DEV. J. (1989) 1, 20; H.R. Miller, "The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play", 69 AM. BANKR. L. J. (1995) 431, 440–444; E.S. Adams, "Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results" 73 B. U. L. REV. (1993) 581, 592–593.

165. I am not contesting the position adopted by Israeli court. I also support the appointment of an trustee for reorganizing corporations in Israel. However, the substantive justification for this issue goes beyond the parameters of this article (for the justification of the appointment of an trustee, see Hahn, *supra* note 106). My intention here is exclusively to point out the factors behind the Israeli judicial initiative for appointing a trustee during the years of legislative silence on the matter.

166. *See* Insolvency Act, 1986 § 8(2), Sch. B1 § 10.

167. For a comparison of the American and English concepts of corporate governance during reorganization, *see* Hahn, *supra* note 106.

168. Regarding the various business options available in the framework of a reorganization plan, *see* Bankruptcy Code § 1123.

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corporation, not by way of a merger, but rather through a new investor purchasing stock of the corporation; a sale of parts of the corporate business enterprise; or the continued management of the corporation as beforehand by the shareholders and the historical managers. The particular option chosen will necessarily affect the manner of distribution to creditors under the reorganization plan. Plans premised on the investment of new cash are liable to ensure cash payment to the creditors within a relatively short time framework.[169] On the other hand, plans that focus on the restructuring of the creditors' claims will tend to defer payments to creditors over a longer period of time, or to convert the debts into equity rights in the corporation.[170]

The varying content of a proposed reorganization plan precludes the establishment of fixed formats. On the other hand, it is both feasible and desirable that there be a legal determination of the *identity* of the proponent of a reorganization plan, irrespective of its content. The Moratorium Statute does not stipulate who is entitled to file a plan for settlement or an arrangement.[171] In a control regime in which an external trustee is appointed over the corporation, one of his primary roles is the formulation of a reorganization plan.[172] The external trustee is conferred with powers to manage the corporation and to formulate a reorganization plan. He is regarded as an objective factor who is not biased in favour of a particular group of creditors or shareholders. Accordingly, a plan filed in his name will be regarded as relevant and objective and it is no surprise that Israeli courts made a practice of appointing external trustees in reorganization files, equipping them with the powers to formulate reorganization plans and to present them for confirmation.[173]

However, the court was not content with establishing the practice of appointment of an external trustee and authorizing him to formulate a reorganization plan. In addition to the appointment of the external trustee, the District Courts gradually developed an Israeli oral tradition that affected the nature of the actual reorganization plan. The courts' policy is to encourage the auctioning of corporate control as a proceeding that enhances and furthers the process of formulating the reorganization plan that will ultimately be confirmed.[174] An auction is nothing but

169. See T.H. Jackson, "Comment on Baird, 'Revisiting Auctions in Chapter 11'" 36 J. L. & ECON. (1993) 655, 657–658.

170. An outstanding example in Israel of a reorganization plan premised on the conversion of a debt for equity rights is the reorganization of Gilat Satellites, *see* A. Gabai, "Debenture holders of Gilat Satellites approve the reorganization plan; will soon declare a reverse split" GLOBES, 5.2.03 (Hebrew).

171. Section 350(a) of the Companies Ordinance uses the terms "where a settlement or arrangement were proposed", without any provision regarding the identity of the proponent. Surprisingly, the Reorganization Rules too contain no explicit provision in this matter.

172. See Gower, *supra* note 71, at 827–828.

173. Regarding the formulation of the reorganization plan and its presentation for the confirmation by the special manager or trustee, *see Tabor Marble Industries, supra* note 21; C.App. (Haifa) 438/02, 2191, 1452 *Chayal Holdings (1965) Ltd. v. Israel Discount Bank Ltd.* Tak-Dist. 2003 (1) 2209, (The special manager and the trustee formulated a reorganization plan).

174. See, for example, B.F. (T.A.) 1202/02 *Tadir Gan (Metals) Ltd. v. Israel Discount Bank Ltd.* Din—Dist. 33(7) 786; B.F. (T.A.) 1153/02 *Hamashbir LeTzarchan LeYisrael v. Adv. Lipa Meir* (not yet published) (Auction of Zara—Z.M. Fashion Rooms); *Feichtunger, supra*, note 99; B.F. (Haifa) 555/02 *Amitex and Amdau 1991 v. Ofnat Caffe (in temporary liquidation)*, Tak-Dist. 2003 (1) 2962; B.F.(B.S.) 3169/02 *Receiver of Neot Midbar Ltd v. Avisrur Moshe and Sons Construction and Development Works Ltd*, Tak-Dist. 2003 (1) 1322 (hereinafter—*Neot Midbar*).

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a public sale of corporate control.[175] In this public sale, conducted by the external trustee, any commercial entity is entitled to bid on the corporation: a new purchaser, a prereorganization controlling shareholder, or the previous managers of the corporation. By way of auctioning, the courts aspire to maximize the value received for the operations of the corporation as a going concern.[176] Maximization of its value increases distribution to creditors and enables the continued operation of the corporation. In contrast to the realization of a single asset the property which is the subject of an auction proceeding in reorganization cases is the entire corporate estate, in one package deal. In other words, the bidders are competing for purchase of control of an entire going commercial concern. The financing of such proposals is complex. There are cases in which the proponent can finance its proposal from independent sources. In other cases it will finance it by credit, and in still other cases it may request to finance at least part of the consideration in deferred instalments paid over time. It thus emerges that the conduct of an auction does not necessarily require cash consideration to be immediately distributed to creditors. There may be auctions in which a high price is offered for the corporation, but in which the creditors (who are "selling" the corporate assets against the discharge of their claims) are to be paid from future corporate income or by way of an issuing of securities in exchange for their claims against the corporation. In fact, while the courts indeed encourage the auction proceeding as a desirable stage in the framework of corporate reorganization, they do not demand that the bids necessarily be in cash.[177]

In my opinion, the judicial encouragement of the auction proceeding is desirable. It provides a response to the problems of proposing reorganization procedures that are tainted by conflicts of interest, and unfair advantage vested in the historical corporate controlling groups.[178] The publicity of the sale leads to the maximization

175. See C.A. 509/00 *Levi v. Bankruptcy Trustee of Yitzchak Bilu*, 55 (4) P.D. 410, 422–423 (para. 7). This judgment dealt with the foreclosure on a bankrupt's assets, and the court made a distinction between an open auction and a tender (or a sealed-bid auction). Whereas the auction proceeding is public and the competitors' proposals are adjusted in accordance with the competing proposals, in the tender procedure the confidentiality of the proposals is preserved, as a result of which the proposals are fixed and the proponents have no opportunity to improve their proposal. Regarding the auction process within the framework of commercial insolvency proceedings, *see also* in B.A. Markell, "Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations", 44 STAN. L. REV. (1991) 69, 107–116; E.M. Ryland, "Bracing for the 'Failure Broom': Should a Revlon Auction Duty Arise in Chapter 11?" 90 COLUM. L. REV, (1990) 2255, 2271–2276; R.K. Rasmussen & D.A. Skeel, Jr., "The Economic Analysis of Corporate Bankruptcy Law", 3 AM. BANKR. INST. L. REV, (1995) 85, 104–106, 108–109; M. Abramowicz, "The Law-and-Markets Movement", 49 AM. U. L. REV, (1999) 327, 332–335; D.G. Baird, "Revisiting Auctions in Chapter 11" 63 J. L. & ECON (1993) 633.

176. Neot Midbar, *supra* note 174, para.15.

177. On the other hand, in Sweden the law requires that an auction of an insolvent corporation be in cash. *See* B. Espen-Eckbo & K.S. Thorburn, "Overbidding vs. Fire-Sales in Bankruptcy Auctions" available at: http://papers.ssrn.com/sol 3/papers.cfm? abstract_id = 305619.

178. A similar trend developed a few years ago in the case law of the US Supreme Court. Under Chapter 11 the incumbent management, which continues to control the corporation during reorganization, has a 120-day period during which it has the exclusive right to file a reorganization plan. Quite a few of the reorganization plans that were offered left corporate equity in the possession of the historical shareholders, while not allocating equity to the creditors equal to the sum of their debts. The Court put a stop to this practice in its ruling in *Bank of America National Trust and Savings Assoc. v 203 North Lasalle St. Partnership*, 526 U.S. 434 (1999). In this case the court ruled that whenever a plan was filed that allocated equity to the historical shareholders without paying 100% of the creditors' debts, the exclusivity period would be automatically terminated, and the entitlement to file reorganization plans would be open to public competition.

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of value in favour of the creditors and as such ensures the efficiency and fairness of the reorganization. At the same time, the District Court decisions also indicate an appropriate degree of caution and understanding that a particular solution is not necessarily suited to all reorganization cases. Market conditions may periodically change. There are down periods during which there are almost no proposals for purchasing control of corporations in a particular commercial sector.[179] Alternatively, a dearth of proposals may also stem from the unique character of a corporation's activities, in an area with only a limited number of commercial players. In these circumstances the trustee should be allowed to formulate a reorganization plan by way of private negotiations with the corporate creditors.[180] Furthermore, even where a public sale is conducted, the trustee conducting the sale may decide to qualify his undertaking to choose the highest bid. I clarified above that the auctioning of the entire commercial network of a corporation must be distinguished from the auctioning of a single asset. The entire commercial network of a corporation includes its commercial connections with suppliers and customers, its ability to satisfy the qualifying conditions of governmental tenders or particular licences, and the employment of the corporation's employees. Prior to choosing any specific proposal, and in addition to the price criterion, the trustee must also give serious consideration to the various formats of corporate governance being proposed and the way that these formats impact upon the aforementioned considerations. A striking and recent example of this was given last year in the Feichtunger Ltd auction. In this auction the District Court authorized the trustee to reject the highest proposal received for the corporation and to accept the second highest proposal instead. The reason was that the proponents of the second proposal also undertook to continue employing the employees of the corporation, whereas the first proponent refrained from such a commitment.[181]

IV. Summary

In 1995 the Knesset incorporated the Moratorium Statute into the legislation of Israel. The initiative did not merit an extraordinary media response. Nor was there any intention to totally revamp an entire legal area, and in terms of the initial perception of the legislation, it was a far cry from the thunderous effect of the Companies Act in 1999.[182] Nonetheless, this article surveyed the long journey travelled by Israeli reorganization law, from 1995 until today. I showed the tremendous power inhering in one small subsection, which empowered the courts to grant a stay of proceedings order, *i.e.* a temporary injunction against the corporate creditors

179. A. Shleifer & R.W. Vishny, "Liquidation Values and Debt Capacity: A Market Equilibrium Approach", 47 J. FIN, (1992) 1343; P. Aghion, O. Hart & J. Moore, "The Economics of Bankruptcy Reform", 8 J. L. ECON. & ORG., (1992) 523.

180. *Cf*. also *Levi, supra* note 175, at 421.

181. B.F. (T.A.) 1739/02, C.App 18849/02, the case of *Foichtunger Industries Ltd* (*op.slip* 30.10.02) paras. 10–11.

182. In another context I pointed out that the media storm accompanying the adoption of the Companies Act was far more extensive than the substantive changes that were actually introduced by the law as opposed to the law that preceded its adoption. *See* D. Hahn, "Interclass Cramdown in Merger Transactions", MISHPATIM 32 (2002) 419, 420.

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in their entirety. Though initially intended exclusively as a temporary ancillary remedy for financially distressed corporations, in fact it served as a catalyst for the extensive development of Israeli reorganization law. For the first time Israel has a substantial, feasible alternative to the liquidation procedure. Nonetheless, the Moratorium Statute has numerous deficiencies, which were also examined in this article. Despite its importance, given the number of legislative "holes" it occasionally seems that the Israeli legislation was produced by a factory manufacturing Swiss cheese. The law however triggered additional developments—the secondary legislation in 2002 and case law—that sealed up many of the legislative *lacunae*. But these solutions were provided in a piecemeal manner and are effective as temporary, provisional arrangements and not as an ideal legislative creation. It is my hope that I have joined the voice emanating from the Supreme Court imploring the legislature to complete its work and to enact a comprehensive reform of insolvency law, and that this will be the last time that such a plea is necessary.

Apart from emphasizing the tremendous importance attaching to the Moratorium Statute as such, the article also indicated an interesting trend in the development of Israeli insolvency law during the period examined. The article demonstrated the reservation displayed by the Supreme Court in the development of corporate reorganization law until its groundbreaking decision in *Caspi* at the beginning of 2003. The conservative position adopted by the Supreme Court is not characteristic of this institution. In insolvency, it was a legislative initiative that heralded the change in the rules of the game by converting the laws of bankruptcy and corporate insolvency from laws that have exclusive consideration for creditors' rights, into laws that also factor in the debtors' rights together with the creditors rights. The District Courts began to internalize these principles in their rulings in reorganization cases. During the last two years the Supreme Court too became part of the trend and this completes the process.

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