A colonial inheritance

Elias Neocleous and Maria Kyriacou of Andreas Neocleous & Co explain why Cyprus's corporate insolvency regime may, despite its age, offer an attractive legal framework for restructuring

After gaining independence from the UK in 1960, Cyprus enjoyed almost 50 years of uninterrupted prosperity. As a result, its insolvency laws were rarely used, and received little attention. For a time the island appeared unaffected by the global economic crisis of 2008, but the Cypriot banks' significant exposure to the Greek economy and an imbalance in public finances have brought about the first recession and the first significant insolvencies that most people can remember. The number of corporate liquidations in the first half of the last decade averaged 324 per year. In the second half of the decade it rose to 554, and in 2011 it was 1163. For the first 11 months of 2012 the figure was 1137, which would indicate a continued increase. These figures include liquidations of solvent companies, and with more than 250,000 companies on the register they are not substantial, but nevertheless the trend is clear. Having been something of a legal backwater for many years, insolvency is becoming an increasingly important topic. In the following paragraphs we give a brief overview of Cyprus's corporate insolvency regime and some tentative conclusions on its fitness for purpose.

Cypriot insolvency law would be familiar territory for most British practitioners, or at least for those of a certain age. The Companies Law is a legacy of colonial rule, and closely follows the England and Wales Companies Act of 1948. Although it has been extensively added to in order to bring it into line with EU legislation, large sections, including those relating to receivership and liquidation, remain unchanged since before independence.

The Companies Law provides four main procedures for dealing with insolvency, ranging from arrangements and compromises for viable companies with temporary funding problems, to winding up by the court for those whose problems are terminal. In roughly increasing order of rigour and finality they are:

- arrangements under sections 198 to 200 of the Companies Law;
- the appointment of a receiver and manager;
- creditors' voluntary liquidation;
- winding up by the court, often referred to as compulsory liquidation.

The Companies Law also includes a members' voluntary liquidation procedure for the winding up of solvent companies.

"Something of a legal backwater for many years, insolvency is becoming an increasingly important topic"

Sections 198 to 200 of the Companies Law

The procedure under sections 198 to 200 of the Companies Law is appropriate for the financial restructuring of a company which is viable but subject to short-term liquidity problems. It can provide a cram-down and also be used to accomplish mergers and reorganisations of companies, owing to the favourable tax treatment of reorganisations.

The procedure can be used to achieve a compromise or arrangement between a company and its creditors, or between a company and its members, or any class of them. Once

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approved, the arrangement is binding on all the creditors or members, as the case may be, on the company and, in the case of a company being wound up, on the liquidator and contributories.

The procedure is initiated by an application to the court for an order for a meeting of the creditors or members of the company to be convened, in whatever way the court directs, to consider the proposals (section 198, Companies Law). The application may be made by the company, a member or a creditor.

The notices of the meetings sent to creditors and members must be accompanied by a statement explaining the effects of the proposals. This statement must identify any interests of the directors and the effect of the proposals on those interests.

If the arrangement is approved by a majority in number representing 75% in value of the creditors or members present and voting at their respective meetings, and is subsequently sanctioned by the court, it is binding on all creditors or members, as the case may be.

The reorganisation procedure is flexible and fast, and with proper planning, reorganisations can be completed within weeks. It is important to note that the procedure provides no protection from action by creditors and it is important to keep creditors informed and acquiescent.

> "Compulsory liquidation is the nuclear option for creditors"

Receivership

A creditor holding a charge over assets may appoint a receiver to realise the assets subject to the charge, and discharge the debt out of the proceeds. A creditor holding a floating charge over substantially all the assets of the company may appoint a receiver and manager with power to carry on the business. The purpose of receivership is the recovery of the secured creditor's debt. It does not bring the existence of the corporate debtor to an end, as liquidation does, and therefore offers the best chance of the debtor continuing as a going concern. The secured creditor's recovery prospects are entirely determined by the value of the security in relation to the debt.

Debenture holders or other creditors of a company can make an application to the court for the appointment of a receiver. Alternatively, a secured creditor may appoint a receiver under a specific power contained in the charge. The appointment ends the directors' powers of management over the assets subject to the receivership and places them in the hands of the receiver. If the appointment is under a floating charge over substantially all the assets of the company, the receiver must immediately notify the company, which must provide the receiver with a statement of affairs within 14 days, including a statement of all assets and liabilities. The receiver may decide to realise assets piecemeal (for example, if there are sufficient readily realisable assets to discharge the amount payable to the secured creditor) or as a whole.

The receiver's powers and the degree of supervision over him are set out in the document appointing him, which may be a court order or an appointment under a charge. While the appointment of a receiver does not give any protection against recovery actions by creditors, if it is under a crystallised floating charge, the creditor will be unable to enforce any judgment he may obtain.

Once the receiver has repaid the sum due to the appointer (or has concluded that it is uneconomic to continue the receivership), he will account to the appointer and the company, and notify the registrar of companies that he has ceased to act. He is required to submit an account of his aggregate receipts and payments to the appointer, to the company, and to the registrar of companies within two months of ceasing to act.

Creditors' voluntary liquidation

Creditors' voluntary liquidation is the process by which the available assets of an insolvent company are distributed among the creditors and the company's existence is brought to an end. It may also involve investigation into

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His main areas of practice are banking and finance, company matters, international trade, intellectual property, trusts and estate planning and tax. Elias is a founder member of the Cyprus Society of Trust and Estate Practitioners and serves on its committee. He is the honorary secretary of the Limassol Chamber of Commerce and Industry.

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the conduct of persons involved in the company to ascertain the reasons for its demise and their part in it.

The first step in a creditors' voluntary liquidation is the convening of separate meetings of members and creditors. The creditors' meeting must be convened for the same day as the members' meeting, or the following day, and notice of the meeting must be posted to creditors simultaneously with the notice to members, and advertised in the official Gazette and two local newspapers.

The purpose of the members' meeting is to pass a resolution to wind up the company and appoint a liquidator. While a special resolution or an ordinary resolution may be used in certain circumstances, most creditors' voluntary liquidations are initiated by means of an extraordinary resolution that the company cannot, by reason of its liabilities, continue its business, and that it is advisable to wind up. This requires a 75% majority of votes cast at a general meeting, of which notice has been given specifying the intention to propose the resolution as an extraordinary resolution. The appointment of a liquidator may be by ordinary resolution.

The purpose of the meeting of creditors is to present creditors with a statement of the company's financial position and a list of creditors' claims and, if the creditors wish, to nominate a liquidator to act in place of the person appointed by the members and appoint a committee of inspection of up to five persons to assist and oversee the liquidator and fix his remuneration. If the creditors and members nominate different people to act as liquidator, the creditors' wishes will prevail, subject to a right to apply to the court.

The effect of liquidation is to vest the assets in the liquidator as trustee. The company may no longer trade except to the extent required for beneficial realisation of the assets. A creditor who has issued execution against a company's property or has attached any debt due to the company after commencement of the winding up cannot retain the benefit of the execution or attachment against the liquidator in the winding up.

The liquidator has extensive powers, including the right to bring and defend actions on the company's behalf, to continue to trade for the beneficial realisation of assets, to borrow on the security of the company's assets and to do anything else that may be necessary for the purposes of the winding up. He can exercise most of those powers without reference to anyone, although he will need the approval of the committee of inspection if there is one, or of the court for certain matters. The liquidator can also apply to the court to determine any issue or to exercise any of the powers available to the court in a compulsory liquidation.

The liquidator realises the company's assets and distributes the proceeds according to the following statutory order of priority. Within each category of claim, creditors rank equally and abate in equal proportions if there are insufficient funds to pay them in full.

- First, the costs of the winding up.
- Second, the preferential debts, which comprise: (i) all government and local taxes and duties due at the date of liquidation and having become due and payable within 12 months before that date and, in the case of assessed taxes, not exceeding one year's assessment; (ii) all sums due to employees, including wages, up to one year's accrued holiday pay, deductions from wages (such as provident fund contributions) and compensation for injury.

Claims of employees who are shareholders or directors may not rank as preferential depending on the nature of the shareholding or directorship. A person who has advanced funds for the purpose of paying employees will have a subrogated preferential claim to the extent that the employees' direct preferential claims have been diminished because of the advances.

- Third, any amount secured by a floating charge.
- Fourth, the unsecured ordinary creditors.
- Fifth, any deferred debts such as sums due to members in respect of dividends declared but not paid.
- Finally, any share capital of the company. Where there are different classes of share capital, such as preference shares, their respective rankings will be determined by the terms on which they were issued.

Secured creditors are paid out of the proceeds of sale of the assets subject to the charge. If the charge is a floating charge the charge holder ranks behind the preferential creditors. If there is a surplus from the sale of the assets subject to the charge it becomes part of the general pool of assets: if there is a shortfall the creditor concerned will have an unsecured claim for the shortfall.

Liquidations may take several years to complete and separate annual meetings of members and creditors must be held within three months of each anniversary to consider

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Maria served as registrar of companies and official receiver, and registrar of patents, trademarks and copyright between 1989 and 2001. She oversaw the successful harmonisation of Cypriot company and IP law with the acquis communautaire. As official receiver, she conducted and supervised major liquidations, including investigation, identification, tracing and recovery of alienated assets.

Maria is a member of Insol, and has written numerous articles and papers and lectured in Cyprus and abroad on legal, social and political matters, particularly topics relating to the economy, companies, insolvency and intellectual property.

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the conduct of the liquidation and the liquidator's receipts and payments account. Once the liquidation is complete the liquidator convenes final meetings of members and creditors to receive his accounts. Following submission of the reports of the final meetings to the registrar of companies, the company is dissolved and removed from the register.

Compulsory liquidation

Compulsory liquidation is the nuclear option for creditors. The company immediately ceases to trade, the assets are realised and distributed, and the company's existence comes to an end. While the threat of compulsory liquidation may be used as a debt collection tool, if a company actually goes into compulsory liquidation, recovery prospects are slim. Compulsory liquidation also involves investigation into the conduct of persons involved in the company to ascertain the reasons for its demise and their part in it.

The procedure begins with an application (petition) to the court, which may be presented by the company, any creditor (including a contingent or prospective creditor), a member or a contributory.

On hearing the petition, the court may dismiss it, adjourn it, or make any order that it deems fit. If a winding up order is made, the liquidation will be deemed to have commenced at the time of presentation of the petition unless a resolution has previously been passed for a voluntary winding up, in which case liquidation will be deemed to have begun with the passing of the resolution.

There are a number of grounds on which the court will make a winding up order, but overwhelmingly the most common is the company's inability to pay its debts. On the making of a winding up order, the company may no longer trade, except with the approval of the court (or the committee of creditors, if there is one) for the beneficial realisation of assets. No action may be proceeded with, or commenced against, the company except by leave of the court and subject to such terms as the court may impose. Any disposition of the company's property that takes place after the commencement of winding up (which may be some time before the winding up order) and any transfer of shares or alteration in the status of the members of the company after the commencement of winding up will be void unless the court orders otherwise.

All the company's assets vest in the official receiver, a government official, who is responsible for realising them and distributing the proceeds among the creditors. The directors are required to provide the official receiver with a statement of affairs detailing all the company's assets and liabilities, including prospective and contingent assets and liabilities. The official receiver may apply to the court for another person to conduct the liquidation under his direction and will convene meetings of creditors and contributories to ascertain their wishes on this. The official receiver or the liquidator appointed to act in his place will realise the assets, determine the amount of individual claims and distribute any funds in accordance with the statutory priorities set out earlier.

Liquidators in compulsory liquidations have extensive powers to investigate the conduct of persons involved with the company, including the power to apply to the court for the public examination of any officer of the company or anyone involved in its promotion. The court may order the arrest of any person it considers liable to abscond and the seizure of any relevant records.

No legal action or proceeding can be continued or commenced against a company in respect of which a winding up order has been made, or a provisional liquidator has been appointed, except with the leave of the court and subject to such terms as the court may impose. As in a voluntary liquidation, a creditor who has issued execution against a company's property or has attached any debt due to the company after commencement of the winding up cannot retain the benefit of the execution or attachment against the liquidator in the winding up.

Compulsory liquidation is the most formal insolvency process and proceedings generally take several years to complete. Once the assets have been realised and the funds have been distributed, the liquidator may apply to the court for the dissolution of the company. The company is dissolved with effect from the date of the order.

An old-fashioned but effective regime

Given that the Companies Law was introduced more than 60 years ago, Cyprus's corporate insolvency regime looks rather old-fashioned. It is creditor-friendly rather than debtor-friendly and, particularly since the current recession began, questions have arisen as to whether it does enough to promote an enterprise culture. Critics of the law argue that the opportunity should have been taken during prosperous times to put in place a regime that rescues troubled businesses rather than terminates them.

However, this is a simplistic argument, which overlooks the fact that most of the companies on Cyprus's register are not operating companies, but holding and finance companies. Companies that operate locally and that might benefit from a more rescue-oriented regime represent a small minority.

Indeed, it can be argued that the regime, far from being a disadvantage, positively benefits Cyprus as an international business centre. Investors are comfortable with the assurance that operating in an environment with clear, simple and well-tested rules gives them. Courts in Cyprus follow English precedent where no local precedent exists and there is a wealth of such precedent. Investors and lenders can therefore predict the outcome of various scenarios with confidence.

Some people have gone further, and said that Cyprus could provide an attractive environment for main insolvency proceedings in the context of the European Insolvency Regulation. Arrangements and compromises under the Companies Law are a very fast, simple and low cost means of restructuring. Furthermore, the absence of a statutory obligation for management to file for bankruptcy such as exists in Germany facilitates the rescue and restructuring of businesses. The main objective of the French insolvency code is to maintain a going concern and preserve employment, and creditors have little say in the restructuring process. Despite this objective, insolvency proceedings in France are generally regarded as costly and time consuming, and most result in the liquidation of the insolvent company. As was demonstrated in the Daisytek case, where a choice of jurisdiction is available, international practitioners prefer the UK. Cyprus offers the same flexibility as the UK, with lower costs.

While Cyprus's insolvency regime may look old-fashioned, it actually provides a reliable and predictable legal framework, together with and a fast and effective means of restructuring.

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