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Debt Recovery For Creditors And The Law Of Insolvency In Israel

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In connection with its global assignment of recovery and issue ratings, Standard & Poor's Ratings Services has assessed the Israeli insolvency regime as a Group A2 jurisdiction, based on its relative degree of "creditor-friendliness" as defined in Standard & Poor's report titled "Jurisdiction-Specific Adjustments To Recovery And Issue Ratings," published June 20, 2008, and available on Global Credit Portal at www.globalcreditportal.com.

Executive Summary

Israel has a well-developed body of commercial law and an experienced and practical bar, judiciary, and financial service community. Its insolvency regime is, on the whole, "creditor-friendly." Debt recoveries for secured creditors are mostly strong, primarily due to creditors' ability to foreclose on collateral, even during liquidation proceedings. Unsecured creditors usually have a voice in a debtor's insolvency proceedings due to their ability to instigate liquidation proceedings and their right, under certain limitations, of approval of any creditors' arrangement proposed as part of a reorganization. Creditors, including secured creditors (subject to certain conditions described below), are subject to a nine-month extendable stay during reorganization proceedings. While some jurisdictions, particularly in Europe, have amended their insolvency laws in recent years to enhance protections for debtors or creditors, no material reforms are currently expected in Israel.

Introduction

While the creditworthiness of borrowers has always been of paramount concern to creditors, recent developments in the debt markets have put a spotlight on creditors' prospects for recovery of principal and interest after a borrower defaults. These include the deteriorating credit of some major corporate borrowers, the growth of the credit default swap markets, as well as the credit crunch, the implementation of Basel II and Basel III guidelines, pending amendments to the Israeli Companies Law regarding arrangements affecting distressed companies and a planned reform in the bankruptcy proceedings in Israel. From the creditors' perspective, it is no longer only a question of whether a particular borrower will default, but also whether (and to what extent) they will be repaid principal and interest after a default, and how long it will take. Standard & Poor's believes that the key to answering these questions begins with an assessment of how creditors may fare under the particular insolvency regime that has jurisdiction over all or part of the borrower's insolvency proceedings.

Below, we review the distinctive characteristics of Israel's insolvency regime from both a secured and unsecured creditor's perspective and assesses how those characteristics may affect post-default recovery prospects. Standard & Poor's has evaluated the insolvency regimes and prospects for debtor recovery in a number of jurisdictions.

Overview Of Israel's Insolvency Regime

Israeli insolvency law is rooted in English law, though it is increasingly influenced by U.S. bankruptcy practice. The modern Israeli insolvency regime is constructed around the Companies Ordinance (New Version) 5743-1983, the Companies Regulations (Liquidation) 5477-1987, the Bankruptcy Ordinance 1980, and certain provisions of the Companies Law 5759-1999. The Companies Ordinance, together with the Companies Regulations promulgated thereunder, and the Bankruptcy Ordinance govern liquidation and receivership proceedings. The Companies Law governs creditors' arrangements (generally similar to a "plan of reorganization" in Chapter 11 proceedings) in court-supervised reorganization proceedings that are intended to rehabilitate the debtor. During these reorganization proceedings, the court appoints a trustee to manage the company during the stay period and until the recovery plan is approved.

The Israeli system tends to favor creditors' interests at the expense of the debtor and its shareholders, but will also consider other parties' interests, including employees. As such, Standard & Poor's regards the Israeli insolvency regime as being relatively "creditor-friendly."

The Israeli insolvency regime contemplates various scenarios for distressed companies:

- A voluntary liquidation by either the debtor's shareholders (provided that the debtor being liquidated is a solvent entity) or its creditors;
- A court-ordered liquidation;
- A court-supervised voluntary liquidation initiated by the debtor's shareholders or creditors; and
- A reorganization in which the debtor may seek a stay of proceedings while it pursues a recovery plan.

Creditors or shareholders, rather than courts or administrators, initiate the Israeli insolvency process. Once the court appoints a liquidator after its election by the creditors' or shareholders' meetings, that liquidator manages the debtor and the liquidation process. The courts, however, are also involved in the process and review material decisions in most proceedings. In involuntary liquidation or court-supervised voluntary liquidation proceedings, the court will review decisions made by the liquidator. In addition, any interested party may also approach the court seeking instructions or an order in the voluntary liquidation process, and the court may opt to supervise or manage that process.

The district courts in Israel, which rank above magistrates' courts and below the Supreme Court and have jurisdiction over monetary disputes exceeding new Israeli shekel (NIS) 2.5 million (approximately \$700,000) as well as residual jurisdiction over certain issues not in the jurisdiction of any other court, have jurisdiction over a debtor's liquidation, receivership, and reorganization proceedings. The debtor's headquarters or main place of business determines the district in which the case is heard.

The duration of insolvency proceedings varies depending on the court handling the matter and the complexity of the proceedings. Complexity is affected by, among other things, the number of creditors and secured creditors, whether the debtor is still a going concern, the ratio between the total obligations and the assets' value, as well as the assets' shelf life and market conditions.

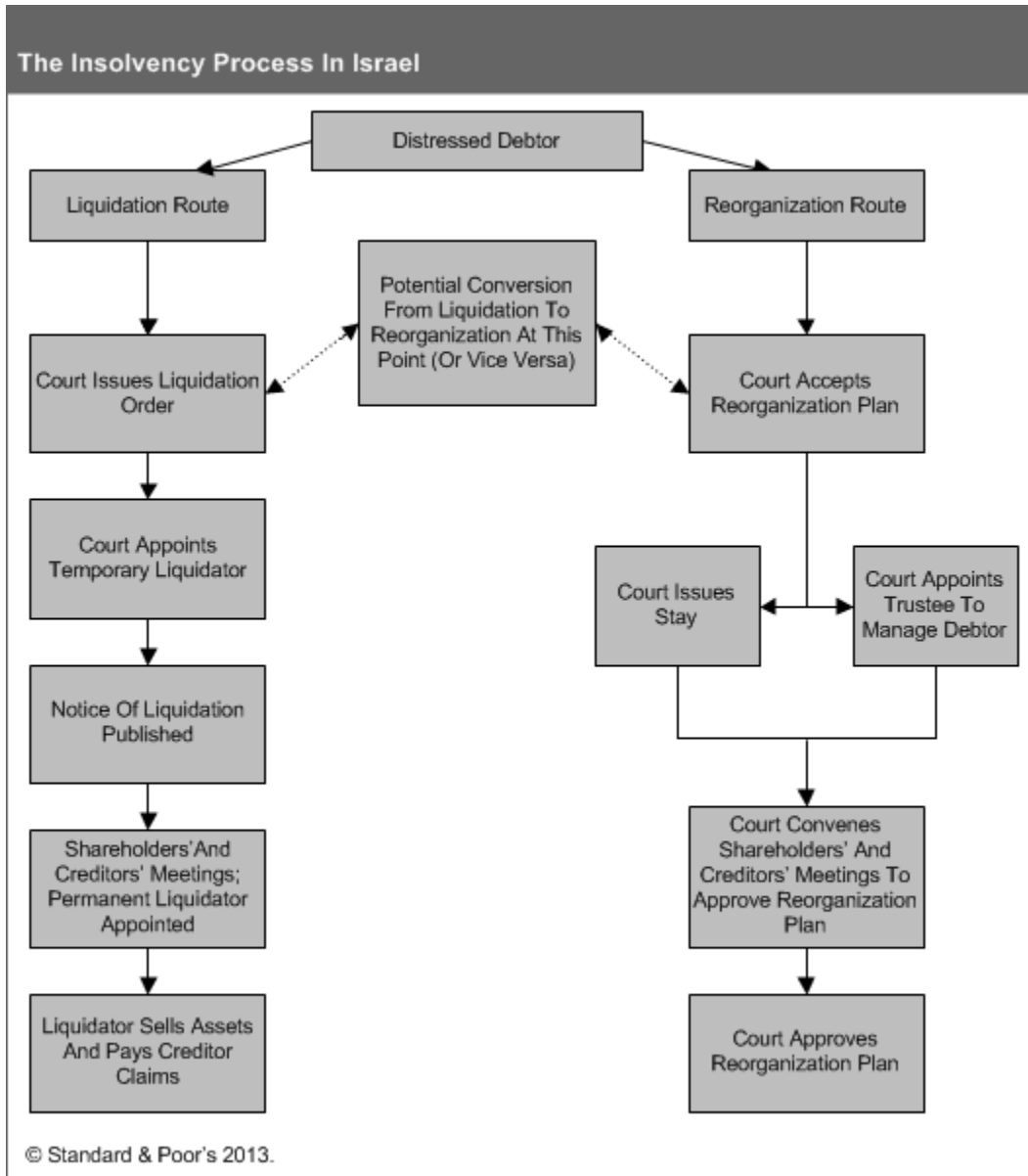
Standard & Poor's believes that the liquidation route is more frequently chosen in Israeli insolvency proceedings than reorganization. In addition, certain aspects of the Israeli reorganization process appear more akin to liquidation than, for example, a Chapter 11-style reorganization (see the Africa Israel Investments, Ace Auto Depot and Pilat Group examples in the Insolvency Experiences In Israel section below).

Similarly, there is no official or unofficial "median" time of bankruptcy proceedings. Standard & Poor's believes, however, that insolvency proceedings, despite prominent examples to the contrary, average more than three years from commencement to conclusion. Finally, actual recovery rates often remain confidential, and the courts or litigants do not typically disclose these rates at the end of insolvency proceedings, though the courts retain discretion to do so.

Process

Liquidation and reorganization proceedings

The chart below illustrates the Israeli insolvency process when involuntary liquidation or reorganization commences: The left side of the chart applies to liquidation only, and the right side applies to reorganization. Involuntary liquidation proceedings may, upon court order, convert to reorganization proceedings, or from reorganization to liquidation when it becomes apparent that a plan cannot be agreed upon.



The court appoints the Official Receiver as the debtor's "temporary liquidator" until the permanent liquidator is appointed following the respective shareholders' and creditors' meetings.

Commencement of liquidation proceedings

Various parties can petition the court to open liquidation proceedings. If the company is "solvent" (that is, able to repay all of its outstanding liabilities within 12 months from the commencement of liquidation, according to its directors' affidavit), its shareholders may commence voluntary liquidation proceedings, during which they will appoint the liquidator. The debtor's creditors, including future or contingent creditors, may also initiate voluntary or involuntary proceedings. Employees, entities liable for the debtor's obligations, the legal adviser to the government, or the Official Receiver may also petition the court to open liquidation proceedings in certain circumstances.

A court-ordered liquidation can be opened when the debtor adopts a special resolution requesting that it be liquidated by the court, when it becomes insolvent, when it ceases its operation for a period of more than a year (or has not commenced operations for more than a year since its incorporation), or when the court deems it is appropriate to liquidate the debtor. Most court-ordered liquidations are brought because the debtor has become insolvent. The court may decline to grant a liquidation order or it may grant other remedies besides a liquidation order. For example, the court may determine that the interests of other third parties, such as the debtor's employees and unsecured creditors, will be better served by a different type of insolvency proceeding, such as a creditors' arrangement (plan of reorganization), if the secured creditors are not materially prejudiced. There are three tests for insolvency under Israeli law:

- The debtor fails to pay its debts as they become due;
- An Execution Office or court order in a creditor's favor remains wholly or partly unsatisfied; or
- The debtor's liabilities exceed its assets such that it is unable to pay its debts.

Winding-up begins on the date that the debtor makes its application to the court, not the date that the court issues its liquidation order.

Appointment of a liquidator

Once involuntary liquidation proceedings are initiated, the court will (typically upon the court's issuance of a liquidation order) appoint an Official Receiver to act as the temporary liquidator until a permanent liquidator is appointed. Shortly after involuntary liquidation proceedings are initiated, a shareholders' and a creditors' meeting are usually convened to elect the permanent liquidator. If different candidates for liquidator are proposed, then the court will appoint the one that the creditors elected.

Once appointed, the liquidator acts in accordance with the court's instructions to realize the debtor's assets and distribute the proceeds among its creditors. Distributions are made after the liquidator has examined the debtor's liabilities and has determined the appropriate distribution priorities under Israeli law, as discussed below.

Receivership

Following a default with respect to a secured debt, a secured creditor may petition a court to appoint a receiver, who is authorized to manage certain assets over which a creditor had a security interest. If security is granted in the form of a floating charge (a type of inchoate security interest over changing assets, such as inventory, that becomes "fixed" on those assets upon a "crystallization" event, such as a default), a receiver may take over all of the debtor's assets and manage its business. During the process of foreclosing on pledged assets, the receiver also acts as an officer of the court. As such, the receiver must consider the interests of all of the debtor's creditors. In practice, this duty is essentially discharged by the liquidator's attempts to maximize the pledged assets' sale proceeds.

Liquidation

In liquidation, the debtor's board of directors' authority is revoked and the liquidator is vested with the board's authority. It is common practice for employees to be dismissed without prejudice to amounts due to them as a result of this termination. In addition, the court will issue a stay order at the commencement of proceedings to prevent other creditors from filing claims before the liquidation order is issued, though this will not prevent secured creditors from exercising charges granted in their favor. At the same time, the court usually appoints a temporary liquidator, who is

responsible for gathering information about the debtor's creditors and its assets, before the court hearing at which the court decides whether to order the liquidation.

Once the court issues a liquidation order or appoints a temporary liquidator, no action may be filed against the debtor without the court's permission.

Following the issuance of the liquidation order, any transaction involving the debtor's assets or any purported transfer of shares is void unless approved by the court. The debtor effectively loses rights of control over its assets and the liquidator becomes responsible for the equitable distribution of the proceeds obtained from the sale or disposition of the assets.

Certain transactions that the debtor entered into before the liquidation proceedings commenced may also be invalidated on the grounds that the transaction was "fraudulent," meaning that a specific creditor was granted a payment preference over other creditors. This invalidation renders the act of payment void, and the liquidator is authorized to demand that any person or entity that received property or money from the debtor return that property or money to the debtor, subject to certain limitations set forth in the law.

Israeli law identifies certain conditions that, together, will cause a transaction to be deemed fraudulent conveyance:

- At the time of the transaction's undertaking, the debtor was unable to pay its obligations as they came due;
- A specific creditor or guarantor was sought, or the transaction was made under illegal duress or solicitation; and
- The transaction was consummated within three months prior to the filing of the liquidation request. In the event of a fraudulent conveyance, the counterparty may be able to sue for damages.

Reorganization

If a debtor or one of its shareholders or creditors, or any class of creditors or shareholders, proposes a settlement as part of a reorganization, these persons or entities, as applicable, may request that the court convene a meeting of creditors or shareholders (or both, if applicable) from such a class, as the case may be, to approve the settlement. In the interim, the court-appointed trustee will take charge of the debtor's affairs and will be responsible for structuring and negotiating the creditors' arrangement.

Amendments to the Companies Law, which came into force in February 2013, make provision for the appointment of an expert to review the terms and conditions of such settlement proposals, in particular, those relating to publicly held debt. The expert's opinion, which is filed with the court, will be available to the debtor, the court-appointed trustee and the creditors prior to any approval of the proposed settlement. In addition, the amended Companies Law requires that any settlement or arrangement be approved not only by the court, but also by a simple majority of the bondholders by represented value of each class (in contrast to the prior 75% requirement).

The court may order a stay of proceedings against the debtor in connection with any reorganization, liquidation, or application for a settlement for an initial period of up to nine months, which, under the amended Companies Law, the court may extend at its discretion for successive three-month periods. The court will issue the stay if it is convinced that it would assist the debtor in preparing or adopting a plan of reorganization. Upon issuance of the stay order, any legal or execution proceeding against the debtor can be initiated or continued only with the court's permission. Under the amended Companies Law, the stay may apply even to third-party-owned assets in the possession of the company

if the court determines that, notwithstanding such third-party ownership, the assets are necessary for the operation of the company's business.

Even upon the issuance of a stay order, however, the court may allow a secured creditor to foreclose on the assets pledged to it. The court may also allow floating charges to be crystallized and foreclosure on assets over which there is a crystallized floating charge. The court will allow foreclosure and crystallization if either the secured creditor could be otherwise harmed, or when the actions would not impede the preparation and adoption of a creditors' arrangement during the stay. During the stay, the court usually appoints a trustee to run the debtor.

It should be noted that a court can issue a stay of proceedings to allow the debtor to prepare or adopt a recovery plan even after liquidation proceedings have already begun. If this procedure fails, the liquidation process may proceed.

Security

In principle, security can be taken over almost all assets in Israel, including real estate, equipment, rentals, receivables, shares, bank accounts and intellectual property. Security charges granted by debtors must be registered with the Registrar of Companies to be enforceable by the secured party against the debtor and other third parties. Certain types of collateral (for example, real estate) may require registration with other entities to be enforceable by the secured party. Realization of security should, subject to certain exceptions, be effected either through the Execution Office or the courts.

Similar to English law, Israeli law also provides for a floating charge over all or most of a debtor's assets. A floating charge crystallizes upon the occurrence of a trigger event, such as a payment default, as stipulated in the floating-charge document. Until then, the debtor is free to transfer the asset in the ordinary course of business. Unless prohibited by the floating-charge document, the debtor may also grant secondary fixed charges over assets subject to the floating charge. It is common lending practice in Israel to prohibit the creation of additional charges on assets already subject to a floating charge without first securing the floating chargees' consent, though this limitation does not apply to charges for securing credit. When a floating charge crystallizes, it attaches to the specific charged assets and, thereafter, the debtor may only transfer the assets with the secured creditor's consent.

During liquidation, secured creditors can enforce their security without delay by appointing a receiver, by court order, to realize the secured assets. The security document will principally regulate the receiver's powers. Where security is taken over the debtor's enterprise as a whole, the receiver will realize the enterprise to satisfy the secured claim, returning excess proceeds to the debtor.

Priority Ranking In Liquidation

A liquidated debtor's assets will be distributed among its creditors (with any excess going to shareholders) based on their seniority. The assets are distributed *pari passu* among all creditors of the same priority class since these creditors have no priority over each other, except that with respect to statutory preferential creditors (such as taxes), employee wages will take priority. However, secured creditors will have priority over all other creditors up to the secured assets'

value. In the event that a secured claim exceeds the pledged assets' value, the excess portion will be treated as unsecured. To the extent a secured claim is less than the pledged assets' value, the court will treat any excess as available to the unsecured claims, pro rata. After the repayment of all of the debtor's outstanding obligations, the remainder of the debtor's assets, if any, is distributed among its shareholders pro rata.

By law, creditors are secured, unsecured, or "statutorily preferred." Secured creditors, as described below, take priority over all others. The following sets forth de facto payment priorities in liquidation proceedings:

- Creditors secured by fixed charges up to the value of the assets underlying the charges;
- Liquidation fees and expenses, certain taxes on land secured by statutory first lien, and claims secured by contractual liens;
- Statutory preferential creditors up to a certain cap (employees' salaries, municipal taxes, fees due to the Companies Registrar, and rent);
- Creditors secured by a floating charge; and
- Unsecured creditors.

Financial Assistance And Guarantees

There is no general limitation on guarantees provided by subsidiaries. Upstream guarantees may be deemed fraudulent conveyances depending on the conditions in which they are granted. Thus, if the subsidiary is unable to pay its debts as they fall due, if the guaranty was entered into for the purpose of preferring particular creditors or guarantors, and if it was consummated within three months prior to the instigation of insolvency proceedings, the guaranty payment may be held to be a fraudulent conveyance. The primary defense to a fraudulent conveyance action is to show the guaranty has a genuine business purpose and that it was not given to prefer particular creditors or guarantors.

Consolidation

As in many other jurisdictions, a parent debtor or other true owner may, under certain exceptional circumstances, become liable for its subsidiary's obligations under the legal concept known as "piercing the corporate veil." However, as is the case in common law jurisdictions, Israeli courts are slow to disregard a debtor's separate legal personality.

Creditors' Rights

Secured creditors are relatively well protected in Israel. Secured creditors can take security by fixed and floating charges over a debtor's assets, in addition to other forms of security. While a stay granted in furtherance of reorganization may result in a payment delay to secured creditors, that delay is relatively short compared with certain debtor-friendly jurisdictions. From a debt recovery standpoint, the limited nature of the stay allows Israel's insolvency system to compare favorably with other creditor-friendly jurisdictions.

The debtor, any secured or unsecured creditor, conditional or future creditors, any current shareholder or other equity owner of the debtor, and any such owner of the debtor within the year prior to the initiation of liquidation proceedings, may petition to have the debtor put into liquidation. Secured creditors may also file a petition requesting the

appointment of a receiver. In receivership, a court may only confirm the receiver's proposals if it is satisfied that the proposals are fair and equitable in relation to every class of creditors that did not accept the proposals, and that these proposals are not unfairly prejudicial. Unlike certain other jurisdictions, creditors also have the ability to appoint a liquidator in a creditor's voluntary liquidation, provided that the debtor's directors have not submitted a solvency declaration.

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Insolvency Experiences In Israel

The following three experiences are examples of the debt recovery of creditors and the insolvency process in Israel.

Africa Israel Investments Ltd.

Africa Israel Investments Ltd. (AFI) is an international holding and investment group of several private and public companies active in real estate, construction, infrastructure, manufacturing, tourism and leisure.

On Nov. 6, 2009, AFI proposed a debt rescheduling with its various creditors. Within the framework of this arrangement, which was completed in May 2010, outstanding debt of NIS7.4 billion was reduced to NIS4.4 billion, and bondholders received two new bond series valued at NIS3.4 billion. By May 2013, one of these series had been repaid, early, while the other series is due to be repaid by 2025.

The bondholders also received NIS1.2 billion in shares in AFI's subsidiaries, and NIS1.4 billion in AFI shares (which reflected a total market value of the company of NIS2 billion).

On Jan. 1, 2013, AFI completed an exchange offer of bonds par value NIS1.5 billion.

Ace Auto Depot Ltd.

Ace Auto Depot Ltd. (Ace) is a publicly owned chain of stores selling do-it-yourself products. Ace commenced insolvency proceedings on Jan. 18, 2012, with debts of NIS452 million, owed mostly to its bondholders (Series A).

The District Court in Petach Tikva granted Ace petition, imposed a stay of proceedings until September, and appointed two trustees to run Ace's businesses during the insolvency process. On Feb. 13, 2012, Electra Consumer Products Ltd. offered to buy part of Ace's activities, and the offer was approved by the court on Feb. 22, and by the Anti-Trust Commissioner, with limitations, on March 8. On March 12, 2012, the trustees filed a request for liquidation of the company to the court, and on May 9, the court issued Ace's liquidation order. The liquidation procedure is still in process.

Pilat Group Ltd.

Pilat Group Ltd., formerly Pilat Technologies Ltd., is a publicly owned, human-resource holdings company. Among its subsidiaries are Pilat (North America) Inc., Pilat Europe, Pilat Israel Ltd., Pilat Guidance of Conventions and Events, and Pilat Holdings (1986). On August 16, 2012, 34 out of Pilat Israel's 110 employees filed a petition to begin insolvency proceedings with the Tel Aviv District Court. On August 22, the court appointed a temporary liquidator to Pilat Israel. On August 29, 2012, Pilat Group Ltd. filed for a stay of proceedings in order to reach a debt recovery

arrangement with its creditors. On Nov. 14, 2012, the court ordered Pilat Israel's liquidation and on Feb. 26, 2013, the court approved Pilat Israel's creditors' arrangement.

The company's outstanding debts total NIS5.3 million.

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