The Restructuring Review

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Chapter 6

CYPRUS

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I OVERVIEW OF 2007/2008 RESTRUCTURING AND INSOLVENCY ACTIVITY

i Liquidity and state of the financial markets

The economic crisis that commenced in the US has spread to the European Union, of which Cyprus is a member. To date, the effect on the Cyprus economy has been negligible and cannot in any way be characterised as critical.

Local business remains relatively untouched by the turbulence in the world's financial markets, with confidence still high in the local banks, and there is little indication of imminent job cuts.

The local banks have not invested in toxic debt abroad, and both banks and cooperatives rely on depositors from households and SMEs (small and medium-sized enterprises), and do not have to resort to inter-bank borrowing. Local financial institutions also generally have capital adequacy and high profitability.

The Cyprus banking system follows conservative and traditional practices and has been criticised in the past for lacking 'sophistication' by not investing in novel structured products. Local banks' lending is primarily asset-based, usually supported by mortgages on real property as collateral.

House prices remain at more or less the same levels as last year due to the small size of the island, the great demand and limited availability, particularly along the coastline.

Irrespective of the above positive note for 2008, it is anticipated that in the first six months of 2009, the tourism sector and the construction industry will be affected, as a great deal of demand in these sectors comes from overseas.

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ii Market trends, techniques and statistics

Like other jurisdictions, in Cyprus, restructurings, even though not extensively used, are mainly concluded on an informal out-of-court basis, as this method can be faster and avoids bureaucracy.

The official figures published by the Department of the Registrar of Companies and the Official Receiver, comparing the registration of new companies and the number of companies going into compulsory or voluntary liquidation, are instructive.

The number of company compulsory liquidations continues a downwards trend, being only 95 in the first 10 months of 2008 compared with 141 in 2007 and 140 in 2006 and 158 in 2005.

The number of company voluntary liquidations was only about 190 in the first 10 months of 2008, compared to 200 in 2007; 205 in 2006; and 206 in 2005. Of these 190 voluntary liquidations in 2008, the vast majority were members' voluntary liquidations and only five were creditors' voluntary liquidations.

The number of new company registrations reached 29,016 in 2007, compared with 20,280 in 2006 and 14,494 in 2005. From January to October 2008, 20,000 new companies have been registered. Generally there is a higher number of new companies registered towards the end of the year, so this year's figure for the year as a whole is expected to be as high as last year's.

Irrespective of the international credit crunch, the number of companies going into liquidation compared to the number of companies registered is extremely low.

The industry that has been most affected by the credit crunch is the construction industry, with three small construction companies going into liquidation in 2008, which nevertheless has not affected property prices in the market. Property prices remain stable at the moment but demand has dropped by 40 to 50 per cent for second homes, whereas there is no change for primary residential homes.

II GENERAL INTRODUCTION TO THE RESTRUCTURING AND INSOLVENCY LEGAL FRAMEWORK

The Cyprus Companies Law – creditor-friendly

Both restructuring and winding-up fall under the Companies Law, which is based on the UK Companies Act of 1948 with the necessary amendments to incorporate the relevant EU Directives. The sections referring to reconstruction and corporate insolvency, winding up voluntarily or compulsorily, registration and enforcement of charges and appointment of liquidators or receivers and managers remain basically the same, with the exception of the incorporation of the Third Council Directive on mergers and division of public companies.

The Companies Law generally favours creditors and clearly defines the collection, liquidation and distribution of proceeds to the creditors, and the remainder, if any, to the contributories.

In practice, banks, when lending to companies, take as security fixed and floating charges over the company's assets, undertaking and goodwill, together with personal guarantees from all the directors of the company. The directors' personal guarantees are a shield against mismanagement and possible alienation of company assets.

In the event of default, the holder of a floating charge may appoint a receiver and manager to take over the company and sell it, preferably as a going concern. The receiver and manager has wide powers to cease operations or continue the management of the company or may sell the business as a going concern or dispose of the assets, in the best possible manner for the benefit of the chargeholder appointing him.

The holder of the floating charge ranks in priority after the administration expenses of the receiver and manager, followed by any prior mortgages, and prior fixed charges, followed by preferential creditors (government and municipal taxes and salaries) that rank in priority under the law.

A 'rescue culture' as such, has not developed extensively in Cyprus, as companies in distress usually either renegotiate financing with their bankers or even attempt to obtain private loans, or issue share capital to finance new projects.

Formal insolvency and restructuring procedures available for companies

i Arrangements and reconstructions

The company will usually agree to an informal arrangement with its creditors before any reorganisation occurs or before entering the formal procedures.

Pursuant to Section 198 of the Companies Law, where a compromise or arrangement is proposed between a company and its creditors or between the company and its members or any class of them, the court may, on application by the company or any creditor or member or, in the case of a company being wound up, by the liquidator, order a meeting of the creditors or of the members of the company to be summoned in such a way as the court directs. At this meeting, any compromise or arrangement passed by a majority in number representing three-quarters in value of the creditors or members present and voting will be binding on all the creditors or members and also on the company. In the case of a company being wound up, this will also be binding on the liquidator and contributories of the company.

In order to be binding, the order of the court must be delivered to the Registrar of Companies for registration and a copy of every order must be annexed to every copy of the memorandum of the company issued after the order has been made. If no memorandum exists, then a copy of every order must be attached to every copy of the instrument comprising or defining the constitution of the company.

In harmonisation with the Third Council Directive 78/855/EEC, the procedure for reorganisations of public companies through merger or division by acquisition of a company and merger or division by the formation of a new company are specifically provided for in the Companies Law. These provisions include, *inter alia*, an operation whereby a company is wound up without going into liquidation and transfers to another existing company all of its assets and liabilities in exchange for the issue to the shareholders shares of the latter acquiring company and any cash payment; also the acquisition of one company by another that holds 90 per cent or more of its shares; or where several companies are wound up without going into liquidation and transfer to a company that they establish for the purpose all their assets and liabilities in exchange for the issue to their shareholders of shares in the new company. Alternatively a company may, without going into liquidation, transfer to more than one existing company all of its property, assets and liabilities in exchange for the allocation to the shareholders of the

company being divided, of shares in the companies receiving contributions as a result of the division and possibly an agreed cash payment.

ii Winding-up proceedings

Part V of the Companies Law sets out the circumstances under which a company may be wound up by compulsory or voluntarily liquidation, or subject to the supervision of the court:

a compulsory liquidation – a company may be wound up by the court usually on the petition of a creditor in the event that it is unable to pay its debts, or if the court is of the opinion and it is just and equitable that the company shall be wound up, or in a number of other specialised circumstances. A company is deemed unable to pay its debts where a creditor to whom the company is indebted for a sum exceeding €854.30 has applied for payment and the company has neglected to pay, or if it is proved to the satisfaction of the court that the company is unable to pay its debts, taking into account the contingent and prospective liabilities of the company;

b voluntary liquidation – a company may be wound up voluntarily when the period fixed for the duration of the company by the articles of association of the company expires, or an event occurs, on the occurrence of which the articles of association provide that the company is to be dissolved, and the company has in general meeting passed a resolution requiring the company to be wound up voluntarily. A company may also be wound up voluntarily if the company resolves this by special or extraordinary resolution to the effect that it cannot by reason of its liabilities continue its business, and that it is advisable to be wound up. A notice of any such resolution must be given by advertisement in the Official Gazette. Voluntary winding-up may be a members' voluntary winding-up, or a creditors' voluntary winding-up. Members' voluntary winding-up is available only to companies that are not insolvent: the directors of the company must make a statutory declaration of solvency. If the directors are unable to make such a declaration, the winding-up is a creditors' voluntary winding-up, where the liquidator appointed by the members may be replaced by a liquidator chosen by the creditors; and

c by supervision of the court – a company may be wound up subject to the supervision of the court, where, after having passed a resolution for voluntary winding-up, the court makes an order that the voluntary winding-up shall continue subject to such supervision of the court as the court thinks just.

Informal methods to restructure companies in financial difficulties

A company finding itself in serious financial difficulties, despite having good future growth prospects, may seek to put into place informal arrangements with its major creditors in order to remain a 'going concern'. This could entail the renegotiation of financing usually made on more rigorous terms, or the company may enter into a 'sale and lease back' agreement selling the company's premises, e.g., factory or offices, and then leasing it back. This will give the company more liquidity as it will sell a major asset but at the same time, through a long term lease agreement, retain use of its property as

before. Strategic investors or new business partners may also buy a stake in the company's shareholding.

Other laws relevant to insolvency and restructuring

i Taking and enforcement of security

The security most commonly granted over immoveable property is the legal mortgage. A legal mortgage is a charge over the mortgaged property in favour of the lender until full repayment of the loan or the performance of some other obligation. Mortgages or other charges over immoveable property must be registered with the Department of Lands and Surveys and with the Registrar of Companies if the borrower is a company.

The security devices for moveables are liens, pledges and floating charges.

A lien may be legal under common law or equitable. The common law lien is the right to retain possession of property belonging to another person until a debt has been paid. A common law lien lasts only so long as possession is retained but an equitable lien exists independent of possession.

A pledge is the bailment of goods as security for payment of a debt or performance of a promise. The lender has the power to sell in the event of default by the borrower but the general ownership of the goods remains with the borrower. The pledge must be in writing, duly signed and witnessed by two witnesses.

A floating charge is a security interest, generally over all of the assets of a company, which 'floats' until an event of default occurs or until the company goes into compulsory liquidation, at which time the floating charge crystallises and attaches to all the relevant assets. It gives the secured creditor two key remedies in the event of default: (i) the creditor may crystallise the charge, and then realise any assets subject to the charge as if it was a fixed charge; or (ii) if the floating charge encompasses substantially all of the assets and undertaking of the company, the charge holder may appoint a receiver to take control of the business with a view to discharging the debt out of income or selling off the entire business as a going concern.

In general, secured creditors are not affected by a winding-up order and they can realise their security outside the insolvency proceedings if the instrument by which the charge is created or evidenced is duly stamped and delivered to the Registrar of Companies for registration in the company's file.

ii Duties of directors of companies in financial difficulties

When a winding-up order is issued or a resolution for winding-up is passed, the powers of the directors cease and the liquidator takes over. The directors must submit to the liquidator a statement of affairs of the company. The liquidator, in performing his duties, will examine the directors' conduct at the time when the company was carrying on business.

In a compulsory liquidation, the winding-up is deemed to commence at the time of the presentation of the petition to the court and derivative action may be brought against a director for any wrongful acts.

In general, if the directors act honestly for the benefit of the company they represent, they discharge their legal duty and are not themselves liable, even in the case of their own negligent mismanagement.

Exceptions to the general immunity of the directors are the following: the directors are personally liable if they sign a document in their personal capacity and not in the company's name, or without the authority of the company; directors may be jointly liable with the company, where for example they personally guarantee a company loan; directors have statutory liabilities that may be enforced against them during the company's winding-up.

Statutory liabilities of directors include the following: where the director has incurred secret profits; improper payment by a director to a promoter; where a director has applied the company's assets for an *ultra vires* or illegal object; where dividends have been paid out of capital; where there has been a fraudulent preference or a sale of the company's assets at under value; and in certain circumstances, where directors have sold their personal property to the company at an excessive price.

Under the Companies Law, criminal offences that may be committed by a director before or in the course of winding-up include the following: if the director is bankrupt, failing to keep proper books of account throughout the period of two years immediately preceding the commencement of winding-up; failing to disclose and deliver property and books to the liquidator; concealing, destroying, mutilating or falsifying any book or document; fraudulently altering any documents; and attempting to account for any part of the property of the company by fictitious losses or expenses.

During winding-up, the most serious statutory responsibility of the directors is in relation to fraudulent trading. The Companies Law interprets fraudulent trading very widely to protect creditors and to pierce the corporate veil. Fraudulent trading, in accordance with the law, can be enforced if, in the course of a winding-up of a company, it appears that any business of the company has been carried on with intent to defraud creditors or for any fraudulent purpose, whereupon the court may declare that any of the directors who were knowingly parties to the fraud shall be personally responsible for all or any of the debts of the company. The law covers past and present directors and *de facto* controllers of the company's business who were taking an active part in the management of the company during the period of fraudulent trading. Where a director is found liable, he cannot set off against that liability any debt owed to him by the company. Under the law, fraudulent trading is also a criminal offence as well as a civil offence. As the standard of proof for fraudulent trading is high, successful actions for fraudulent trading are rare.

Also a director of a company in liquidation may face disqualification by the court, and may not be allowed to be appointed director for a specific period not exceeding five years.

iii 'Claw-back actions'

Further to the above, under the Companies Law, certain transactions entered into within six months prior to the commencement of the winding-up of the company are deemed invalid.

Any conveyance, charge, including a floating charge, mortgage, delivery of goods, payment, execution or other act relating to property made or done by or against the company, to the preference of a creditor at a time when the company was unable to pay its debts, shall be deemed to be a fraudulent transaction and is invalid. Further, any

conveyance or assignment by a company of all its property to trustees for the benefit of its creditors is void.

The Fraudulent Transfers Avoidance Law, Cap 62, also provides that every gift, sale, pledge, mortgage or other transfer or disposal of any moveable or immoveable property made by any person with intent to hinder or delay his creditors or any of them in recovering from him, their debts shall be deemed to be fraudulent, and shall be invalid as against such creditor or creditors.

III RECENT LEGAL DEVELOPMENTS

Recent legislative developments

Winding up under the Companies Law has remained broadly the same for the last few years. However, there have been a number of major amendments (either in the Companies Law or in other legislative instruments) to facilitate restructuring or to improve the position of otherwise unsecured creditors or employees, as follows:

a the Social Security Law No. 41 of 1980, as amended, protects employees of companies in liquidation, and, together with the Companies Law, gives priority of payment, as a preferential debt, to salaries, sums or benefits owed to an employee and any sum withheld by the employer from the employee's salary for the payment of any debts owed to the employee, or any amount that the employer has not paid;

b in the Companies Law, a new case of winding-up has been introduced, in the case where an SE fails to maintain its head office and registered office in the same member state;

c also under the Companies Law, any company that fails to file any statutory document with the Registrar as required under the law may be struck off the Register of Companies as it is considered that it is not carrying on business;

d under the Law for the Protection of Employees against the Insolvency of their Employer, a special fund has been established under the Social Security Department which compensates the employees in the event of insolvency;

e under the Cyprus banking laws, a Deposit Protection Fund has been established since 2000. The Fund constitutes a separate legal entity. It provides protection and pays compensation to depositors in the case that a bank is unable to pay the deposits to its customers. The amount of compensation, which is currently set at €20,000, is expected to increase to €100,000 following the announcement of the Minister of Finance in October 2008;

f under the Investment Firms Law, two separate compensation funds were established, one for clients of investment firms and one for clients of credit institutions which offer investment services, to secure the claims of clients through the payment of compensation in the event of the financial insolvency of the investment or credit institution; and

g most business transactions in Cyprus are settled by cheque rather than by credit cards or bank transfers. To minimise the likelihood of non-payment or dishonoured cheques, a Central Information Register ('CIR') was established in 2003 to tackle the serious problem of dishonoured cheques undermining the

reliability of business and trading transactions, with negative repercussions for the economy. A person or a company is recorded in the CIR if over 12 months they have issued three dishonoured cheques (or fewer than three if their combined value exceeds €1,700). Once a person or company is recorded in the CIR, all the accounts in all banks and cooperatives, of that person or company are frozen and all unissued cheques are claimed back. To be deregistered, all dishonoured cheques must be honoured. The CIR has helped the market regain trust but also it has helped as a deterrent for borrowers from going from one bank to another seeking credit as all banks and cooperatives coordinate over this.

Case law

i Commercial morality

In considering whether to issue a winding-up order, the court takes into account the creditors' numerical majority as well as majority in value but the latter carries greater weight. Opposing creditors should state the reasons for their opposition. The court will investigate whether their reasons are good, e.g., if there was a fair, possible and reasonable chance of obtaining payment without winding-up. Where, however, there are special circumstances rendering a winding-up desirable an order will be made in spite of their opposition. An order will be made where the majority view is clearly erroneous or inspired by personal benefit. Where the opposition comes from creditors of a different class, e.g., secured creditors, the court may prefer the wishes of the unsecured creditors since in some cases refusal of the order will deprive them of what is virtually their only remedy. The court is invested with a wide jurisdiction in the interests of 'commercial morality'.[1]

ii Meaning of 'creditor'

Regarding the meaning of creditor, in *Loukos Manufacturers Ltd*,[2] it was held that the word creditor has a very wide meaning, and can be any person, as long as the amount of credit owed can be determined, including the Director of Social Insurance.

iii Powers of directors

In *Mariou Lazarou v Antoni Koumettou and others*,[3] it was held that the powers of the directors and representatives of the company cease to exist after a winding-up order, and any disposition by the company of its property made between the commencement of the winding-up and the order for winding-up shall be void, unless the court otherwise orders. The law in this sense aims to obstruct the officers of the company from improperly disposing or alienating assets of the company after an application for the issue of a winding-up order has been filed.

1 *A&P Fokas Ltd v AKC Development Ltd*, Civil Appeal No. 11186, 21 May 2003.

2 Application No. 109/1998, 30 November 1998 and Civil Appeal No. 10373, 13 June 2000.

3 Civil Appeal No. 11352, 25 February 2003.

iv Court proceedings after winding-up order

Once an application for a winding-up has been filed, no legal action or proceeding can be commenced or proceeded with against the company except by leave of the court. This aims to provide protection to the creditors and the property of the company, to ensure the equal payment of the creditors of the same class and to obstruct certain creditors from gaining advantages through any proceedings. In the cases of *Andrea I Tsaggari v. Makedonias Gavriilidou and others*[4] and *Stefanos & Andreas Cold Stores Trading Ltd v. Company of Soft Drinks Kean Ltd*,[5] it was held that the court with authority to grant permission for the continuance or initiation of proceedings against a company in liquidation is the court that issued the winding-up order.

IV SIGNIFICANT TRANSACTIONS AND HOT INDUSTRIES

Acquisitions and takeovers have proved beneficial for Cyprus companies given that foreign investors are often sophisticated institutional investors with vast knowledge of the stock and credit markets who are in a position to make available their technical know-how as well as open up new markets to local companies and add new clients to their roster.

i Cyprus College – (European University)

In 2005, Laureate Education Inc, a network of private accredited academic institutions worldwide, acquired a 45 per cent interest in Cyprus College, one of the oldest private colleges in Cyprus. Laureate Education strengthened the College both technically and academically, and at the same time have widened its academic presence.

ii Arab Bank plc

In 2007, Piraeus Group (Piraeus Bank Cyprus) obtained approval to operate a banking institution in Cyprus by acquiring Arab Bank in January 2008. Arab Bank had a network of four branches in Cyprus with 105 employees to its workforce. Its portfolio included loans of €126 million and deposits of €246 million. The objective of Piraeus Bank Cyprus in acquiring Arab Bank was to develop and establish itself as a powerful financial organisation in the greater geographical region. The price for this objective was €15 million, which included the acquisition of a landmark building in the centre of Nicosia.

The deal meant that Arab Bank effectively terminated all of its operations and withdrew from the Cyprus market with only five employees (top management team) being made redundant. The Bank has thrived in the Cyprus market since the acquisition, with deposits increasing to €800 million, loans to €260 million, a network of 15 branches and 260 employees.

Aside from the unanticipated difficulties an acquisition may carry, today Piraeus Bank leads a group of companies covering all financial and banking activities in the Greek

4 Application No. 88/1998, 18 March 1999.

5 Civil Appeal No. 9515, 25 September 1998.

market with particular know-how in the areas of retail banking, small and medium-sized enterprises ('SMEs'), capital markets and investment banking, leasing and financing of the shipping sector.

iii Cyprus Development Bank

The Cyprus Development Bank ('CDB') was established in 1963 as a public company to promote economic development in Cyprus. Its main shareholders were the Republic of Cyprus and the European Investment Bank. The government sold its controlling share in the CDB to a consortium of high-profile investors for €75 million. Just over 88 per cent of the proceeds went to the state and the remaining 11.99 per cent to the European Investment Bank to cover its stake in the CDB. There had been a previous plan to sell CDB to Greece's Piraeus Bank but the deal fell through.

V INTERNATIONAL

Since the accession of Cyprus to the EU on 1 May 2004, EU Regulation No. 1346/2000, on cross-border insolvency proceedings has been in force, thus providing the possibility of opening secondary local insolvency proceedings in another Member State where the debtor has an establishment or assets.

Various attempts at international cooperation on cross-border insolvency procedures have established that a foreign judgment cannot affect the insolvency provisions of another state.

Under the Judgments of Foreign Courts (Recognition, Registration and Execution by Treaty) Law (Law 121(I) of 2000), a foreign judgment may be recognised and enforced in Cyprus where there is a binding bilateral treaty between Cyprus and the country in which the judgment was delivered or where Cyprus is bound by any multilateral convention to which it is a signatory.

EU regulations and bilateral agreements are used as tools for cooperation and a foreign judgment cannot substitute automatically a national court. An application for registration of a foreign judgment may be made *ex parte*, accompanied by an affidavit in support which should exhibit a certified copy of the judgment (authenticated by its seal) and a duly certified Greek translation of the judgment. The judgment creditor may choose to have the judgment registered either in the District Court where the debtor resides or where any property to which the judgment relates is situated.

In general Cyprus courts will enforce a foreign judgment provided, *inter alia*, that:

a the judgment has been given by a court which has jurisdiction in accordance with Cypriot rules in the conflict of laws;

b the judgment has not been obtained by fraud; and

c the proceedings which led to the issue of the judgment were not contrary to natural justice.

A judgment of a foreign court obtained by fraud, either on the part of the court or on the part of the party seeking to enforce it, will not be recognised.

The foreign court proceedings must conform to the foreign procedural law and in any event must respect the basic procedural principles of due process as reflected in local procedural law.

Legislation based on the UNCITRAL Model Law on cross-border insolvency has not been adopted in Cyprus as yet.

VI OUTLOOK

Changes in banking regulations and related legislation are considered to comply with Basel II Accord provisions, regarding the Banks and credit institutions.

A law has been drafted and is awaiting approval by the Council of Ministers to streamline the sale of mortgaged property.

New proposals to strengthen corporate governance, transparency and deal with conflicts of interest of directors are also in the pipeline.

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Maria Kyriacou is partner and head of the Nicosia office of Andreas Neocleous & Co LLC. She is a barrister-at-law of the Inns of Court (Middle Temple), London (1971) and was admitted to the Cyprus Bar in 1974.

Maria Kyriacou served as the Cyprus Registrar of Companies and Official Receiver, Registrar of Patents, Trade Marks and Copyright between 1989 and 2001 and oversaw the successful harmonisation of Cyprus company and intellectual property law with the *acquis communautaire*, taking part in negotiations with the European Union.

As Official Receiver, Maria has dealt with and overseen major liquidations, including investigation, identification, and tracing of assets in the biggest winding-up cases (construction, banking, mining, and insurance) and has successfully claimed back alienated assets.

Maria has written numerous articles and papers and lectured in Cyprus and abroad on a wide spectrum of legal, social and political matters, in particular topics relating to the economy, companies, insolvency, trademarks, patents and copyright.

Maria Kyriacou has been a member of the Cyprus Parliament since 2001. She is Secretary of the House and deputy chairperson of the House standing committee on trade, industry and tourism, a member of the House standing committees on financial and budgetary affairs, a member of the agricultural committee and coordinator of the labour and social insurance committee in the House for the Democratic Rally Party.

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