UNITED
NATIONS

EP

United Nations
Environment
Programme

Distr.
LIMITED

UNEP/OzL.Pro/ExCom/25/7
25 June 1998

ORIGINAL: ENGLISH

EXECUTIVE COMMITTEE OF
THE MULTILATERAL FUND FOR THE
IMPLEMENTATION OF THE MONTREAL PROTOCOL
Twenty-fifth Meeting
Montreal, 29-31 July 1998

PROJECT IMPLEMENTATION DELAYS: BANKRUPTCY

Background

1. The issue of enterprises with Multilateral Fund-assisted projects going bankrupt was raised at the Fourth Meeting of the Sub-Committee on Monitoring, Evaluation and Finance in March 1998 in the discussion of implementation delays of approved projects. A decision was adopted by the Executive Committee to "request the Secretariat to analyze specific types of delays, such as bankruptcy, with the implementing agencies and present a paper on the subject to its next meeting." (Decision 24/7(c)). The specific cases of bankruptcy reported by the implementing agencies to the Secretariat are listed below.

Cases of Bankruptcies

2. UNDP presented the following cases:

(a) Brazil: MACFORM:

The enterprise completed the ODS phase-out, the certificate of completion was signed in September 1997. Most costs including incremental operating costs and part of contingency costs were disbursed. Subsequent to that, the enterprise declared bankruptcy. However, <u>UNDP legally still owns the equipment</u> <u>since it has not signed the Hand-Over Protocol. Of the US $243,500 grant, US $206,679 was disbursed by end of 1997</u>.

(b) Peru: INLENSA:

The enterprise experienced financial crisis and declared bankruptcy shortly after the refrigeration equipment was delivered and installed in June 1997. However, the <u>Government of Peru temporarily "repossessed" the delivered equipment</u>. <u>Of the project budget of US $201,443, US $44,284 had already been disbursed. The Government has requested time to try and find a solution to this problem.</u>

(c) Sri Lanka: GLACIO:

The enterprise is now fully bankrupt as a result of a prolonged labour strike. <u>A court recently ruled that the Multilateral Fund equipment which had been delivered to the enterprise but had remained unpacked on the premises could be retrieved by UNDP/UNOPS. Of the project budget of US $239,500, US $162,105 had been already disbursed</u>.

3. UNIDO presented the following cases:

(a) In 1996, UNIDO received retroactive funding for a Brazilian enterprise which went bankrupt before UNIDO disbursed the money. The funds are withheld by UNIDO.

(b) Another Brazilian enterprise (also approved in 1996) went bankrupt and was subsequently sold to a Canadian firm. UNIDO suspended the bidding and withheld funding.

4. The World Bank presented the following case:

(a) Real Value, an Indian enterprise engaged in the production of fire extinguishers, had its project approved in 1995 which contained a retroactive funding component. The Bank was informed in Oct. 1996 that liquidation proceedings were initiated against Real Value Group by its creditors. The World Bank is withholding disbursement and wants to cancel the project in accordance with its regular practice. However, the Government of India requested the Bank to put the project on hold rather than cancel the project since 80% of the conversion is already completed.

5. Before addressing the above-mentioned specific cases, the issue of how bankruptcy impacts ODS phase-out and the assets of the Multilateral Fund is elaborated below.

Bankruptcy and Phase-Out

6. The bankruptcy of a Multilateral Fund-assisted enterprise may give rise to one of the following outcomes:

(a) Cessation of production due to the total liquidation of the enterprise's assets;
(b) Continuation of production under the same ownership (protection from debtors); or
(c) Continuation of production under new ownership (take-over).

7. While the legal implication of these outcomes is not the subject of this paper, their impact on ODS phase-out needs to be assessed as follows:

(a) Under the "cessation of production due to total liquidation" outcome, irrespective of the stage of implementation of the project be it completed or otherwise, ODS phase-out is achieved through bankruptcy because production, whether ODS-based or ODS-free, is discontinued. The project should be canceled.

(b) Under the outcome of ownership transfer, the stage of project completion is a deciding factor. If bankruptcy and the subsequent takeover by a new owner take place after the project is completed, that is production has already shifted to a non-ODS based technology and key ODS-based equipment has been rendered unusable, the objective of the Multilateral Fund-assisted project will have been achieved if the new ownership continues with ODS-free production.

(c) If bankruptcy and subsequent takeover take place before project completion, the new owner may have inherited the ODS-based production. Under such circumstances, the action required varies depending on the disposition of the new owner with regard to commitment to the ODS phase-out. If the new owner is committed to completing the project and the phase-out of the ODS as committed by the previous owner, the government concerned should arrange that the responsible implementing agency work with the new owner and complete the project. If the new owner does not intend to complete the project, the project should be canceled.

(d) If bankruptcy is declared by the original owners for protection reasons prior to project completion, the project should be canceled. If, on the other hand, the project was completed before that, the phase-out will have been accomplished.

Protecting the Assets of the Multilateral Fund

8. Under any of the outcomes discussed previously, bankruptcy results in the transfer or freezing of Multilateral Fund assets. In the case of an enterprise with a Multilateral Fund-assisted project, transfer or freezing of assets could involve those assets which legally belong to the Multilateral Fund.

9. Depending on its modus operandi, an implementing agency enters into different legal arrangement with the enterprise which governs, *inter alia*, the ownership of the assets of the Multilateral Fund.

The United Nations Agencies (UNIDO, UNDP, UNEP)

10. In their legal agreements with the Executive Committee, the United Nations Agencies have a standard clause on Ownership and Disposal of Property, which states:

> "Ownership of equipment supplies and other property financed from the contribution shall vest in UNDP (UNIDO & UNEP) for the duration of the specific project or programme activity. Following the completion of the above specified project or programme activity, ownership shall be transferred to the appropriate institution or agency in the recipient country in accordance with the relevant policies and procedures of UNDP (UNIDO & UNEP), taking into

account recommendations that may be received from the Chief Officer of the Fund Secretariat."

11. UNDP/UNOPS provides this interpretation of the clause:

" 1) Before signature of Hand-Over Protocol (HOP), UNDP/UNOPS retains title (ownership) of the equipment. UNDP/UNOPS only accords the right of use. Therefore, before HOP, the equipment can not be included in the official "estate" of the recipient company and can not be legally impounded.

2) After signature of Hand-Over Protocol (HOP), UNDP/UNOPS transfers title, rights, ownership and liabilities to the recipient company. As of that date, the equipment belongs to the recipient company which then has the sole responsibility for the use or otherwise of their equipment.

The HOP specifies that the company commits itself not to use CFCs any more and that it accepts that the Ozone Office verifies this fact at any time."

12. Under this general legal framework, the treatment of the assets of the Multilateral Fund in the event of bankruptcy is differentiated below.

Total Liquidation

13. Under total liquidation, the post versus the pre-Hand Over Protocol (HOP) from the UN agencies to the bankrupt enterprise differentiates as follows.

(a) Post-handover:

If bankruptcy takes place after the handover, the assets of the bankrupt enterprise paid for by the Multilateral Fund belong to the enterprise;

(b) Pre-handover:

If bankruptcy takes place before the handover, the assets remain the property of the Multilateral Fund and should not be liquidated as part of the assets of the enterprise. The project should be canceled and the remaining funds returned to the Multilateral Fund. Apart from those expenditures where cost recovery is impossible (expenditures in civil engineering, training and other unretrievable items), all other assets paid for by the Fund, (equipment, compressors and chemicals) should come into possession by the government under caretaking for transfer to other similar projects in the country if any, or in neighbouring countries.

Ownership Transfer

14. Under the ownership transfer (takeover) where production is resumed under a new ownership, if bankruptcy and the subsequent takeover happens after signing the HOP, the implementing agencies/ozone office concerned should monitor the performance of the enterprise to ensure sustainability of the new production over a period of one year.

15. If the bankruptcy and the subsequent takeover happens before signing the HOP, the implementing agency should ensure that the new owner is committed to ODS phase-out and the continuation of ODS-free production. Decision 19/38 on change of ownership should be applied if the takeover is by a non-Article 5 entity. If the new owner, for whatever reason, does not intend to complete the project as designed, the project should be canceled and the remaining funds returned to the Multilateral Fund. Apart from those expenditures where cost recovery is impossible (expenditures in civil engineering, training and other unretrievable items), all other assets paid for by the Fund, (equipment, compressors and chemicals) should come into possession by the government under caretaking for transfer to other similar projects in the country if any or in neighboring countries.

Bankruptcy for Protection Reasons

16. If such bankruptcy is declared before official handover of ownership protocol, the commitment of the enterprise owner to completing the project as designed should be ensured. If the owner is still committed to the project objective and schedule, the implementing agencies should complete the project as planned. If, however, the owner does not intend to complete the project as designed, the project should be canceled and the remaining funds returned to the Multilateral Fund. Apart from those expenditures where cost recovery is impossible (expenditures in civil engineering, training and other unretrievable items), all other assets paid for by the Fund, (equipment, compressors and chemicals) should come into possession by the government under caretaking for transfer to other similar projects in the country if any or in neighbouring countries.

17. If bankruptcy happens after the official handover from the UN agency, the assets paid for by the Multilateral Fund belong to the enterprise.

The World Bank

18. Unlike the agreements of the United Nations Agencies with the Executive Committee, the agreement of the World Bank with the Executive Committee does not contain an explicit clause governing the ownership and disposal of properties of the Multilateral Fund. However, the World Bank operates on a different set of disbursement procedures.

19. First, the Bank procedure requires a financial appraisal of the recipient enterprise to determine its financial viability prior to disbursement to the project. Under this procedure, an enterprise which is assessed as not financially viable is disqualified for disbursement from the Multilateral Fund and this is also reflected in the agreement between the World Bank financial intermediary in the country and the recipient enterprise. For instance in the case of Real Value of India, the agreement between the World Bank's financial intermediary and the enterprise states, "A beneficiary voluntarily or involuntarily becoming the subject of proceedings under any bankruptcy or insolvency law is a ground for cancellation of the grant." This disbursement procedure could serve as an up-front safeguard against bankruptcy by the enterprise before disbursement takes place.

20. Second, according to the disbursement procedure of the World Bank the recipient enterprise is reimbursed for the expenditures it incurs in implementing the project. This post-factual disbursement serves as another safeguard against a loss of the assets of the Multilateral Fund because even if the recipient enterprise passes the financial appraisal but has gone bankrupt afterwards, disbursement could be terminated once bankruptcy is known, thereby reducing further loss on the assets of the Multilateral Fund.

21. However, once disbursement takes place against expenditure under the World Bank disbursement procedure, it cannot be recovered. It is highly important that the World Bank and its financial intermediary in the country maintain a high degree of vigilance in project monitoring.

Conclusion

22. It can be seen from the analysis in the preceding paragraphs that if an enterprise which is implementing an ODS phase-out project financed by the Multilateral Fund goes into bankruptcy, this may cause disruption to the achievement of the ODS phase-out committed by the enterprise. Since bankruptcy in most cases involves the transfer of assets, protecting the assets of the enterprise and those of the Multilateral Fund in the event of bankruptcy should also be properly dealt with. A balance has to be maintained between ensuring that ODS phase-out is achievable and protecting the legitimate interests of the Multilateral Fund.

23. In dealing with the event of bankruptcy, the United Nation Agencies and the World Bank follow different financial/disbursement procedures as dictated by internal policies and modes of operation. While it is not known whether any side could change to accommodate the operating procedures of the other side, each side has its own rationale and advantages. The World Bank procedure tends to emphasize the up-front safeguard against the event of bankruptcy before it takes place, but loses claim over the assets of the Multilateral Fund once disbursement has been effected. On the other hand, United Nations Agencies have a clear-cut, legal procedure to protect the ownership of the Multilateral Fund assets; however, it works on a post-factual basis and may represent a potentially lengthy legal situation in order to recuperate the funds.

24. Based on the analysis in this paper, the following recommendations are proposed for consideration by the Executive Committee.

Recommendations

25. Disbursement to the project should immediately discontinue once it becomes known that an enterprise with a Multilateral Fund-assisted project is experiencing financial difficulties that might lead to bankruptcy. The Ozone Offices/financial intermediaries should monitor the situation and report to the implementing agencies and government concerned.

26. In view of the liquidity of the incremental operating costs whose recovery may cause inconvenience in the event of bankruptcy, the implementing agencies should withhold disbursement of such assets until such a time as it is operationally required.

27. A project should be canceled and all the remaining funds should be returned to the Multilateral Fund in the following cases:

(a) If the bankrupt enterprise enters into total liquidation and this takes place before the official handover from the implementing agency;

(b) If under ownership transfer, the new owner does not intend to complete the project; and

(c) If bankruptcy is declared for the purpose of protection and this takes place before the handover and the owner does not intend to complete the project as designed.

28. In all the three cases, and apart from those expenditures where cost recovery is impossible (expenditures in civil engineering, training and other unretrievable items), all other assets paid for by the Fund, (equipment, compressors and chemicals) should come into possession by the government under caretaking for transfer to other similar projects in the country if any, or in neighboring countries.

29. If bankruptcy led to change in ownership before signing of the Hand Over Protocol and the new owner is committed to completing the ODS phase-out, the implementing agencies should work with the new owner and complete the project, bearing in mind Executive Committee Decision 19/38 on change of ownership.

30. The UN agencies should consider including in their legal agreements with the recipient enterprises provisions against bankruptcy.

31. In light of the above recommendations, the specific cases of bankrupt enterprises reported by the implementing agencies could be addressed as follows:

UNDP:

32. In the case of the MACFORM project in Brazil, the project should be canceled and remaining funds returned to the Fund. Apart from the sunk costs incurred, the government should possess the assets of the Multilateral Fund for caretaking and transfer them to another project in the country with the instructions of the Executive Committee.

33. However UNDP raised the following issues:

"(a) Before bankruptcy, the enterprise fully converted and stopped using ODS. The certificate of completion was signed. While it is true that UNDP still has legal title to the equipment since the HOP was not signed, this could then become a court case with the enterprise or the its creditors arguing that MACFORM successfully completed the conversion and thus fulfilled the objectives of the Multilateral Fund project. The fact that a legality has not been completed - the signing of the HOP - may not be considered a sufficient justification by a court to take back the equipment and order the enterprise to pay back all monies received.

(b) If the Executive Committee does indeed decide in this case to legally repossess the equipment, it could involve a lengthy court battle. The Executive Committee would have to set up a procedure to handle these situations since neither UNDP nor UNOPS is geared to argue and defend in such bankruptcy proceedings. Court costs - lawyers, fees, travel. etc. - could run to substantial amounts, potentially far more than the cost of the project. The Executive Committee would have to make provisions to cover these costs since they are not part of regular project and programme implementation.

(c) We have received recent information that MACFORM may be bought by another enterprise which is already implementing an ODS phase out project with UNDP. If this is the case, the problem would be resolved in one of the options mentioned in the paper."

34. In the case of INLENSA project in Peru, the project should be canceled and the remaining funds returned to the Multilateral Fund. The equipment which is being possessed by the government should be transferred to another project with the instruction from the Executive Committee

35. However UNDP raised the following issues:

"(a) The Government has always felt that the company will recover and both UNOPS and the Government have been working with the company to see if some solution can be found.

(b) If the Government can not resolve the situation and INLENSA either remains bankrupt or is not taken over by another owner, the refrigeration equipment which was temporarily repossessed by the Government can be sold or possibly used in another project. Unfortunately, UNDP has already delivered the equipment for all its projects in Peru and the only option is a similar type project possibly in Brazil."

36. In the case of the GLACIO project in Sri Lanka, the project should be canceled and the remaining funds returned to the Fund. The equipment delivered should be possessed by the Government for transfer to another in the country with instruction from the Executive Committee.

37. However UNDP raised the following issues:

"(a) A competitor company which has completed its ODS phaseout with UNDP and which has taken over the market share of GLACIO wants to purchase the machine at a fraction of its cost;

(b) There is no other small domestic refrigeration enterprise in the surrounding countries for which UNDP has to order equipment. If the equipment can be placed in another project in a distant country, shipping costs may be high. UNOPS is working with UNDP and the national ozone unit to determine what should be done."

UNIDO:

38. The two cases from UNIDO should be dealt with by canceling the projects and returning the funds to the Multilateral Fund.

WORLD BANK:

39. The World Bank should cancel the project according to the legal agreement which the Financial Intermediary entered into with the enterprise and return the funds to the Multilateral Fund.