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Book Review

Pre-Insolvency Proceedings: A Normative Foundation and Framework

Nicolaes Tollenaar

By Dr Jennifer L. L. Gant[1]

European insolvency and restructuring law has undergone significant reforms over the last twenty years, in particular since the financial crisis of 2007/08. National reforms among the Member States are now being supplemented with what could only be described as a radical reform aimed at giving companies a much earlier window to engage in restructuring in order to prevent ultimate corporate failure. The EU has drawn from well-used examples in the UK and the USA, relying heavily on the latter in its design of a preventive restructuring framework for implementation throughout the EU. However, while borrowing ideas from other legal systems can sometimes result in a good and well-used set of rules, legal transplants can also have unforeseen consequences.[2]

The Preventive Restructuring Directive[3] should come into force imminently at the time that this review is written. The publication of *Pre-Insolvency Proceedings: A Normative Foundation and Framework*[4] by Nicolaes Tollenaar is a timely piece that indeed provides a normative foundation and framework for preventive restructuring generally, but that also comments on the purpose, practicality and ultimately the fairness of such frameworks. By examining both the US Chapter 11 procedure and the UK's Scheme of Arrangement, he critically interrogates the viability of both frameworks as preventive restructuring procedures as well as their relative 'fairness' to creditors within the normative framework of the creditor's bargain theory, though the author is also highly critical of that theoretical paradigm. The result is a framework for preventive restructuring that takes into accounts the faults and advantages of Chapter 11 and the Scheme of Arrangement, along with the author's solution to some of these faults, that goes beyond a recommendation to the current progress toward a preventive restructuring framework in the EU to a nuanced design supported by highly critical analysis and reason that could form the basis for future reforms. It could be that Tollenaar has foreseen the problems that the current suggested framework for the EU will have and has already provided potential solutions.

Key Concepts and Distinctions

One important distinction to note is that reorganisation has been defined in this book as a sale of the business to the creditors who still have an economic interest because all claims and shares in the company, which is the way in which 'in-the-money' creditors would be repaid in a restructuring, gives them the entitlement to the entire value of the business.[5] This is a key underpinning definition for the framework that Tollenaar presents at the end. In addition, liquidation is defined as including both the piece-meal sale of a business as well as the sale of a going concern, which is clearly influenced by the

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[2] See for example Pierre Legrand, 'The Impossibility of Legal Transplants' (1997) 4 Maastricht J Eur & Comp L 111 and Helen Xanthaki, 'Legal Transplants in Legislation: defusing the trap' (2008) 57(3) ICLQ 659.

[3] At time of writing, the current most recent iteration of the Preventive Restructuring Directive is the Parliamentary version following first reading and awaiting Member State input from 28 March 2019: Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency, and discharge procedures and amending Directive 2012/30/EU (COM(2016)0723 – C8-0475/2016 – 2016.0359(COD)) ("Preventive Restructuring Directive").

[4] Nicolaes Tollenaar, *Pre-Insolvency Proceedings: A Normative Foundation and Framework* (Oxford University Press 2019).

[5] *idem*, 17.

Dutch insolvency law framework in which business transfers are made through a liquidation procedure. This allows the author to draw a clear distinction between restructuring as only a collective debt enforcement mechanism, and other forms of business rescue, which do not necessarily have to take place outside of a liquidation procedure, conceptually.[6]

Another key distinction that influences the framework later produced by Tollenaar is the distinction between cash and payment in kind, which as explained with great detail and reason are not identical and interchangeable. In short, by equating cash and non-cash payments in a restructuring plan, issues of liquidity and risk have been overlooked.[7] This affects how he decides to treat dissenting classes of 'in-the-money' creditors in a cram-down situation as it is unlikely in an *ex ante* position that a creditor would accept a repayment that might not amount to the cash value he would otherwise receive, which would therefore be contrary to the creditors bargain.

Also, critically, the author submits that a preventive restructuring framework that affects a creditors' contractual rights should not be available unless the debtor is in a state of insolvency or pre-insolvency, the latter of which the author defines as a type of insolvency where such a state is imminent and assessable. Otherwise, the problem addressed by collective procedures is not present, i.e. avoiding the race to enforcement to the detriment of the creditors as a whole. Without the trigger of enforcement actions associated with at least an imminent insolvent state, an impairment of creditors' rights is not justified. The author predicates this submission upon a slightly adjusted normative framework derived from the creditors' bargain theory.[8]

The Creditor's Bargain (or Not)

The creditors' bargain theory is based a hypothetical Rawlsian type of *ex ante* bargain in which creditors would consent to a system that sacrifices their individual enforcement rights for a collective enforcement procedure that effectively would increase returns to the collective of creditors overall, safeguard an efficient distribution, and to avoid unnecessary costs.[9] Tollenaar refines this by saying that:-

> "a sufficient justification for a restructuring system can be found if and to the extent that all constituencies benefit from the system, or at least that no subgroup can be identified that is worse off under the restructuring than without" [10]

This refinement is based on a Pareto efficiency standard[11] in that no subgroup may be worse off with a proposed measure than it would be without it. No party would enter into a transaction by choice if its utility were diminished relative to a viable alternative.[12]

Tollenaar presents an interesting and well-formulated justification for his version of the creditors' bargain theory, however, this author sees it differently. Given the context of Rawls' Theory of Justice[13] from which the creditors' bargain theory is derived, Rawls would likely take a different approach. He would take all of the *stakeholders* that might be affected by a company's insolvency, not only those

[6] *idem*, 47-47, 253.
[7] *idem*, 26.
[8] See for example T H Jackson, *The Logic and Limits of Bankruptcy* (Beard Books 2001); T H Jackson, 'Bankruptcy, non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91(5) YLJ 857; D G Baird and T H Jackson, 'Corporate Reorganisations and the Treatment of Diverse Ownership Rights: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 U Chi L Rev 97; and T J Jackson and R E Scott, 'On the Nature of Bankruptcy: An Essay of Bankruptcy Sharing and the Creditors' Bargain' (1989) 75 Va L Rev 155.
[9] Tollenaar (n 4) 13.
[10] *idem*, 253.
[11] See R Cooter and T Ulen, *Law and Economics* (Addison-Wesley 2008) 17.
[12] Tollenaar (n 4) 24.
[13] See J Rawls, *A Theory of Justice* (HUP 1971).

with contractual relationships (creditors)[14] to decide on the fairest insolvency system. It is not just creditors who are affected – employees could be made redundant; environmental ills could remain uncured; and there could be unforeseen consequences for communities. Taken from the Rawlsian perspective, these additional groups would also have a say in how their interests would be dealt with in an insolvency or restructuring procedure, which would lead to a system that considers more than the priority rights of contractual creditors. Further, these individual stakeholders would not know what type of stakeholder they would be in reality, so it is unlikely they would decide on a framework that considers only contractual entitlements as creditors.

While Tollenaar acknowledges that in a true Rawlsian hypothetical situation would likely settle on a stakeholders' bargain theory for a full insolvency system, rather than just creditors', he contends that a pre-insolvency plan does not extend beyond that of a collective enforcement mechanism and that therefore other stakeholders do not need to be considered. This author does not fully agree with this assessment, particularly given that a plan could also impact employees if redundancies are also envisaged, but the normative foundation the author has chosen to underpin his reasoning certainly produces a sound argument, regardless of whether this author is in agreement with those foundations.

What is a "Cram-Down" Anyway? Fairness in Assessing Value

Tollenaar takes an inspired look at the mechanisms of the cram-down common to some restructuring frameworks. Firstly, he states that in its basic form, a plan is merely a mechanism for democratic decision making as the participants can take a majority decision to approve a plan that affects their rights.[15] Within a single class of creditors, a cram-down does not occur conceptually because the class is simply bound by the majority vote. A true cram down occurs only when a whole class has voted against a plan, in which case their adherence to it can no longer be described as democratic as only a court can then force the class to abide by the plan.[16] This is often termed a "cross-class cram-down", but in Tollenaar's estimation is the only real cram-down that occurs outside of democratic intra-class decision-making where it is simply that the majority rules. This particular discussion in the book offered a conceptual clarification that is most welcome to a process that is described in a number of ways in different jurisdictions that terminologically can be the cause of much confusion.

In addition to a useful simplification of the idea of the cram-down, one of the key conclusions of the work is that a restructuring framework should not interfere with, but should respect, pre-existing priority rights and be unbiased in distribution. One might view this as axiomatic for an insolvency law framework generally, but with the added complication of Tollenaar's view of the difference between cash and payments in kind in a restructuring plan, it becomes difficult to justify the latter, particularly in the context of a cram-down in which dissenting classes have been denied their consent to a plan. There is a fundamental flaw in equating payment in cash to payment in non-cash (equity) instruments. Cash value is set while non-cash value must be sold on the market, which is subject to fluctuations and risk. As such, a dissenting class may not actually find themselves in a position that is no worse off than if there was no plan at all depending on the manner in which they are being paid[17] and the valuations up which those payments in kind are based.

Tollenaar spends a full chapter on how value should be assessed. This came with a helpful disclaimer about the complexity of the chapter and the limited scope within which it could be described in the current work, and while the topic is somewhat impenetrable to a mere lawyer, the author clearly has an

[14] Tollenaar (n 4) 18-19.
[15] *idem,* 81.
[16] *idem,* 96.
[17] *idem,* 65.

excellent grasp of the concept and relays in in the most accessible fashion likely available on the subject. The tome would not have been complete without this highly technical discussion.[18]

Plans, Schemes, and Arrangements, and Criticisms

Two chapters are dedicated to the US Chapter 11 procedure and the UK Schemes of Arrangement respectively (Chapters 6 and 7). These chapters are extremely useful discussions of the procedures, offering a clear and concise description of their form and functions. In addition, Tollenaar describes and critically analyses both frameworks with a view to borrowing or rejecting various aspects of these plans for the framework he recommends in the end.

For Chapter 11, several areas of weakness are identified. These include the costs and extent of judicial involvement; the exclusivity period; and the compulsory prior court approval of a disclosure statement.[19] In addition, Tollenaar views Chapter 11 applying too little weight to creditor democracy with too much scope for the court to set aside the wishes of majority creditors.[20] He also views the automatic stay as sometimes lasting too long with little power for the creditors to apply for a discontinuation. This essentially favours lower-ranking creditors who no longer have an economic interest, over in-the-money creditors who are prevented from exercising their enforcement rights.[21] Also, he views the expression of the absolute priority rule as inaccurately illustrating the underlying principle,[22] which has caused much conceptual confusion as other jurisdictions have adopted or adapted similar rules. Finally, and in common with much of Tollenaar's arguments regarding fairness to dissenting classes of creditors, he criticises the Chapter 11 cram-down as infringing the right to cash by preventing dissenting creditors from liquidating and exiting the plan.[23] One of the key underpinning criticisms of all of these issues is the need for court involvement and determination, which may work for the specialist courts in the United States, but cause problems for traditional and non-specialist courts.

Among the criticisms of the Scheme of Arrangement in UK law are the costs and formalities of the procedure; the lack of cram-down; and the lack of moratorium (though obviated by English courts' willingness to issue injunctions to suspend enforcement); and no provisions for dealing with executory contracts.[24] In addition, the nature of the scheme requires a 'give and take', which means that the court will not have jurisdiction to consider a scheme that divests a class of their rights without due compensation,[25] which prevents using a scheme in a way that eliminates the rights of parties who no longer have an economic interest.[26]

Tollenaar also offers criticism of various types of confirmation criteria that is used in both procedures, which will be discussed below.

A Recommended Framework

The author refrained from turning his work into a commentary on what the EU Commission, Council, and Parliament have gotten wrong about the framework for preventive restructuring that will come into force imminently. While where appropriate, some legislative instruments and recommendations were referred to, the work distances itself sufficiently from the current legislative process to produce a commentary that has a potentially timeless quality. That said, it would be a missed opportunity if this

[18] *idem*, 99-13.
[19] *idem*, 146, 151-152.
[20] *idem*, 258-259.
[21] *idem*, 147-151.
[22] *idem*, 154.
[23] *idem*, 155.
[24] *idem*, 184-186.
[25] *Re NFU Development Trust* [1972] 1 All ER 35.
[26] Tollenaar (n 4) 260.

author were to ignore the obvious critique that Tollenaar's normative foundation and framework makes of the incoming Directive.

A key difference that Tollenaar sets out in his framework relates to the treatment of dissenting in-the-money creditors who are faced with a cram-down. While the Directive provides that dissenting classes should be treated at least as favourably as any other class of the same rank and more favourably than any junior class[27] (or that the absolute priority rule is applied by way of derogation[28]), it does not specify the means of that treatment. In fact, it leaves the means of payment quite hazy, referring to "the same or equivalent" means, which fails to consider a factor that Tollenaar identified as fundamental: the right to repayment in cash or debt instruments. The latter requires that the holder rely on the vagaries of the market if a creditor wishes to cash in, which can hardly be considered "equivalent" necessarily when such instruments are generally volatile in terms of value retention. As such, Tollenaar recommends that for the best interests of dissenting creditors to be fully taken into account, they must have the option to receive payment in cash equal to the distribution in cash that they would have expected to receive in a liquidation.[29] Alternatively, dissenting classes should have the ability to receive their share of the reorganisation value when it comes to implementing the plan.[30]

Tollenaar is also highly critical of the various tests for confirmation of a plan suggested by the new Directive and other frameworks discussed in the book, primarily because of the requirements for the court to apply such tests and the costs and lack of expertise that courts and judges are likely to have in order to apply them. The requirement for "adequate information" suffers from the problem that it would be in the court's role to assess this, which would be difficult without extensive time and costs and the need for special business skills, when in fact creditors are in a better position to assess whether they have in fact received adequate information under the plan.[31] He also criticises the feasibility test, which he suggests that creditors are also in the best position to assess as they will have formed a view on the feasibility and it is also their choice to vote for or against the plan. [32]

Finally, Tollenaar challenges the "best interests of creditors test", which is also present in the new Directive.[33] This test requires that a creditor would be better off in the plan than in a liquidation, however it is impossible to actually establish this and would also be highly speculative. If a plan is approved by a majority of creditors, why shouldn't their decision-making be treated as sound? Tollenaar avers that there is not sufficient justification for an invasive court assessment of any of these tests where all classes have accepted the plan and the decision-making was sound.[34] Rather, Tollenaar suggests two new tests: an insolvency test at entry into the procedure and an assurance that there is no prejudice to excluded parties. The insolvency test should be applied upon confirmation because a plan should not have the ability to impair rights of creditors if the debtor is not already assessable as insolvent, as discussed above. [35] Secondly, the court should be satisfied that the interests of excluded parties have not been prejudiced.[36]

Tollenaar admits that a restructuring framework will likely only be applied to large cases, just as the Scheme and Chapter 11 are applied now as the costs of the plans would be prohibitive for smaller companies. He also challenges the emphasis of rescuing feasible businesses as an aim of restructuring law reform. Rather, he suggests that much can still be accomplished through business sales in a

[27] Preventive Restructuring Directive, Art 11(1)(c).
[28] Preventive Restructuring Directive, Art 11(2)
[29] Tollenaar (n 4) 62-63, 55-158, 237.
[30] *idem,* 239.
[31] *idem,* 228.
[32] *idem,* 229.
[33] Preventive Restructuring Directive, Art 10(2)(d).
[34] Tollenaar (n 4) 230, 232.
[35] *idem,* 213.
[36] *idem,* 233.

liquidation (or other) procedure, accusing the Commission of some short-sighted ness in this regard, ignoring what can be achieved through an expedited going concern sale for an SME that a restructuring cannot achieve.[37] While the author agrees that business sales can also accomplish many of the objectives of insolvency law, a good restructuring scheme offers an alternative that in may jurisdictions, is not currently available. A menu of options offers more avenues for rescue which is particularly important for the complex corporate world of the modern day.

Conclusion

Tollenaar's work is at times paradigm shifting in its treatment fundamental concepts, while maintaining much of the status quo of the generally respected normative foundations of insolvency law. This comes with a practical element often lacking in academic insolvency law discussions.

One question that arises in this author's mind is whether, if the recommended framework were to be applied, it would actually satisfy the preventive aspect of a preventive restructuring framework. If a company must be notionally insolvent in order to enter the procedure, can such a procedure be called truly preventive? Granted, it may effectively prevent liquidation, but is that the intention of a preventive restructuring framework? Or is it to prevent formal insolvency and the attendant obligations and risks that state has in a number of jurisdictions. That said, Tollenaar's discussions of the justifications that underpin collective procedures generally and whether or not these justifications allow for a non-insolvency readjustment of rights also rings true. However, if one were to go beyond the creditors' bargain and consider other normative frameworks, such a contractarian or communitarian style of approach espoused by insolvency theorists such as Elizabeth Warren,[38] Karen Gross,[39] and Donald R. Korobkin,[40] among others, that have been used to justify a broader interventionist framework for insolvency law that extends to include stakeholders that do not have a contractual interest in the company, a justification for non-insolvency collective procedures could also be found.

[37] *idem*, 250.
[38] See Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 U Chi L Rev 775 & 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 Mich L Rev 336 as commenting on .
[39] See Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) 72 Wash U L Q 1031.
[40] See Donald R Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91(4) Columbia Law Review 717 and 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1993) 71 Tex L Rev 541.