

KEY POINTS

- The forthcoming EU Preventive Restructuring Directive permits a restructuring plan to be approved even if that plan has not attracted requisite support amongst a claimant class whose members' claims the plan affects.
- As a condition for such "cross-class cramdown", however, the Directive allows the well-known "absolute priority rule", developed in practice under Chapter 11 of the US Bankruptcy Code, to be supplemented or substituted by a "relative priority rule".
- The Directive also provides a new understanding of the "best interest of creditors" test. A plan must meet this test in order to be binding on creditors who have rejected it.
- This article explains the ways in which these features of the Directive are likely to facilitate approval of a greater proportion of fair and efficient plans.

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Has Newton had his day? Relativity and realism in European restructuring

The forthcoming EU Directive on Preventive Restructuring incorporates two innovative rules for which the authors of this article had previously advocated: a "relative priority rule", and a new interpretation of the "creditor best interest" test in which dissenting creditors must receive at least as much under the restructuring plan as they would in the scenario likely to materialise if the plan were not approved. This article introduces both new rules and explains their genesis and rationale.

The APR requires that no claimant class ranking below the dissenting one should receive or retain anything under the plan unless each member of the dissenting class has been paid the full-face value of its outstanding claim.

Isaac Newton had good reason for believing space to be absolute, and absolute space to be essential to the operation of his laws of motion. In a famous example, he noted that water in a rapidly spinning bucket is at rest relative to the bucket, yet has a concave surface. This, he thought, evidences the water's being in motion in relation to absolute space. Similarly, according to his first law, in the absence of an applied force, a body stays at rest or, as the case may be, continues in a straight line, in either case again in relation to absolute space. And so on. The notion of absolute space, then, was indispensable to Newton's monumental contribution to human knowledge. And yet the same concept eventually came to be recognised as a hurdle to scientific progress. The problem – as explained variously by Berkeley, Leibniz, and Mach, the last of whom denounced "the monstrous conceptions of absolute space and absolute time" – is that absolute space is inaccessible to the senses, impervious to meaningful analysis, and useless in practice.¹ The displacement of Newtonian absolutism by Einsteinian relativity marks a milestone in the advance of civilisation.

We do not claim quite the same status for the European Council's proposal to substitute or at least supplement the absolute priority rule (APR) in restructuring law with one based on relative priority (RPR). Yet the

comparison is irresistible, not least because it flatters insolvency law and those who practice, study, and teach it.

CROSS-CLASS CRAMDOWN IN THE PREVENTIVE RESTRUCTURING DIRECTIVE

The Council's proposal concerns the forthcoming Directive on Preventive Restructuring Frameworks, approved by the European Parliament on 28 March 2019 and now awaiting final approval by the Council. The Directive looks set to create an extensive toolbox with which member states may equip entrepreneurs and enterprises seeking to respond to distress without invoking formal insolvency proceedings. Much has already been written about various aspects of the Directive. We focus here on the primary conditions that must be met before a restructuring plan may be made effective against a claimant class amongst whose members it has not attracted requisite support, ie on the preconditions for a "cramdown" against a dissenting class.

Drawing on practice under Chapter 11 of the US Bankruptcy Code, the Commission had proposed that a cross-class cramdown be permitted only if (among other things) the APR was respected, and the plan was in the best interest of creditors, understood in a particular way.

The best interest of creditors test sets the floor in relation to each dissenting creditor by requiring that no such creditor be left worse off under the plan than they would be in the debtor's liquidation. We will call this the "returns in liquidation" test (RIL) and will contrast it with the "returns in realistic alternative" test (REAL).

The very introduction of a cross-class cramdown mechanism would constitute a huge advance in European restructuring law and practice, for which the Commission is to be commended. The availability of cramdown would potentially facilitate value- and employment-preserving restructurings of distressed but viable debtors which, under the current dispensation, are subject to unnecessary liquidations. And the RIL and APR have historically provided the conceptual foundations for the cramdown mechanism. Experience in the US and elsewhere has taught, however, that neither is quite suited to the task.

GETTING REAL ABOUT CREDITORS' BEST INTERESTS

The problem with RIL is that it opens the door to plans under which some of the value that ought to go to members of the dissenting class would be expropriated for others. As noted, RIL guarantees that dissentients would get at least as much under the plan as in

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liquidation. This is not good enough, however, where liquidation is not at all likely regardless of whether the plan is approved. Consider a debtor which is balance-sheet insolvent but fully able to pay its debts as they fall due from the revenues generated by its operations, ie it is cashflow solvent because of a “going concern surplus”. If liquidated, however, it would not be able to meet some of its repayment obligations because of value destruction through counterparty termination of contracts; erosion or refusal of trade credit, supplier discounts, customer confidence and associated willingness to pay for guarantees; departure of key employees; higher rates on financial credit; and so on. The plan proposes to maintain the debtor as a going concern, then, but promises the dissenting class only their liquidation returns, which are significantly lower. Here, RIL clearly does not protect dissenting creditors’ (best) interests.²

The Council proposes that the best interest test may be met if each dissenting creditor received at least as much as it would either in liquidation or else in “the next best alternative scenario if the restructuring plan was not confirmed”. The latter terminology is open to misunderstanding in suggesting comparisons with the position of the dissentients in a hypothetical scenario that, by stipulation, is worse than (ie is *next best* to) the plan. This is perverse, as the example above illustrates, since the dissentients would want their plan returns to be compared with a scenario in which they claimed they would be better off.

We suggest that REAL provides a more sympathetic reading of the Council’s proposal. REAL requires the dissentients’ plan returns to be compared – not with a hypothetical worse scenario – but the scenario realistically likely to materialise if the plan were not approved.

The REAL interpretation of the “creditor best interest” test: dissenting creditors should receive at least as much under the plan as they would if the plan were not to be approved.

This alternative to the approval of the plan may, but need not, be liquidation on either a going concern or a piecemeal basis.

By definition, a dissenting creditor does not want the plan to be approved, and so cannot complain so long as it is paid at least as much as it would precisely in that scenario.

REAL also enjoys scholarly support.

REAL has a proud lineage in restructuring practice. In *In re English, Scottish, and Australian Chartered Bank* [1893] 3 Ch 385, the Court of Appeal of England and Wales approved a scheme of arrangement in relation to a bank whose principal place of business was in Australia. Having found (at p 406) that “anything like sudden realization, anything like a forced sale [of the bank’s assets] would be utterly ruinous to the creditors”, Lord Justice Lindley assessed whether the scheme might be forced upon dissentient creditors thus (at p 413, emphasis added):

“One must look now at this scheme, and... one must bear in mind the alternative. Bearing in mind the alternative to which I have already alluded ... can we say that this scheme is one which creditors cannot reasonably think to their advantage and the advantage of whose who belong to the same class as themselves? That depends upon the scheme itself. Now, looking at the scheme, of course one sees objections to it ... Every creditor who does not get his due would see objections to it if he could get more; but if he cannot get more, it is another thing.”

Similarly, Lord Justice Lopes reasoned thus (at pp 414-5, emphasis added):

“it is not sufficient for the Court to ascertain that the statutory conditions have been complied with; the Court must go further than that, and be satisfied that the statutable majority which are to bind the dissentient minority have acted bona fide, that they have not acted adversely to those whom they professed to represent, and, lastly, that the arrangement contemplated is a reasonable arrangement, such

as that which a man of business would reasonably approve ... The reasonableness must be always regarded with reference to other alternatives. For instance, an arrangement giving a very small benefit to creditors, if the alternative were absolute ruin to the company and no benefit to the creditors, would I think be reasonable. In considering the scheme which is before us I am very much influenced by this.”

To similar effect is the decision of the High Court of England and Wales in *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621 (Ch), where one of the present authors, then a pupil barrister, assisted counsel for the creditors opposing a proposed scheme. In order to decide whether creditors had been correctly placed in the same class, Mr Justice Lewison emphasised (at para 88, emphasis added) that the comparator must be the position of the creditors in the “realistic alternative to the scheme”.

It was advocated in the report of a European Commission-funded project on contractualised distress resolution (CoDiRe) led by the authors of this article together with Professors Lorenzo Stanghelin and Christoph Paulus, in the following terms:³

“(e) Is the plan in the best interests of dissenting creditors (‘the best-interest test’)? This requires dissenting creditors to receive at least as much under the plan as they would in the comparator scenario, that is, one most likely to materialise if the plan were not confirmed ... In all cases, this would require the plan to provide at least as much to dissentients as they would receive in the debtor’s piecemeal sale. A piecemeal sale would not be the comparator where, for example, the court is satisfied on the basis of credible evidence that a going concern sale would likely result if the plan were not confirmed. The law may also qualify as a comparator a different plan that

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was put to a vote, has received adequate support, and is likely to be approved if this plan were not (to the contrary, no merely hypothetical plan should be used for this purpose ...). In any such case, the best-interest test would require the plan to match or exceed dissentients' return with that alternative; matching or exceeding returns in the event of a piecemeal sale would not be always sufficient (e.g. when the comparator is a going concern sale in the context of an insolvency proceeding)."

RELATIVITY DISPLACES ABSOLUTISM

Where the RIL requires too little, the APR demands too much. There are four overlapping problems with it. First, it subjects approval of the plan to a requirement that may be utterly unrealistic on the facts. The debtor's estate may on any credible assessment lack sufficient value to pay the dissentients anywhere near 100 cents on the euro. In such cases, which are unlikely to be rare, the APR does not serve any defensible purpose. Second, the rule incentivises dissent on the expectation of a free ride. Members of a class who expect there to be sufficient support elsewhere for the plan have an incentive to vote against it in the hope of receiving full payment, effectively by free-riding on the sacrifice of those who agree to give up part of their claim by voting for the plan. Third, however, this incentive to hold out risks backfiring. Creditors in multiple classes may have more or less symmetrical incentives to hold out, with the result that some plans that might have been approved in the absence of this strategic behaviour would end up being rejected. Fourth and finally, the absolute priority rule makes it very difficult to award value under the plan to equity. This is particularly problematic in relation to small and medium enterprises in which separation of ownership and control is not feasible because of the size, nature, or location of the debtor's business, and/or because the business is only viable if it were to retain its

pre-distress goodwill, which in turn could only be retained if some of the pre-distress management continued in place under the plan.

The Council proposes that member states may supplement or substitute the APR with an RPR.

The RPR requires that the dissentient class be treated at least as favourably as any other class of the same rank and more favourably than any junior class.

The RPR, which is likely to address many of the APR's problems, again enjoys scholarly support.⁴ The version of the RPR recommended by the Council appears to derive from CoDiRe recommendations.⁵ We understand that this RPR commended itself to members of the Council as a result of workshops to present this project's results conducted at the Bank of Italy in Rome and at the Centre of European Policy Studies in Brussels.⁶ The key now is for member states to particularise and implement the RPR in a way that would facilitate fair and efficient restructurings.

CONCLUSION

The APR, like absolute space, was once crucial to progress, yet must now be acknowledged as a possible barrier to it. Restructuring law is ready for a dose of relativity. Time is also ripe to reinterpret the best interest test by breaking its hitherto invariant focus on the debtor's liquidation, and by aligning it with creditors' returns in the realistic alternative scenario to the plan. The Council's proposals may yet herald restructuring law's Einsteinian revolution. ■

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- 1 Arden Zylbersztajn, 'Newton's absolute space, Mach's principle and the possible reality of fictitious forces' (1994) 15 *European Journal of Physics* 1 provides an interesting and accessible account.
- 2 This point is explicated by Michael Crystal QC and Riz Mokal in 'The valuation of distressed companies: A conceptual framework' (2005) 3 *International Corporate Rescue* 63-68 and 123-131.
- 3 Lorenzo Stanghellini, Riz Mokal, Christoph Paulus, and Ignacio Tirado (eds), *Best Practices in European Restructuring* (Walters Kluwer, 2018) (European Commission Grant JUST/2014/JCOO/AG/CIVI/7627), 44-45 (footnotes omitted); see also Policy Recommendation 2.6.
- 4 See eg Baird and Rasmussen, 'Chapter 11 at Twilight' (2003-4) 56 *Stanford Law Review* 673, 691-693; Douglas G Baird, 'Priority Matters: Absolute Priority, Relative Priority and the Costs of Bankruptcy', 165 (2016) *University of Pennsylvania Law Review* 785, 791; Wessels, Madaus, and Boon, *Rescue of Business in Insolvency Law* (Instrument of the European Law Institute, 2017), pp 335-6, para 686; and Madaus, 'Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law' (2018) 19 *European Business Organisation Law Review* 615, particularly s 5.2.
- 5 See Stanghellini *et al*, *supra*, at pp 45-47, including Policy Recommendation 2.16. For full access to the results of the project, see www.codire.eu.
- 6 A complete recording of the latter proceedings is accessible at the Centre's YouTube channel here: <https://youtu.be/z5ArsT3-Y1w>.

Further Reading:

- What's next for insolvency law reform in Europe: a pan-European Insolvency Law? (2015) 7 *JIBFL* 435.
- Cram-down in European restructurings (2010) 3 *JIBFL* 177.
- LexisNexis R&I Blog: Government proposes legislation to enhance UK insolvency regime.