INSOL INTERNATIONAL

Priorities and Fairness in Restructuring and Insolvency Law

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Acknowledgement

In late 2019, Professor Gerard (Gerry) McCormack was appointed as the INSOL Scholar for 2020 / 2021. To a large extent Professor McCormack's appointment as INSOL Scholar acknowledges his contribution to INSOL's activities over a long period of time, as he himself has acknowledged in the Foreword on the next page. As an academic, Professor McCormack has obviously made a huge contribution to the INSOL Academic Group over the years; however, it needs to be mentioned that Professor McCormack has also made valuable contributions outside the Academic Group, for example as a speaker at INSOL's events and as author of various Special Reports and Technical Papers that are published for the benefit of our members.

As INSOL Scholar, Professor McCormack was expected to publish a number of outputs over his two-year term. The first of his major contributions – "Permanent changes to the UK's corporate restructuring and insolvency laws in the wake of Covid-19" – appeared as an INSOL Special Report in October 2020. The paper contained in this publication represents the second substantial publication during Professor McCormack's term as INSOL Scholar.

In this paper Professor McCormack addresses priorities, fairness, and balance in restructuring and insolvency processes. It focuses its analysis on the US, EU and UK, but also considers Singapore as a "small, nimble, market sensitive Asian jurisdiction that has acted in many ways as a flagship for international reform efforts in the restructuring and insolvency space".

INSOL International would like to sincerely thank Professor McCormack for his substantial contribution and commitment to INSOL International over the years. More specifically, INSOL International thanks Professor McCormack for having prepared this paper as his final major contribution as INSOL Scholar during 2020 / 2021. We have no doubt that members will find the content of this paper insightful and thought-provoking, especially at a time when restructuring and insolvency laws around the world are experiencing somewhat of a reboot in the wake of Covid-19.

November 2021

Foreword

It has been a great honour and privilege to act as INSOL Scholar for 2020 / 2021 and I must thank the President and Board of INSOL for the opportunity.

When I was first appointed to this role little did I know that we would have a global pandemic in the shape of Covid-19 that has greatly impacted business and social life across the globe and severely restricted international travel. Nevertheless, I have been able to carry out my commitments as INSOL Scholar. If anything, the pandemic has highlighted the importance of business restructuring and insolvency and putting in place mechanisms that facilitate business restructuring as well as a fair and appropriate allocation of the benefits that flow from the entrepreneurial opportunities preserved and enhanced.

In liaising with INSOL International I have worked principally with Dr David Burdette who has always been a repository of robust common sense. I thank David for his reassuring presence. It has been a pleasure both professionally and personally to interact with all the INSOL staff and officeholders over the years, including in particular Adam Harris, Juanitta Calitz, Rosalind Mason and the late Ian Fletcher. The interactions have been at valuable international conferences such as those in Cape Town, San Francisco, Miami, Sydney, Hong Kong, Singapore as well as London and The Hague, and at other forums.

On a personal and professional academic level, I must thank my family as well as longstanding academic and professional contacts David Milman, Andrew Keay, Janet Dine, Richard Calnan, Hamish Anderson and Irene Lynch Fannon.

Professor Gerard McCormack
November 2021

Priorities and Fairness in Restructuring and Insolvency

By Professor Gerard McCormack, Professor of International Business Law, School of Law, University of Leeds; INSOL Scholar 2020 / 2021 (INSOL International)*

1. Introduction

The leading UK Insolvency scholar, Professor Sir Roy Goode, has referred to the primary purpose of insolvency law as being to replace the free-for-all attendant upon the pursuit of individual claims by different creditors with a statutory regime. Under the statutory regime, creditors' rights and remedies are suspended, wholly or in part, and this is coupled with the provision of a mechanism for the orderly collection and realisation of assets and distribution of the net realisations of the assets among creditors in accordance with a statutory scheme of distribution.[1] This "primary purpose" is the starting point and is underpinned by a series of "values" or "principles" which prime the system and the outcomes that it sets out to achieve. The alternative to collective collection, realisation and distribution may be a tragedy of the commons scenario, with overfishing of scarce commodities in a common pool or possibly "anti-commons" blocking actions by individual creditors.[2]

The central characteristic of insolvency regimes is that they stymie, in whole or in part, the enforcement of individual rights and replace these with a more collective process. This substitution is seen to be appropriate for the sake of the greater good. The same basic principle applies to proceedings that are designed to achieve the restructuring of viable but financially troubled businesses, as distinct from bringing their affairs and existence to an end.

According to Zacaroli J in a recent English case, *Re Gategroup Guarantee Ltd*,[3] involving the recognition and enforcement of insolvency / restructuring proceedings across international frontiers, the principal "peculiarity" of insolvency proceedings is that they are a collective process, driven by the need to solve the problem that the debtor's assets are insufficient to satisfy the claims of all of its creditors, thus raising at least the possibility of competition among the debtor's creditors and stakeholders.[4]

He added that proceedings designed to enable a company in financial difficulties to reach a composition or arrangement with its creditors involve the same peculiar feature as a straightforward bankruptcy or winding-up. The need for the composition or arrangement arises from the company's inability to satisfy the claims of all its creditors. There is

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* The author is the INSOL Scholar (INSOL International) for 2020 / 2021. This paper has been submitted in partial fulfilment of his obligations as the INSOL Scholar for 2020 / 2021.

1 R Goode, *Principles of Corporate Insolvency Law* (4th edn by Kristin van Zwieten, Sweet & Maxwell 2018) para 1-08.

2 See generally T Jackson, *The Logic and Limits of Bankruptcy Law* (Beard Books 2001).

3 [2021] EWHC 304 (Ch).

4 *Idem*, at para 91.

inherently competition between the company's creditors, requiring a collective solution that is fair to all.[5]

Moving to the international realm, the United Nations Commission on International Trade Law (UNCITRAL) has stated clearly that modern and efficient insolvency laws are critical in enabling a state to achieve the benefits of integration with the international financial system. In its view, such laws and institutions should "promote restructuring of viable business and efficient closure and transfer of assets of failed businesses, facilitate the provision of finance for start-up and reorganization of businesses and enable assessment of credit risk, both domestically and internationally."[6] Many of these initiatives build upon Chapter 11 of the US Bankruptcy Code.[7] As one US court put it, "the purpose of [Chapter 11] is to provide a debtor with the legal protection necessary to give it the opportunity to reorganize, and thereby to provide creditors with going-concern value rather than the possibility of a more meagre satisfaction of outstanding debts through liquidation."[8] Influential US commentators suggest that Chapter 11 deserves a prominent place in "the pantheon of extraordinary laws that have shaped the American economy and society and then echoed throughout the world…"[9] Chapter 11 has been cited as a great success by its proponents and the model to which restructuring laws worldwide should aspire.[10]

Some of the main features of Chapter 11 which may have contributed to its "success" are as follows:

- The management of the company is not displaced in favour of an outside insolvency practitioner and the management itself can prepare a restructuring plan and submit the plan to the creditors.

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5 *Idem*, at para 100.

6 See *UNCITRAL Legislative Guide on Insolvency Law*, (United Nations: New York, 2005), p 10.

7 For a full discussion of Chapter 11 in its historical context, see the American Bankruptcy Institute (ABI) *Commission to Study the Reform of Chapter Full Report* - online: www.commission.abi.org/full-report.

8 *Canadian Pacific Forest Products Ltd v JD Irving Ltd* (1995) 66 F 3d 1436 at 1442. For a somewhat differently nuanced statement, see p 209 of the *UNCITRAL Legislative Guide on Insolvency Law*, (United Nations: New York, 2005) – "The purpose of reorganization is to maximize the possible eventual return to creditors, providing a better result than if the debtor were to be liquidated and to preserve viable businesses as a means of preserving jobs for employees and trade for suppliers. With different constituents involved in reorganization proceedings, each may have different views of how the various objectives can best be achieved."

9 See E Warren and JL Westbrook, "The Success of Chapter 11: A Challenge to the Critics" (2009) 107 *Michigan Law Review* 603 at 604.

10 On international norms in this area, see the *UNCITRAL Legislative Guide on Insolvency Law*, at www.uncitral.org and see generally T Halliday and B Carruthers, *Bankrupt: Global Lawmaking and Systemic Financial Crisis* (Stanford, Stanford University Press, 2009); S Block-Lieb and T Halliday, "Harmonization and Modernization in UNCITRAL's Legislative Guide on Insolvency Law" (2007) 42 *Texas International Law Journal* 481 and also T Halliday, "Legitimacy, Technology, and Leverage: The Building Blocks of Insolvency Architecture in the Decade Past and the Decade Ahead" (2006) 32 *Brooklyn Journal of International Law* 1081.

- A court-appointed trustee may be appointed to monitor the rehabilitation process, but such trustee's powers are not as far-reaching as those under a management displacement regime.

- A moratorium exists to protect the company from its creditors.

- There is also a mechanism for the approval of a restructuring plan including "cram-down" provisions under which a class of creditors, including secured creditors, can be forced to accept a restructuring plan against their wishes if the court determines that there is at least one class of creditors who have accepted the plan and it is of the view that the restructuring plan is feasible.

- There is provision for debtor-in-possession financing under which the company can obtain new funds either to continue its operations or to further the restructuring process. The providers of these new funds may enjoy "superpriority" ahead of other creditors if existing creditors are deemed by the court to be adequately protected.

Nevertheless, it is worth sounding a cautionary note for, as far as particular countries are concerned, different detailed solutions may be appropriate given the differences in history, culture, national economies as well as in the state of economic development. For instance, the importance of the local in the global context was acknowledged by the Insolvency Law Review Committee in Singapore.[11] This Committee recognised that Chapter 11 had proved durable and successful in the US, but nevertheless considered that it would be inappropriate to attempt to replicate it in Singapore where the local economic and social conditions were very different.

The concept of balance is fundamentally important.[12] UNCITRAL, for instance, has stressed that a desirable legal framework should: "(a) Provide certainty in the market to promote economic stability and growth; (b) Maximize value of assets; (c) Strike a balance between liquidation and reorganization; (d) Ensure equitable treatment of similarly situated creditors …"[13]

The notion of "balance" between different actors in the insolvency process has generated much debate in the US and one should exercise a certain caution about using Chapter 11 as a model. It is now in middle age and may no longer be such a comfortable fit. Chapter 11 became part of the US Bankruptcy Code in 1978, though there were earlier precedents.[14] Since then Chapter 11 has undergone a mini-metamorphosis with now much more of a market orientation to the process.

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[11] Report of the Insolvency Law Review Committee, Final Report 2013 at pp 106-107, available at https://www.mlaw.gov.sg/content/dam/minlaw/corp/News/Revised%20Report%20of%20the%20Insolvency%20Law%20Review%20Committee.pdf.

[12] See generally A Keay, "Balancing Interests in Bankruptcy Law" (2001) 30 *Common Law World Review* 206.

[13] See *UNCITRAL Legislative Guide on Insolvency Law* - Recommendation 1.

[14] See generally D A Skeel Jr, *Debt's Dominion: A History of Bankruptcy Law in America* (Princeton, Princeton University Press 2001).

Firstly, there is now a greater emphasis on whole or partial sale of the business assets on a going-concern basis rather than creditors and shareholders coming together under the umbrella of Chapter 11 and working out a restructuring plan. While the figures are disputed, it has been estimated that roughly two-thirds of all large bankruptcy outcomes involve a sale of the firm, rather than a traditional negotiated reorganisation in which debt is converted to equity through the reorganisation plan.[15] Part of the difficulties in working out statistics is that a company may undergo dramatic changes during the Chapter 11 process. Outcomes are often imprecise, difficult to measure and may be assigned potentially to more than one category.

Secondly, since the business and financing landscape has changed fundamentally since Chapter 11 was enacted, this has prompted calls for its revision. In short, there has been more expanded use of secured credit, growth in distressed-debt markets as well as other factors that have impacted on the effectiveness of the current law.[16] Leading commentators have observed:

> "We have a new form of chapter 11 emerging in the courts. Having invented the DIP (debtor-in-possession), American lawyers are now creating the SPIP (secured-party-in-possession). More and more chapter 11 cases seem to be no more than vehicles through which secured parties may enjoy their Article 9 rights under the umbrella, and the protective shield, of the bankruptcy law."[17]

Moreover, insolvency and restructuring law in the US may undergo further significant change in the next few years due to the economic consequences of the Covid-19 pandemic and other externalities – both "known unknowns" and "unknown unknowns". It is worth noting that one of the influential actors in the reform process – the American Bankruptcy Institute (ABI) – produced a comprehensive report in 2014[18] detailing a proposed list of changes to Chapter 11.

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[15] For somewhat different views on the data, see L M Lopucki and J W Doherty, "Bankruptcy Survival" (2015) 62 *UCLA Law Review* 970 and K Ayotte and D Skeel, "Bankruptcy or Bailouts" (2010) 35 *Journal of Corporate Law* 469.

[16] See E Altman, "The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations" (2014) 22 *American Bankruptcy Institute Law Review 75*.

[17] See E Warren and J L Westbrook, "Secured Party in Possession" (2003) 22 *American Bankruptcy Institute Journal* 12. Article 9 (of the Uniform Commercial Code) permits the creation of security interests over personal property on a very liberal basis. It makes it easy to create security (collateral) over almost any asset and makes it relatively easy to ensure perfection of security interests, ie to ensure the effectiveness of security interests against third parties.

[18] American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11, *Full Report* (2014), accessed at www.commission.abi.org/full-report. For detailed criticism of the report by the Loan Syndications and Trading Association (LSTA), see "The Trouble with Unneeded Bankruptcy Reform: The LSTA's Response to the ABI Commission Report" (October 2015) at p 9: "If adopted, these reforms risk disrupting the operation of a bankruptcy system that has served the nation very well – aiding in the economic recovery from the Great Recession – and that has become the envy of the world. They also threaten to increase the cost of credit to both performing and distressed businesses, which will in turn hurt the very businesses that the proposals are designed to help."

The reforms were proposed with a view to achieving a better balance between the effective restructuring of business debtors, the preservation and expansion of employment, and the maximisation of asset values for the benefit of all creditors and stakeholders.[19] While the nature of the political process in the US is such that that these changes are unlikely to be enacted in the very near future, the US, however, has recently enacted and implemented the Small Business Debtor Reorganization Act 2019. The Act adopts and modifies certain aspects of the ABI Commission report. It aims to make small business bankruptcies faster and less expensive by creating a new subchapter in Chapter 11 that is specific to small businesses. It streamlines small business restructurings and removes procedural burdens and costs associated with typical corporate restructurings. In particular, it removes the requirement that holders of "equity", as distinct from debt, in the small business debtor have to provide new value to retain their equity interest in the debtor without paying creditors in full.

This paper will address priorities, fairness, and balance in restructuring and insolvency processes. It will focus its analysis on the US, EU and UK. It will also consider Singapore as a small, nimble, market sensitive Asian jurisdiction that has acted in many ways as a flagship for international reform efforts in the restructuring and insolvency space.

First, it is appropriate to address, however, the ranking of claims and order of priorities in restructuring and insolvency procedures before adopting a more jurisdiction-specific analysis.

2. Priority principles in insolvency and restructuring

2.1 Introduction

Recital 22 of the preamble to the European Insolvency Regulation (recast)[20] acknowledges the fact that "as a result of widely differing substantive laws it is not practical to introduce insolvency proceedings with universal scope throughout the Union. It is said that the application without exception of the law of the State of the opening of proceedings would frequently lead to difficulties given the widely differing national laws on security interests to be found in [European] States. Furthermore, the preferential rights enjoyed by some creditors in insolvency proceedings are, in some cases, completely different."

[19] For other criticisms of Chapter 11 see, eg, D A Skeel, "Rethinking the Line between Corporate Law and Corporate Bankruptcy" (1994) 72 *Texas Law Review* 471 at p 535: "Like an antitakeover device, bankruptcy can impair the market's ability to discipline managers because it may substitute reorganization procedures for market mechanisms that would otherwise lead to the ouster of managers outside of bankruptcy." But this criticism has largely fallen away with new forms of market governance in US bankruptcy cases – see D A Baird and R K Rasmussen, "The End of Bankruptcy" (2002) 55 *Stanford Law Review* 751; "Private Debt and the Missing Lever of Corporate Governance" (2006) 154 *University of Pennsylvania Law Review* 1209; B Adler, V Capkun and L Weiss, "Value Destruction in the New Era of Chapter 11" (2013) 29 *Journal of Law, Economics, and Organization* 461.

[20] Regulation 2015/848, replacing Regulation 1346/2000.

Secured creditors may be broadly defined as the holder of rights over property which are obtained (or possibly retained) with a view to ensuring the payment of money due or the performance of some other obligation. The property over which security is taken is referred to as being "secured" or "collateralised". In some countries secured creditors are paid first after the costs of the insolvency proceedings have been taken care of. Indeed, secured creditors can effectively opt out of the insolvency proceedings and realise their secured property (collateral) separately.

The importance of secured creditor rights, particularly in insolvency proceedings, has been stressed in the influential "legal origins" or "law matters" thesis developed by four economists – La Porta, Lopez de Silanes, Shleifer and Vishny.[21] The Doing Business reports, issued annually since 2004 through the World Bank Group, build on the legal origins literature and employ a more sophisticated version of the same methodology employed by La Porta *et al*.[22]

Legal systems invariably draw a distinction between secured claims – claims backed up by security interests – and unsecured claims. Secured claims generally have priority over unsecured claims but the extent of this priority may vary. There may be a certain proportion of secured property realisations claims set aside for the benefit of unsecured claimants. In some laws, including the UK, a distinction is drawn between security interests over all the assets of a business (an enterprise or floating charge) and other types of security interest, with the carve-out in favour of unsecured creditors being confined to the universal security. Under UK law, a certain percentage of floating charge realisations is set aside for the benefit of unsecured creditors. The percentage is calculated by secondary legislation on a sliding scale, but subject to an overall ceiling of GBP 800,000.[23]

It might be argued that provisions of this nature constitute a fair concession to unsecured creditors without destroying the notion of security in its entirety.[24] They are admittedly blunt instruments since they benefit all unsecured creditors and not merely non-adjusting creditors, that is, those who are unable to adjust the explicit or implicit lending terms to take into account the fact that the borrower has granted security. Fixed ceilings, however, allows attendant risks to be calculated.

To the extent that financial claims are secured they have priority over unsecured commercial or trade claims. Financial claimants are more likely to take security than commercial claimants. To a large extent, therefore, the distinction between financial

21 See R La Porta, F Lopez de Silanes, A Shleifer and R Vishny, "Legal Determinants of External Finance" (1997) 52 *Journal of Finance* 265.

22 See "Doing Business 2020" https://www.doingbusiness.org/en/reports/global-reports/doing-business-2020. It should be noted that the World Bank Group announced on 16 September 2021 that it was discontinuing the Doing Business report – see https://www.worldbank.org/en/news/statement/2021/09/16/world-bank-group-to-discontinue-doing-business-report.

23 Insolvency Act 1986 (Prescribed Part) (Amendment) Order 2020 (S1 2020/211) made under s 176A Insolvency Act 1986.

24 See V Finch "Security, Insolvency and Risk: Who Pays the Price?" (1999) 62 *Modern Law Review* 633 at 652.

claimants and commercial claimants mirrors the distinction between secured and unsecured claims. Accordingly, the financial claimants, *prima facie*, have priority over commercial claimants. In many countries, however, commercial claimants may benefit from "quasi-security" devices such as a retention of title clause in a sale of goods contract or the supply of equipment under a finance or operating lease. "Quasi-security" may be described as a form of legal mechanism that is not strictly speaking security but serves many of the same economic functions.

2.2 Priority of secured claims

Essentially there are two sets of arguments for giving security creditors priority over the unsecured creditors. The first set is based on property rights and freedom of contract. The second set is based on the proposition that recognising the priority of security rights will lead to more credit and at lower cost and this in turn will help to stimulate economic activity and lead to better economic conditions for all. The first set of arguments proceeds on the basis that the secured creditor has bargained for property rights and priority in respect of the debtor's assets. A social market economy should in the normal run of things respect property rights and freedom of contract and recognise this manifestation of the parties' contractual freedom. Security is seen as a fair exchange for the credit; the secured creditor has bargained for security and priority, whereas other creditors have not. Consequently, it does not seem unfair to privilege the secured creditor over other creditors who could equally have contracted for security but chose not to do so.[25]

On the other hand, there may be involuntary creditors, that is, creditors not in a contractual relationship with the debtor, who are not in a position to bargain for security. Moreover, there may be other non-adjusting creditors, or poorly adjusting creditors, where it is unrealistic to suppose that they could bargain for security or where the transaction costs of doing so are too great. These creditors in a weak bargaining position are perhaps most likely to be the ones that will be hit hardest by the debtor's insolvency. The insolvency may impact disproportionately on them in that they are not very capable of sharing or passing on the costs of the loss. Large financial institutions which are most likely to take security are in a much better position to pass on losses. In the second set of arguments, security interests are seen to function as a risk reduction device that increases the availability, and lowers the cost, of credit. The minimisation of risk should encourage lenders to make loans and to reduce the risk premium they might otherwise factor into the calculations of interest rates.[26]

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25 See generally L Bebchuk and J Fried "The Uneasy Case for the Priority of Secured Claims in Bankruptcy" (1996) 105 *The Yale Law Journal* 857; L Bebchuk and J Fried "The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics" (1997) 82 *Cornell Law Review* 1279; E Warren "Making Policy with Imperfect Information: The Article 9 Full Priority Debates" (1997) 82 *Cornell Law Review* 1373.

26 S L Harris and C W Mooney "Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy" (1997) 82 *Cornell Law Review* 1349; D Baird and T Jackson "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy" (1984) 51 *University of Chicago Law Review* 97.

In UNCITRAL's view:[27] "The key to the effectiveness of secured credit is that it allows borrowers to use the value inherent in their assets as a means of reducing credit risk for the creditor. Risk is mitigated because loans secured by the property of a borrower give lenders recourse to the property in the event of non-payment. Studies have shown that as the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls. Studies have also shown that in States where lenders perceive the risks associated with transactions to be high, the cost of credit increases as lenders require increased compensation to evaluate and assume the increased risk." [28]

The argument is that banks and other financial institutions will not engage in large-scale lending activities if their position as secured creditors in the liquidation of their borrowers is not sufficiently certain, or that sufficient means for the enforcement of security are not available. Economists suggest that security plays a crucial role in lending decisions by addressing the problems of adverse selection, moral hazard and uninsurable risk. The incentives of creditors and borrowers are aligned and a credible commitment is added to the relationship.[29]

On the other hand, it seems that no two national priority systems are exactly identical. This may be because of the influence exerted by powerful groups of creditors; the inertia of legal tradition, or as a result of the conscious and deliberate choice to promote certain values.[30]

2.3 Employee claims

Employees are typically non-adjusting, or poorly-adjusting, creditors. In other words, they cannot realistically be expected to bargain for security over the debtor's assets in response

[27] UNCITRAL, "Draft Legislative Guide on Secured Transactions – Report of the Secretary General – Background Remarks" (A/CN.9/WG.VI/WP.2)", at para 2 (2002), https://undocs.org/en/A/CN.9/WG.VI/WP.2.

[28] See generally J Armour, A Menezes, M Uttamchandani and K van Zwieten, "How do creditor rights matter for debt finance? A review of empirical evidence" in F Dahan (ed) *Research handbook on secured financing in commercial transactions* (2015, Edward Elgar, Cheltenham), chapter 1. See also World Bank, "Building Effective Insolvency Systems – A report from the Working Group on Debtor-Creditor Regimes" (1999) at p 3 and see generally D Arner, *Financial Stability, Economic Growth and the Role of Law* (New York, CUP, 2007).

[29] See generally J Stiglitz and A Weiss "Credit Rationing in Markets with Imperfect Information" (1981) 71 *American Economic Review* 393; G Akerlof "The Market for 'Lemons': Qualitative Uncertainty and the Market Mechanism" (1970) 84 *Quarterly Journal of Economics* 488; O Hart and J Moore "Default and Renegotiation: A Dynamic Model of Debt" (1998) 113 *Quarterly Journal of Economics* 1.

[30] See generally E Ghio, "Transposing the preventive restructuring directive 2019 into French insolvency law: Rethinking the role of the judge and rebalancing creditors' rights" (2021) 30 *International Insolvency Review* 54 at 55 (footnotes omitted): "French insolvency law remains internationally known for the comparatively low level of protection afforded to the interests of creditors in comparison to those of other stakeholders. As a result, France ranks quite low regarding the 'strength of its insolvency framework' in international and comparative studies, because of the limited role of creditors in restructuring proceedings. Transposing the Directive therefore provides a unique occasion for France to reform its preventive restructuring landscape to rebalance the protection afforded to different stakeholders' interests."

to the fact that financial institutions may have taken security. Their own bargaining power is too weak or the economic and other costs associated with taking security would be too great.

Unpaid employees invariably have preferential status, subject to certain monetary limits, which gives them priority over unsecured claims. Preferential claims are generally paid in the third tier of priority, that is, after expenses of the insolvency proceedings and then secured claims. In some countries, however, employee claims are payable ahead of secured claims. The reason for this, it seems, is largely redistributionist and to protect the weaker party. Recital 22 of the preamble to the European Insolvency Regulation (recast) provides that at the "next review of this Regulation, it will be necessary to identify further measures in order to improve the preferential rights of employees at European level."[31]

Protecting employee claims through a social insurance or guarantee fund arguably offers a more uniform and potentially complete protection than priority or preferential status under insolvency law. Employees are also likely to be paid much more promptly their arrears of salary and other entitlements from such a fund. The alternative is for unpaid employees to wait a potentially long time before an insolvency practitioner (IP) establishes the value of an insolvent estate and the extent of the liabilities owed by the estate. Establishing a guarantee fund however, requires a substantial administrative commitment and there are also "moral hazard" and financing issues, that is, whether the fund should be financed through *ex ante* or *ex post* contributions from employers.[32]

2.4 Tax claims

Countries also differ on whether tax claims should have any priority or preferential status in insolvency proceedings.[33] The main justifications given for tax priority centre around the social costs of non-collection and the importance of minimising losses for the public purse. Moreover, it has been argued that insofar as the State is claiming unpaid taxes and social security contributions, it is an involuntary creditor who has not consciously assumed the risk of the debtor's insolvency. It is also argued that the State authorities are not in a position effectively to monitor the debtor's behaviour and to assess the risk of default or insolvency. The reasons for not giving priority are that the State is generally in a much more powerful position than unsecured creditors and it is therefore unfair to prioritise its claims. Moreover, not giving priority to the State authorities means that they are much more likely to monitor the debtor's behaviour and enforce payment discipline. The State authorities are also likely to have powerful and coercive collection tools available outside of insolvency proceedings.

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31 Regulation 2015/848.

32 See generally J Armour, "The Law and Economics Debate about Secured Lending: Lessons for European Lawmaking?" (2008) 5 *European Company and Financial Law Review* 3 and J Armour, "Should We Redistribute in Insolvency?" in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (Oxford, OUP 2006).

33 See generally A Keay and P Walton "The Preferential Debts Regime in Liquidation Law: In the Public Interest?" [1999] *Company, Financial and Insolvency Law Review* 84.

The priority status of tax and other "public law" claims have been considered by many countries of different political persuasions, including in Singapore by a government appointed Insolvency Law Review Committee. The Committee however concluded by saying that that this was an "issue which is intertwined with the policies and financial considerations of the Government and the Committee defers to the views of the Government." [34]

2.5 Shareholder claims

The standard position is that insofar as shareholders are seeking compensation for the value of their shares in the insolvency proceedings, their claims are subordinated to those of the unsecured creditors. They cannot receive anything in return for their shares unless creditor claims are met in full. If, however, shareholders are seeking reimbursement for loans they have made to the insolvent debtor, it depends on whether the loans are secured or unsecured. If the loans are secured, then the shareholder is treated as a secured creditor subject to the possibility of the IP challenging the loan as a voidable transaction if it is made during a "suspect" period.

If the shareholder loan is unsecured, then the claim for recovery of the loan is generally treated in the same way as other unsecured claims and payable rateably with these claims. A few countries may apply, however, a doctrine of "equitable subordination". This means that, in certain circumstances, a shareholder loan may be deemed to constitute a disguised capital contribution and is therefore subordinated to ordinary unsecured claims on this basis. Alternatively, a more general principle of subordination may apply.

If the debtor is not insolvent, then the expectation is that all creditor claims, whether secured or unsecured, would be met in full. If creditors and shareholders bargain over the debtor's assets when the solvency of the debtor is threatened but in a situation outside formal insolvency proceedings, then the parties bargain in the shadow of the law and the expectation is that normal liquidation priorities would be respected. The nature of restructuring proceedings in some countries, however, means that shareholder claims have a "hold-up" or obstruction value over and above their strict liquidation entitlements. Therefore, it is not uncommon for existing shareholders to receive or retain some "equity" in a restructured business entity. This also helps to ensure their continued co-operation and may reduce valuation disputes which have the potential of slowing down the restructuring process. This "hold up value" operates in practice in many countries, including even the US, where the so-called "absolute priority" principle is enshrined in Chapter 11 of the Bankruptcy Code. The "absolute priority" principle mandates that unless creditors are to be paid in full, or unless each class of creditors consents, the company's old shareholders are not entitled to receive or retain any property through the

[34] Report of the Insolvency Law Review Committee, Final Report 2013 available at https://www.mlaw.gov.sg/content/dam/minlaw/corp/News/Revised%20Report%20of%20the%20Insolvency%20Law%20Review%20Committee.pdf at p 21.

restructuring process on account of their old shares.[35] The position is different, however, if the shareholders contribute "new value".[36]

3. Restructuring priorities in the US

In a business restructuring context, parties bargain in the shadow of the framework provided by liquidation law.[37] The parties must consider the alternatives if the negotiations fail. Liquidation and debt enforcement law provides these alternatives and liquidation law is ultimately a distributional exercise – "who gets paid what". Liquidation law reflects distributional norms and interest group politics rather than being purely an exercise in abstract economic efficiency.[38] The provisions that give priority to certain categories of claim express the political bargains that have been reached.

The US Chapter 11 creates a context that is conducive to business restructuring, *inter alia* by allowing majority decisions and also by facilitating the continuation of the enterprise during a period of ongoing negotiations.

The traditional view of a successful Chapter 11 outcome is that it results in a reorganisation plan agreed by a majority of creditors. For example, Stevens J remarked in the US Supreme Court in *Bank of America v 203 North LaSalle Street Partnership*:[39] "Confirmation of a plan of reorganization is the statutory goal of every chapter 11 case. Section 1129 provides the requirements for such confirmation, containing Congress' minimum requirements for allowing an entity to discharge its unpaid debts and continue its operations."

The past decades, however, have seen significant changes in Chapter 11 practice, including a marked rise in the number of pre-packaged Chapter 11 filings – so-called "pre-packs" – and also with creditors gaining increased influence over the Chapter 11 process through contractual arrangements with the debtor.[40] "Pre-packs" are seen to have

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[35] For a suggestion that the "absolute priority" principle in the US is less absolute than it might superficially appear, see M J Roe and F Tung, "Breaking bankruptcy priority: How rent-seeking upends the creditors' bargain" (2013) 99 *Virginia Law Review* 1235 and the comment at 1237: "The bankruptcy process is in fact rife with rent-seeking, as creditors and their professionals contest existing distribution rules and seek categorical changes to improve their private bankruptcy returns. Priority is not in fact absolute. It is often up for grabs."

[36] See the US Supreme Court decision in *Case v Los Angeles Lumber Products Co* (1939) 308 US 106, 115–119. See also American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11, *Full Report* (2014), at pp 224–6.

[37] See generally S Paterson, "Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards" (2014) 14 *Journal of Corporate Law Studies* 333; "Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century" Law Society and Economy Working Paper Series, WPS 27-2014 December 2014.

[38] See generally *A* Levitin, "Bankrupt Politics and the Politics of Bankruptcy" (2012) 97 *Cornell Law Review* 1399.

[39] (1999) 526 US 434 at fn 4 of his judgment.

[40] See D G Baird and R K Rasmussen, "The End of Bankruptcy" (2002) 55 *Stanford Law Review* 751 who comment: "Corporate reorganizations have all but disappeared. Giant corporations make headlines when

significant advantages over both a traditional Chapter 11 and a corporate restructuring that takes place fully out of court through reducing the costs and disruption to all parties. The pre-pack mixes elements from private restructurings and the traditional Chapter 11 process. Such a case should be disposed of quicker and more cheaply if the debtor company has made adequate disclosure of its financial condition to creditors before the Chapter 11 filing.

A clearly predefined exit strategy minimises the time that a debtor needs to spend in Chapter 11. With a pre-pack, an agreement can be reached that satisfies the majority of creditors and then Chapter 11 is used for the purpose of implementing the agreement. The process reduces the leverage of minority groups of creditors who could otherwise hold up an out-of-court workout. Nevertheless, a pre-pack is not likely to be successful in resolving complex, litigious disputes among many different creditor groups with sharply divergent interests.

In a Chapter 11, the "old" management remains initially in place although legally transformed into quasi-trustee status and called the debtor-in-possession (DIP). The DIP can run the business of the debtor in the ordinary way during the Chapter 11 process but it will need court approval for substantial asset sales. Such "non-plan" sales, that is, sales outside the parameters of a restructuring plan, are now quite common and have been used to circumvent some of the protections afforded by the formal plan confirmation process under section 1129 of the US Bankruptcy Code, including the detailed cram-down rules.[41]

Asset sales not under the auspices of a restructuring plan need court authorisation under section 363 of the US Bankruptcy Code – a provision which regulates sales outside the ordinary course of business. In the leading case *In re Lionel Corp*[42] the court approved a "business justification test" which sought to strike a balance between a debtor's ability to sell assets and the right to an informed vote on confirmation of a restructuring plan. The *Lionel* court concluded that there has to be some articulated business justification for the use, sale or lease of debtor property outside the ordinary course of business. A non-exhaustive list of factors was set out as matters that were appropriate for consideration.

The court also concluded that a debtor could not enter into a transaction that would amount to a disguised ("*sub rosa*") restructuring plan or an attempt to circumvent the Chapter 11 requirements for confirmation of a restructuring plan. If, however, the transaction had a proper business justification which had the potential to lead towards

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they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds." See also D G Baird and R K Rasmussen, "Chapter 11 at Twilight" (2003) 56 *Stanford Law Review* 673 and D G Baird, "The New Face of Chapter 11" (2004) 12 *American Bankruptcy Institute Law Review* 69.

[41] See generally American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11, *Full Report* (2014), www.commission.abi.org/full-report at pp 201–6.

[42] (1983) 722 F2d 1063.

confirmation of a plan and was not an attempt to evade the plan confirmation process, then the transaction may be authorised.

Creditor classification and division is very important in a Chapter 11 restructuring context,[43] particularly if the restructuring is in any way contentious.[44] Moreover, It may also facilitate negotiations over the division of the "restructuring surplus" since different creditors may have different views on the value of the restructured enterprise and the risks that may be presented by extending the maturity of debts. The "restructuring surplus" refers to the premium over liquidation value produced by the restructuring process.

Chapter 11 makes a sharp distinction between claims,[45] that is, debt claims or indebtedness, and "interests"[46] – equity or shares. A Chapter 11 plan will divide claims (indebtedness) and interests (equity shares) into separate and distinct classes (or groups of classes) for voting purposes and also for purposes of treatment and payment. Each class of claims or interests should be designated as either impaired or not impaired and, in accordance with section 1126(f) of the US Bankruptcy Code, the holders of claims or interests that are not impaired are deemed to have voted to accept the plan since their rights against the debtor outside bankruptcy are preserved and protected in full. The notion of "impairment" is fundamental because only the holders of "impaired" claims or interests are entitled to vote on the restructuring plan. Section 1124 provides that a claim or interest is impaired unless the plan leaves unaltered the rights outside bankruptcy that are associated with that claim or interest.

A class of creditors, including secured creditors, can be crammed down in the US, that is, forced to accept a restructuring plan against its wishes provided that at least one other class of impaired creditors has accepted the plan. Creditors in Chapter 11 are protected by the "best interests" test[47] and also by an extensive list of conditions set out in section 1129. The restructuring plan must not discriminate unfairly and has to be fair and

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[43] According to p 218 of the *UNCITRAL Legislative Guide on Insolvency Law* available at https://uncitral.un.org/en/texts/insolvency/legislativeguides/insolvency_law: "The primary purpose of classifying claims is to satisfy the requirements to provide fair and equitable treatment to creditors, treating similarly situated claims in the same manner and ensuring that all creditors in a particular class are offered the same menu of terms by the reorganization plan. It is one way to ensure that priority claims are treated in accordance with the priority established under the insolvency law." See also American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11, *Full Report* (2014) at pp 257–65.

[44] See generally S Norberg, "Classification of Claims under Chapter 11 of the Bankruptcy Code: The Fallacy of Interest Based Classification" (1995) 69 *American Bankruptcy Law Journal* 119; B Markell, "Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification" (1995) 11 *Bankruptcy Developments Journal* 1; P Meltzer, "Disenfranchising the Dissenting Creditor through Artificial Classification or Artificial Impairment" (1992) 66 *American Bankruptcy Law Journal* 281; L J Rusch, "Gerrymandering the Classification Issue in Chapter Eleven Reorganization" (1992) 63 *University of Colorado Law Review* 43.

[45] See the definition in the US Bankruptcy Code, s 101(5).

[46] There is no definition of "interest" as such in the US Bankruptcy Code but the right of an equity holder is an "interest", as can be seen from ss 101(16), 101(17) and 501(a) of the US Bankruptcy Code.

[47] Section 1129(a)(7)(A)(ii).

equitable.[48] This requires that creditors who are similarly situated should be treated in a comparable fashion. *A fortiori*, it would for example be unfair discrimination for a junior creditor to receive a higher interest rate than that imposed on a senior creditor on the same property. The fair and equitable standard means that an unreasonable risk of the plan's failure should not be imposed on the secured creditor.

Secured creditors are effectively entitled to payment of the amount secured in full over time. Section 1129(b)(2)(A) requires that a secured creditor should get either:

(1) retention of its secured interest plus sufficient deferred payments to equal the present value of the collateral; or

(2) sale of the collateral with the creditor's security interest attaching to the proceeds of sale; or

(3) receipt of the "indubitable equivalent" of its security interest.

Under (2), the property is sold free and clear of the lien, subject to section 363(k), and the security interest attaches to the proceeds of the sale. Section 363(k) provides that, "unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." This practice is referred to as "credit-bidding".

The US Supreme Court in *RadLAX Gateway Hotel, LLC v Amalgamated Bank*[49] held that a debtor may not confirm a chapter 11 plan that provides for the sale of collateral free and clear of existing security interests, but does not permit a secured creditor to credit-bid at the sale. The *RadLAX* decision is important because it establishes that the creditor must be permitted, subject to section 363(k), to bid on the assets using its outstanding secured debt.

Relying on the "commonplace of statutory construction that the specific governs the general," the Court reasoned that "clause (ii) is a detailed provision that spells out the requirements for selling collateral free of liens, while clause (iii) is a broadly worded provision that says nothing about such a sale. . . . [T]he 'general language' of clause (iii), 'although broad enough to include it, will not be held to apply to a matter specifically dealt with' in clause (ii)."

[48] See s 1129(b)(1): "the court, on request of the proponent of the plan, shall confirm the plan . . . if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."

[49] (2012) 132 S Ct 2065. See generally V Buccola and A C Keller, "Credit Bidding and the Design of Bankruptcy Auctions" (2010) 18 *George Mason Law Review* 99, 102-04 (2010) (providing an overview of credit bidding); and for a comparative analysis R J de Weijs, "Secured credit and partial priority: Corporate finance as a creation or an externalisation practice?" (2018) 7 *European Property Law Journal* 63.

Transaction costs and legal restrictions associated with cash bidding may sometimes preclude a secured creditor from bidding at all if it cannot credit-bid. The right to credit-bid thus ensures that creditors can get their collateral whenever they value it more highly than other bidders, rather than being cashed out for whatever the highest cash bidder thinks the collateral is worth.

On the other hand, concerns have been expressed that "credit bidding" has been used aggressively by hedge funds and other specialist investors ("vulture funds") who are pursuing "loan to own" strategies.[50] Credit bidding is a formidable weapon in the hands of such investors who may acquire secured debt from existing creditors at a discount and then credit bid the full amount of the debt so as to acquire the secured property at a knockdown price. The fact that a specialist investor has bought distressed debt at a discounted price and then "credit bid" for the full face value of the debt may "chill" prices since it acts as a disincentive to other potential buyers. There are also concerns about the potential use of confidential information to pitch bids at a minimum threshold.[51]

Be that as it may, in a restructuring, unsecured creditors are protected by the absolute priority principle.[52] This means that shareholders cannot, in principle, be paid before the creditors unless the creditors consent or the shareholders are providing some new or additional value.[53] Section 1129(b)(2)(C)(ii) provides that the "holder of any claim or interest that is junior to the claims of such class [of unsecured creditors] will not receive or retain under the plan on account of such junior claim or interest any property".

The absolute priority principle was explained in detail by the US Supreme Court in *Czyzewski v Jevic Holding Corp*.[54] The court said that the Bankruptcy Code sets forth a basic system of priority that ordinarily determines the order in which the court will distribute assets of the debtor's estate. Secured creditors are highest on the priority list in that they must receive the proceeds of the collateral that secures their debts.[55] Special classes of creditors, such as those that hold certain claims for taxes or wages, come next in a particular order followed by lower priority creditors, including general unsecured creditors. Equity holders are at the bottom of the priority list and they receive nothing until

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[50] M M Harner, "Trends in Distressed Debt Investing: An Empirical Study of Investors Objectives", (2008) 16 *American Bankruptcy Law Review* 69 (reporting results of empirical survey on, among other issues, investors' loan-to-own strategies in bankruptcy).

[51] See generally C J Tabb, "Credit Bidding, Security, and the Obsolescence of Chapter 11", [2013] *University of Illinois Law Review* 103.

[52] See B Markell, "Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations" (1991) 44 *Stanford Law Review* 69 at p 123, arguing that this priority scheme is recognised as "the cornerstone of reorganization practice and theory".

[53] But for a suggestion that the absolute priority principle in the US is less absolute than it might superficially appear, see M Roe and F Tung, "Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain" (2013) 99 *Virginia Law Review* 1235; and also S Lubben, "The Overstated Absolute Priority Rule" (2016) 21 *Fordham Journal of Financial and Corporate Law* 581.

[54] 137 S Ct 973 (2017). For an analysis see J Lipson, "The Secret Life of Priority: Corporate Reorganization after JEVIC" (2018) 93 *Washington Law Review* 645.

[55] 11 USC, s 725.

all previously listed creditors have been paid in full.[56] In the liquidation of a debtor's assets under Chapter 7 of the Bankruptcy Code, a distribution must follow this prescribed order.[57] There is somewhat more flexibility for distributions in Chapter 11 plans, which may impose a different ordering with the consent of affected parties. Nevertheless, the court may not confirm a plan with priority-violating distributions over the objection of an impaired creditor class.[58]

One might argue that, effectively, the absolute priority principle provides the senior creditors with the chance of appropriating the entire going-concern surplus. The absolute priority principle was originally applied, however, to prevent senior creditors and shareholders from colluding to squeeze out junior creditors, particularly in the context of so-called "equity receiverships" which were common in the practice of railroad company reorganisations in the late 19th and early 20th centuries. [59] In these proceedings, the assets of insolvent companies were sold in court to a purchaser company that was usually set up by the senior lenders and old shareholders. In this way, "old" equity received a share in the restructured business while unsecured creditors often got paid little to nothing.[60]

The US Supreme Court in *Bank of America v 203 North LaSalle Street Partnership*[61] considered how the absolute priority rule was developed in response to a concern about "the ability of a few insiders, whether representatives of management or major creditors, to use the reorganization process to gain an unfair advantage".

It has been argued by some "law and economics" specialists that deviations from the priority rules that apply outside insolvency are costly and will increase the cost of borrowing since lenders adjust their rates to reflect the fact that shareholders retain some value that would otherwise have gone to the lenders.[62] To use slightly different language, the failure to enforce the absolute priority rule will affect investment decisions; drive up the cost of capital and distort allocations between equity and debt. On the other side of

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[56] See ss 507 and 726.

[57] Sections 725, 726.

[58] Sections 1129(a)(7) and 1129(b)(2).

[59] For a history of absolute priority in the US see, eg, D Baird, "Present at the Creation: The SEC and the Origins of the Absolute Priority Rule" (2010) 18 *American Bankruptcy Institute Law Review* 591; S Lubben, "The Overstated Absolute Priority Rule" (2016) 21 *Fordham Journal of Corporate and Financial Law* 581 (2016); and see also the original US Supreme Court decision in *Case v Los Angeles Lumber Products Co* (1939) 308 US 106, 115–119. The US Supreme Court also introduced the idea of a "new value exception" to the absolute priority rule on the basis that distributions to shareholders were valid as long as the shareholder provides new value to the company of (at least) the same amount. See also American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11, *Full Report* (2014), at pp 224–6.

[60] For a detailed description of equity receivership practices, see S Lubben, "Railroad Receiverships and Modern Bankruptcy Theory" (2004) 89 *Cornell Law Review* 1420.

[61] (1999) 526 US 434 at 444 quoting HR Doc No 93–137, pt I, p 255 (1973).

[62] See generally D Baird, "Priority Matters: Absolute Priority, Relative Priority and the Costs of Bankruptcy" (2016) 165 *University of Pennsylvania Law Review* 785; A J Casey, "The Creditors' Bargain and Option-Preservation Priority in Chapter 11" (2011) 78 *University of Chicago Law Review* 759; E Janger, "The Logic and Limits of Liens" (2015) *University of Illinois Law Review* 589.

the argument, it may be the case that these propositions are based on perfect market theories that are not necessarily sound in practice.[63]

In the US, it seems that valuation disputes are a significant part of the Chapter 11 landscape.[64] Each of the relevant creditor classes will be armed by their own expert(s) with a plausible value to put on the business and making use of standard valuation methodology in the form of comparable transactions, discounted cash flow and leveraged buyout pricing models. The approach adopted may feel very subjective so that the result is somewhat unpredictable, and the judge hearing the valuation dispute may "feel gamed".[65] It is the case, however, that unless the judge at the valuation hearing takes a particularly optimistic view of the company's prospects, those lower down the priority hierarchy may be left with meagre pickings.

The 2014 report from the ABI on Chapter 11 reform suggested some changes to the absolute priority principle by giving the "out of the money" stakeholders "redemption option value'.[66] The report pointed out that "valuation may occur during a trough in the debtor's business cycle or the economy as a whole, and relying on a valuation at such a time may result in a reallocation of the reorganized firm's future value in favour of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair and inconsistent with the Bankruptcy Code's principle of providing a breathing spell from business adversity."[67]

Under the Chapter 11 reform proposals, a class receiving no distribution under a restructuring plan but next in line to receive such a distribution, is given a "redemption option value" that equals the value of an option to purchase the entire company and pay in full or "redeem" all the outstanding senior debt. The option is valued using a market-based model such as the Black-Scholes model.[68] It is designed to reflect the possibility that within three years the value of a restructured company might be such that the senior creditors can be paid in full and there is incremental value for the immediately junior class of stakeholders. The Commission, however, also acknowledged that the redemption option value principles were essentially guidelines for courts and parties to use in developing allocation principles for more nuanced and complex capital structures than those vetted by the Commission. The Commission found great potential utility to the redemption value option, and it encouraged the restructuring community and

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[63] See S Lubben, "The Overstated Absolute Priority Rule" (2016) 21 *Fordham Journal of Corporate and Financial Law* 581 and see also National Bankruptcy Review Commission Report, *Bankruptcy: The Next Twenty Years* (Washington DC, The Commission, 1997) at p 566.

[64] See generally K Ayotte and E Morrison, "Valuation Disputes in Corporate Bankruptcy" (2011) 166 *University of Pennsylvania Law Review* 1819.

[65] See UK Insolvency Service, *A Review of the Corporate Insolvency Framework: Summary of Responses* (September 2016) at p 539 – response by S Paterson https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/578524/Summary_of_responses_26-10-16_Redacted.pdf.

[66] *Report* at pp 207–224 (available at www.commission.abi.org/full-report).

[67] *Idem*, at p 207.

[68] *Idem*, at p 221. For a discussion, see generally D Bernstein and J Millstein, "ABI Commission Report: Redemption Option Value Explained" (2015) 34 *American Bankruptcy Institute Journal* 10.

commentators to build upon this concept to develop more completely fair allocation rules in chapter 11 cases.

Nevertheless, the detailed rules proposed increase the complexity of Chapter 11 and there appears to be little prospect of the proposals being implemented in the near future.[69] The ABI report, however, also suggested an "equity retention plan" for small business debtors and a modified version of these proposals was implemented in the Small Business Reorganization Act 2019.[70]

The Act introduces a new sub-chapter into the US Bankruptcy Code which eliminates the rule that a shareholder cannot retain equity in a business unless creditors are paid in full.[71] The provision allows existing owners of a business to retain their full "equity" ownership without providing any "new value" if the plan provides for the debtor to distribute all of its projected disposable income over at least three years, and no more than five years, from the date the first payment is due under the plan. [72]

The new Act statutorily reverses a US Supreme Court case, *Norwest Bank Worthington v Ahlers*,[73] which held that the "absolute priority rule" barred confirmation of a restructuring plan where the old owners' sought to reclaim the company, as it were, through a contribution of "sweat equity". Now the new Act specifically validates this approach.

4. Priorities in restructuring proceedings in Singapore

Cram-down is undoubtedly a controversial topic and it generated some disagreement in Singapore when new rules were being considered and drafted in that country with a view

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[69] See generally S Paterson, "Rethinking Corporate Bankruptcy Theory in the Twenty-First Century" (2016) 37 *Oxford Journal of Legal Studies* 697, in particular at pp 718–20; "Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards" (2014) 14 *Journal of Corporate Law Studies* 333.

[70] See American Bankruptcy Institute, *Commission to Study the Reform of Chapter 11 2012–2014: Final Report and Recommendations* (2014), pp 296–8. For comment on these proposals, see R J de Weijs and B Wessels, "Proposed Recommendations for the Reform of Chapter 11 US Bankruptcy Code", Centre for the Study of European Contract Law, Working Paper Series No 2015-05 at paras 40–45 and see the comment at para 45: "The equity retention plan is set up in such a way that it will likely be only attractive if the company files in a timely manner, which is of course the preferred course of action. However, if the problems have already grown to large proportions, the equity retention plan would seem to provide little incentive if there is not a realistic projection of repaying the outstanding debts."

[71] Small Business Reorganization Act, 11 USC, ss 1181-1195 (Pub. L No. 116-54). For an analysis of the Act and the background to its enactment, see E J Janger, "The U.S. small business bankruptcy amendments: A global model for reform?" (2020) 29 *International Insolvency Review* 254.

[72] On the Act, see the US Congressional testimony online: https://www.congress.gov/event/116th-congress/house-event/109657 and in particular the statement by the ABI Commission Co-Chair, Robert Keach, "Chapter 11 doesn't work for small and medium-sized businesses because the Bankruptcy Code …(d) makes it difficult for a small business owner to maintain an ownership interest in the business under the current Chapter 11." It should be noted that the relevant liability threshold was amended (temporarily) by the Coronavirus Aid Relief and Economic Security Act P.L. 116-136, H.R. 748 (2020) passed as a result of the COVID-19 crisis.

[73] (1988) 485 US 197.

to promoting Singapore as an international and "restructuring-friendly" jurisdiction.[74] The issue was considered at some length in the 2013 report of Singapore's Insolvency Law Reform Committee (ILRC).[75] According to the ILRC, if dissenting creditors got the same or more under a restructuring plan as they would in a liquidation and were not the subject of discrimination, then this showed the hollowness of any complaint that a restructuring plan was being unreasonably imposed upon them.[76] As the ILRC pointed out, the objections might come from creditors seeking to improve their bargaining position and to receive a greater stake in the restructured business. A cross-class creditor mechanism could also reduce the amount of time spent in disputes about creditor classification since it ceased being the most decisive issue to resolve. At the same time, a minority in the ILRC were against the introduction of cram-down provisions since they were said to rely "on comparative valuations between rescue and liquidation, which are often speculative or in some cases nuanced to make rescue sound more attractive".[77] The ILRC therefore recommended "a high threshold of proof", allowing the court to check against unreasonable valuations and abuse of the cram-down provisions.[78] It also suggested that the court should have the option of appointing an assessor or expert to provide assistance in valuation matters.

Reforms were introduced in 2017 that largely followed the US in terms of cross-class creditor cram-down with some differences; most notably the fact that cram-down is more difficult to accomplish in a Singapore context because of the requirement that 75 per cent in value of creditors should approve a scheme rather than merely one impaired class of creditors. This form of cram-down is now possible in a Singapore plan once three basic conditions have been satisfied: the existing class consent requirements are satisfied in respect of at least one class; creditors representing a majority in number and at least 75 per cent in value of total claims against the debtor for which votes are actually cast vote; and the court is satisfied that the scheme is "fair and equitable" to dissenting creditors and does not "discriminate unfairly" between two or more classes of creditors. The "fair and equitable" and "unfair discrimination" requirements are based upon the cram-down provisions in section 1129 of the US Bankruptcy Code and the US precedents can be drawn upon in working out their detailed meaning.

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74 For a general analysis of the Singapore reforms, see G McCormack and W Y Wan, "Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's Restructuring and Insolvency Laws: Opportunities and Challenges" (2019) 19 *Journal of Corporate Law Studies* 69; INSOL International, *Special Report* by N McCoy, "Will Singapore become an international centre of debt restructuring? A comparative analysis of Singapore's bold insolvency reforms" (London, November 2018). See also M S Wee, "Whither the Scheme of Arrangement in Singapore: More Chapter 11" (2018) 15 *European Company and Financial Law Review* 553; and useful Singapore references in A Gurrea-Martinez, "The Future of Reorganization Procedures in the Era of Pre-Insolvency Law" (2020) 21 *European Business Organization Law Review* 829-854.

75 Insolvency Law Review Committee, *Report of the Insolvency Law Review Committee: Final Report* (Ministry of Law 2013), at https://www.mlaw.gov.sg/content/dam/minlaw/corp/News/Revised%20Report%20of%20the%20Insolvency%20Law%20Review%20Committee.pdf (2013 Report) and see also *Report of the Committee to Strengthen Singapore as an International Centre for Debt Restructuring* (2016), at https://app.mlaw.gov.sg/files/news/press-releases/2016/04/Final%20DR%20Report.pdf.

76 For a general discussion of the issue see the 2013 Report at pp 154–7.

77 *Idem*, at p 155.

78 *Idem*, at p 156.

The Singapore provisions, however, were specifically amended in 2018 to make it clear that cram-down should not adversely affect the interests of shareholders.[79] This reform (or clarification) would seem to favour the interests of controlling shareholders which are common even in listed companies in the public securities market in Singapore.[80]

5. Priorities in restructuring proceedings in the EU

This section will address, in particular, the position under Directive (EU) 2019/1023 on preventive restructuring frameworks, discharge of debt and measures to increase the efficiency of restructuring, insolvency and discharge of debt procedures.[81] This Directive has been variously referred to as the Restructuring Directive or the Preventive Restructuring Directive. EU Member States are expected to have implemented Directive 2019/1023 by July 2021, though they may request a one year extension from the European Commission.[82]

In some respects, and to use sporting parlance, the Directive is intended to be a "game-changer", bringing about business rescue for financially distressed businesses. In other respects the Directive builds incrementally on existing EU initiatives in the restructuring and insolvency field and, in particular, on the 2014 European Commission Recommendation on a New Approach to Business Failure and Insolvency.[83] The 2014 recommendation was not legally binding and was considered by the Commission to be only partially implemented in EU Member States.[84] The 2019 instrument provides significantly more detail and also adds legal teeth.[85]

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79 Insolvency, Restructuring and Dissolution Act 2018, s 70.

80 See generally K T Chuanzhong, "A critical evaluation of the new cram-down tool in Singapore's restructuring regime" (2021) 30 *International Insolvency Review* 267 who argues (text accompanying fn 127) that "Singapore seeks to provide greater flexibility in favour of shareholders through deviation from the APR, yet, on the other hand, it introduces a higher threshold for approval in favour of creditors."

81 See generally INSOL International, *Special Report*, "Reforms in Selected EU Member States in Light of the Directive on Preventive Restructuring Framework" (London, April 2020).

82 For analysis of the Directive, see G McCormack, *The European Restructuring Directive* (Elgar Publishing, 2021).

83 Commission Recommendation C (2014) 1500 final of 12.3.2014 on a new approach to business failure and insolvency [2014] OJ L 74/65. See also the Commission Communication "A New European Approach to Business Failure and Insolvency" COM (2012) 742. For discussion of the recommendation see, *inter alia*, G McCormack, "Business restructuring law in Europe: making a fresh start" (2017) 17 *Journal of Corporate Law Studies* 1; S Madaus, "The EU Recommendation on Business Rescue: Only Another Statement or a Cause for Legislative Action across Europe?" (2014) *Insolvency Intelligence* 81; H Eidenmuller and K van Zwieten, "Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency" (2015) 16 *European Business Organization Law Review* 625.

84 European Commission, Directorate-General Justice & Consumers of the European Commission, Evaluation of the implementation of the ECR 2014, 2 & 5. See also European Commission, Directorate-General Justice (A1), 2016/JUST/025 – Insolvency II, Inception Impact Assessment, 3 March 2016, 7.

85 On the general merits of EU, rather than national, initiatives see, eg, H Eidenmüller, "Abuse of Law in the Context of European Insolvency Law" (2009) 6 *European Company and Financial Law Review* 1; J Armour, "Who Should Make Corporate Law: EC Legislation versus Regulatory Competition" (2005) *European Corporate Governance Institute, Law Working Paper* No 54/2005. For general discussions on the

It should be said, however, that the Directive, in its main features, draws on a body of national and international reform efforts in the restructuring and insolvency field. Many EU Member States have reformed their laws so as to implement best practices existing in other jurisdictions,[86] including but not limited to the US Chapter 11. Paulus has spoken of an "almost feverish hectic (sic) among most of the European states to outdo the others in amending their laws ….Each one of these jurisdictions is striving for improvement; thereby, however, always keeping in mind the status of the competitors' laws and, thus, restricting the competition to a field which is located on a solid block of numerous commonalities and uniformity."[87]

The Directive introduces, *inter alia*:

- a new "restructuring" moratorium on the enforcement of claims against a company that is based on the existing debtor retaining control of its business ("debtor-in-possession");
- a new flexible "restructuring plan" procedure with provision for "cram-down" of creditors across classes, though a court / administrative authority still has to approve the restructuring plan.

In principle, each class of affected creditors must accept a restructuring plan before it may be approved by a judicial or administrative authority.[88] If there is no unanimity within the class then the dissenting members of the class are said to be "crammed down". The plan becomes binding on them even though they have not given their individual consent. In some cases, however, judicial or administrative approval for the plan may be given even if all the affected classes of creditors have not given their consent to the plan. This is referred to as cross-class creditor cram-down.[89] However, dissenting creditors must receive at least as much under the plan as they would receive in an alternative scenario – the "best interests of creditors" test.

The Directive goes into considerable detail on these matters, though some issues are left up for grabs and Member States may take divergent views in implementing legislation. The choices for Member States were increased when the original Commission proposal was going through the EU legislative process. The original proposal favoured the absolute

phenomenon of regulatory competition in the EU, see for example H Birkmose, "Regulatory Competition and the European Harmonisation Process" (2006) 17 *European Business Law* 1075; S Deakin, "Legal Diversity and Regulatory Competition: Which model for Europe?" (2006) 12 *European Law Journal* 440; and "Is Regulatory Competition the Future for European Integration?" (2006) 13 *Swedish Economic Policy Review* 71.

[86] For an overview of insolvency law reforms, see The World Bank Doing Business, "Business Reforms in Resolving Insolvency" https://www.doingbusiness.org/en/reforms/overview/topic/resolving-insolvency.

[87] C Paulus, "A Vision of the European Insolvency Law" (2008) 17 *Norton Journal of Bankruptcy Law and Practice* 607, 611.

[88] *Idem,* at articles 9(4) and 10.

[89] *Idem,* at article 11.

priority principle, that is, senior classes of creditors should be paid in full under a restructuring plan before junior classes or shareholders receive or retain any value.

The final version, which was heralded in an October 2018 draft,[90] introduces the possibility of "relative priority", that is, a restructuring plan may be approved if a senior class is treated more favourably than a junior class even if the senior class is not paid in full.[91] The introduction to the October 2018 draft explained the revised provision on the basis that the cross-class cram-down mechanism was new to a number of Member States and this mechanism raised some concerns about the consequences of the absolute priority rule. These fears were therefore addressed by a compromise text which provided an alternative option for Member States allowing them to incorporate a different benchmark – a "relative priority rule" – so as to protect dissenting creditor classes.[92] Accordingly, Member States are given more flexibility in implementing cram-down.

Article 10 of the Directive lays down certain minimum conditions for approval of a restructuring plan such as that "creditors with sufficient commonality of interest in the same class are treated equally and in a manner proportionate to their claim". These conditions include passing a "best interests of creditors" test and a feasibility review. Judicial or administrative approval of the plan is necessary where the plan affects the claims or interests of dissenting affected parties; where it provides for new financing; or where it provides for the loss of more than 25 per cent of the workforce.

Article 2(6) defines the "best interest of creditors test" as meaning that no dissenting creditor should be worse off under the restructuring plan than they would be in the event of liquidation of the business, whether in piecemeal form or by means of a going concern sale or in a next-best-alternative scenario if the restructuring plan were not confirmed.

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[90] See European Council, "Directive on business insolvency: Council agrees its position", *Council of the EU Press Release* (October 10, 2018) online: https://www.consilium.europa.eu/en/press/press-releases/2018/10/11/directive-on-business-insolvency-council-agrees-its-position/. See also "Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30. Confirmation of the final compromise text with a view to agreement", 15556/18, 2016/0359 (COD), at art 11.
For a detailed analysis of the evolution of the Directive through its various iterations, see generally JCOERE Consortium (Judicial Co-operation Supporting Economic Recovery in Europe), "Identifying substantive and procedural rules in preventive restructuring frameworks including the Preventive Restructuring Directive which may be incompatible with judicial cooperation obligations" (2019) Report 1: Chapter 3, online: https://www.ucc.ie/en/media/projectsandcentres/jcoereproject/bannerimages/Chapter3FINALPDF.pdf.

[91] See generally *Confirmation of the final compromise text, supra*.

[92] But for criticism, see R de Weijs, A Jonkers and M Malakotipour, "The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)", *Amsterdam Law School Research Paper* No 2019-10, online: https://europeanlawblog.eu/2019/03/15/the-imminent-distortion-of-european-private-company-and-insolvency-law-by-the-introduction-of-relative-priority-european-style/. See also R de Weijs, "Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt–Equity Divide" (2018) 15 *European Company and Financial Law Review* 403– 444 and R de Weijs and M Baltjes, "Opening the Door for the Opportunistic Use of Interim Financing: A Critical Assessment of the EU Draft Directive on Preventive Restructuring Frameworks" (2018) 27 *International Insolvency Review* 223-254.

Intuitively, one would expect to receive the least value in a piecemeal sale with more recovered in a going concern sale and the most value if another restructuring plan were before the court, rather than the one being considered at the moment. Before opting for the going concern approach, the court would need to be satisfied that this was the most likely alternative to approval of the restructuring plan.[93] For a different, alternative, plan to pass muster as a comparator there would need to be convincing evidence that the alternative plan would be put to the vote should the present plan fail to secure sanction. The article 10(2)(d) proviso suggests, however, that compliance with the best interests of creditors test need only be examined by a judicial or administrative authority if the restructuring plan is challenged on that ground. This is to avoid the need for a valuation of assets having to be being made in every restructuring case.[94]

Cross-class cram-down means confirming a restructuring plan against the objections of one or more classes of affected parties. The Directive envisages the cram-down of affected parties within a class and also the cram-down of whole classes of creditors. This is not a traditional aspect of the European restructuring scene but of course is a feature of the US Chapter 11.

In the Directive, the conditions for cross-class cram-down are laid down in article 11 supplemented by article 2, including the "best interest of creditors" test. Moreover, no creditor class may obtain more than the full value of its claims or interests.[95] A majority of voting classes of affected parties must approve the restructuring plan, provided that at least one of the approving voting classes is a secured creditors class or is senior to the ordinary unsecured creditors class – article 11(1)(b)(i)). By way of contrast, the US Chapter 11 only requires one "impaired" class to accept the plan before the plan can go forward for judicial scrutiny and approval.

An "EU plan" must also adhere to "relative" or "absolute" priority requirements. The original version required adherence to the absolute priority principle and this remains a possibility open in the text ultimately adopted. But Member States are also given the freedom to deviate from absolute priority in order to achieve the aims of the restructuring plan and where the plan does not unfairly prejudice the rights or interests of any affected parties.

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[93] For a discussion of different valuations and the correct approach to adopt in a restructuring context, see N Tollenaar, *Pre-Insolvency Proceedings – A Normative Foundation and Framework* (Oxford, OUP, 2019) pp 99-113.

[94] Directive (EU) 2019/1023 at recital 50. See also L Stanghellini, R Mokal, C Paulus and I Tirado (eds) *Best Practices in European Restructuring: Contextualised Distress Resolution in the Shadow of the Law* (Milano: Wolters Kluwer, 2018) at p 183: "While there is obviously nothing wrong per se in the practice of requesting plan examinations for purposes other than increasing transparency in negotiations, it does create additional costs for an already distressed debtor, hence damaging the interests of non-participating stakeholders".

[95] Directive (EU) 2019/823 Article 11(1)(d).

The prima facie test under article 11(1)(c) is, however, one of relative priority rather than absolute priority. Affected creditors do not have to be paid in full before a junior class receives anything. All that is needed is that "affected creditors are treated at least as favourably as any other of the same rank and more favourably than any other junior class".[96]

There is also specific provision in article 12 to deal with equity holders and cross-class cram-down. Equity holders may be exempted from Article 11 but in those circumstances they must not be allowed to prevent or create obstacles to the implementation of a restructuring plan.[97]

In general, the court / administrative authority may have to carry out a valuation exercise putting a value on the debtor's business where the restructuring plan is challenged on the basis that either the "best interests of creditors" test or more general cram-down conditions have not been met. In this scenario, the court may be assisted by properly appointed experts.[98]

The provision on "relative priority" ensures, however, that junior classes can get much more than they would do in a US Chapter 11 regime. The Restructuring Directive entails that a secured creditor dissenting class can be bound to a plan provided that the class is treated "more favourably" than any lower ranking class. The relative priority rule compromises rather than respects priority. It allows for plans giving value to shareholders without trade creditors receiving payments in full, or plans that make provision for payment to unsecured creditors before preferential or secured creditors receive a full distribution. There is a reshuffling and curtailing of pre-existing rights. The provision is clearly different from relative priority as envisaged even in the proposed revamping of the US Chapter 11 advocated by the American Bankruptcy Institute.[99] European relative priority may leave the shareholders fully or partly in place, whereas relative priority US style freezes out the old equity but leaves them with the option of regaining their stake in exchange for payment in full of the creditors at a later date.

European-style relative priority may be said to rest on three main and related foundations; firstly, the debtor is not actually insolvent at the time that it enters the restructuring process; secondly, encouraging existing managers and shareholders to make use of the restructuring process and thirdly, the valuation uncertainties and the realities of business. On the first justification, according to article 1(1), the Directive is intended to lay down

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96 See generally G Ballerini, "The priorities dilemma in the EU preventive restructuring directive: Absolute or relative priority rule?" (2021) 30 *International Insolvency Review* 34-53; A Krohn, "Rethinking priority: The dawn of the relative priority rule and the new 'best interests of creditors' test in the European Union" (2021) 30 *International Insolvency Review* 75-95.

97 Directive 2019/1023 recital 57 about Member States "not making the adoption of a restructuring plan conditional on the agreement of equity holders that, upon a valuation of the enterprise, would not receive any payment or other consideration if the normal ranking of liquidation priorities were applied."

98 *Idem,* at art 14(2).

99 *American Bankruptcy Institute Full Report* at pp 207-224.

rules when there is "likelihood of insolvency with a view to preventing the insolvency and ensuring the viability of the debtor". But one has to distinguish between likely and actual insolvency. If a debtor is insolvent when it enters the restructuring procedure, then the economic argument would seem to be that the debtor's assets belong fully belong to the creditors since the creditors are entitled to these assets if they have recourse to an enforcement mechanism. Shareholders are not to receive any value due to their subordinated status in a liquidation and therefore they should not be allowed to hold up or veto any restructuring plan that provides for a reorganisation of the debtor's affairs. This is basically the rule in the US Chapter 11 – absolute priority – even though the debtor, technically speaking, does not have to be insolvent before it files for Chapter 11 relief such as where it faces large, but uncertain, tort liabilities and use of Chapter 11 is an expeditious and convenient way of bringing about a settlement of the claims, particularly where the debtor anticipates liquidity issues in meeting the claims. Applications, however, must be made in "good faith" and with the genuine reorganisational objective and petitions have been dismissed where this is not the case.[100]

If the debtor is not yet insolvent however, then from a purely economic point of view the equity still has a value and the debtor is still "owned" by shareholders and not creditors. There may be constitutional protections for the property rights of shareholders; their rights to conduct a business and their rights establish and govern a company. Expropriating shareholders when the insolvency of a company is not fully established may conflict with the due process and substantive rights that lie behind the protection of private property.[101] Wessels has argued that because the Restructuring Directive is designed to prevent insolvency, then applying the logic and rules of insolvency law, including absolute priority, is not justified. Where there is no insolvency, the case for altering the debtor's capital structure and wiping out shareholders and junior creditors is not convincing.[102] The 2017 Report of the European Law Institute argued for a European-style relative priority rule.[103]

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[100] For example, in *SGL Carbon Corporation* 200 F3d 154 (3rd Cir 1999), the court dismissed the company's Chapter 11 case because of bad faith demonstrated by a lack of "reorganization purpose".

[101] *European Convention on Human Rights,* Protocol 1 at art 1 provides: "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties." The European Court of Human Rights in *Sporrong and Lönnroth v Sweden* (1983) 5 EHRR 35, at para 61, said that it "must determine whether a fair balance was struck between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights". See also *James v United Kingdom* (1986) 8 EHRR 123 at para 37; *Lithgow v United Kingdom* (1986) 8 EHRR 329 at para 106 and see generally T Xu, "A law-and-community approach to compensation for takings of property under the European Convention on Human Rights" (2019) 39 *Legal Studies* 398-414.

[102] See http://www.bobwessels.nl/blog/2019-03-doc10-the-full-version-of-my-reply-to-professor-de-weijs-et-al/.

[103] For a discussion of the underlying principles, see S Madaus, "Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law", (2018) 19 *European Business Organization Law Review* 615, particularly section 5.2. See also *Best Practices in European Restructuring* (Milano: Wolters Kluwer, 2018) at pp 45-47, but for a somewhat different perspective see also pp 32-33.

It stated: "A more flexible (relative) priority rule would better reflect pre-insolvency entitlements as it allows to create a new capital structure that also keeps everyone in the picture."

A response to this would say that the Directive alters existing contractual rights of affected parties, especially those of creditors, and is a (solvent) restructuring procedure in name only. It has been argued that inclusion of the relative priority principle jettisons perhaps the most fundamental principle of corporate restructuring law.[104] The procedure, in terms of its consequences, is an insolvency procedure; in other words, "if it's not called a duck, but looks like a duck, swims like a duck and quacks like a duck, it probably is a duck".[105]

On the other hand, the Restructuring Directive is not intended to be an insolvency procedure and therefore it makes sense to have non-insolvency distributional norms, at least as an alternative. It is intended to bring about a balanced system of business restructuring and having an absolute norm, such as absolute priority, set in stone may effectively turn a debate from one of giving opportunities to viable businesses into that of protecting the vested rights of strong secured creditors such as banks and powerful investors. Having the two norms in play of relative priority and absolute priority appears more in keeping with the social considerations of protecting employment and maintaining business activity. The Restructuring Directive is essentially about a careful balancing exercise between all the parties involved – debtor, creditors, shareholders, employees – with a view to broader societal interests and that of the economy as a whole.

The second justification for relative priority is that it encourages managers and shareholders to make use of the restructuring option when the debtor's financial difficulties have become apparent but its prospects of viability have not yet been fatally damaged. Often the temptation is to leave exploration of the restructuring options until late in the day whereas the Directive is intended to enable debtors to restructure effectively at an early stage. Recital 16 stresses the importance of early stage restructuring, stating that removing the barriers to effective preventive restructuring of viable debtors in financial difficulties contributes to minimising job losses and the loss of value for creditors in the supply chain. It also helps to preserves know-how and skills and hence is beneficial for the wider economy. Having the absolute priority rule as the single possibility creates a

[104] See R de Weijs, A Jonkers and M Malakotipour, "The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)", *Amsterdam Law School Research Paper* No 2019-10 online: https://europeanlawblog.eu/2019/03/15/the-imminent-distortion-of-european-private-company-and-insolvency-law-by-the-introduction-of-relative-priority-european-style/. See also R de Weijs, "Harmonization of European Insolvency Law: Preventing Insolvency Law from Turning against Creditors by Upholding the Debt–Equity Divide", (2018) 15 *European Company and Financial Law Review* at pp 403– 444 and R de Weijs and M Baltjes, 'Opening the Door for the Opportunistic Use of Interim Financing: A Critical Assessment of the EU Draft Directive on Preventive Restructuring Frameworks", (2018) 27 *International Insolvency Review* at pp 223-254.

[105] N Tollenaar, "The European Commission's Proposal for a Directive on Preventive Restructuring Proceedings", (2017) 30 *Insolvency Intelligence 5.* See also H Eidenmüller, "Contracting for a European insolvency regime" (2017) 18 *European Business Organization Law Review* 273–304.

disincentive for the management and shareholders and militates against early stage restructuring.

If the future contributions and continued management of equity owners is essential to the business, then the case for giving them an ownership stake in the restructured entity is especially strong. For small and medium-sized enterprises (SMEs), the skills and connections of management and shareholders and their knowledge and understanding of background factors affecting the business, including regional circumstances, may play a crucial role. Recital 58 states that the equity holders in SMEs are not mere investors, but the owners of the enterprise; they contribute to the enterprise in other ways such as by managerial expertise and it is important for them to have an incentive to restructure the business. The absolute priority rule makes it rather difficult to award value under a restructuring plan to "old equity" and, in SMEs, the separation of ownership and control may not be feasible because of the size, nature, or location of the debtor's business and the necessity of maintaining pre-distress goodwill which in turn depends on some or all of the pre-distress management remaining in place under the restructuring plan.[106]

The third justification is based on valuation uncertainties and business cycles. For instance, it gives a measure of protection against certain "loan-to-own" strategies under which buyers of distressed debt use this to acquire a portion of the debtor's equity that is greater than the present economic value of their debt claims. Putting an exact value on a business is very difficult where valuation takes place during a business downturn that "chills" alternative bids for the business. The business reality is that creditors, managers and shareholders may have to work together to accomplish a consensual restructuring and having a base rule of absolute priority stacks the odds in favour of certain parties to the negotiation. Moreover, having a flexible relative priority rule as the Directive anticipates, offers greater flexibility than the complicated pricing methodology envisaged in the US Chapter 11 reform process.

Be that as it may, the relative priority principle in the Directive seems to treat equity owners and junior creditor classes very advantageously. Dissenting senior classes are only entitled to receive more favourable treatment than any junior class.

What exactly constitutes more favourable treatment, however, is not spelled out. *Prima facie*, it would suggest receiving a greater proportion of what is due to them but there is no specification as to what the difference in treatment might be. It could be *de minimis*. This approach may upset the traditional debt–equity applecart too much. In general, debt holders get a fixed return on their debt holdings whereas shareholders are not entitled to any such fixed return but will profit from the success of the business through dividends

[106] See H Eidenmüller, "The Rise and Fall of Regulatory Competition in Corporate Insolvency Law in the European Union" (2019) 20 *European Business Organization Law Review* 547 at 559: "The idea that a complicated plan confirmation process including 'cross-class cram-downs' (Articles 8 et seq.) could be suitable for restructuring SMEs is far-fetched. A process that aims to achieve this must be simple and quick, and a bargaining process amongst stakeholder classes—which includes shareholders (Article 12)—coupled with a complicated voting and confirmation system is just the opposite."

and through enhanced capital values. The shareholders get the gains but should also suffer the pains.

At least one commentator has argued that by only requiring that senior dissenting classes be treated "more favourably" than junior classes, the relative priority principle disregards the legal entitlements of the parties and distorts the incentives around negotiating a restructuring plan. Moreover, by explicitly allowing shareholders to preserve part of their stake in the firm at the cost of creditors, the relative priority principle incentivises moral hazard and weakens the attractiveness of debt investments. Relative priority is not an appropriate solution to the problems caused by absolute priority because it raises a host of new and potentially greater issues such as opportunism and wealth-transfer.[107]

Member States are not obliged, however, to implement a relative priority regime.[108] They may adopt absolute priority instead. Moreover, the Directive softens the edges of absolute priority and allows for variations on absolute priority where these are necessary to achieve the aims of the restructuring plan and where it does not unfairly prejudice the rights or interests of any affected parties.[109] Absolute priority tempered with these qualifications may be the best way forward.

6. Priorities in restructuring proceedings in the UK

The UK is no longer an EU State and is not obliged to implement the Restructuring Directive. Nevertheless, in line with the Restructuring Directive, and also in line with the US Chapter 11,[110] the Corporate Insolvency and Governance Act 2020 made certain changes to restructuring law and practice in the UK.[111] In particular, the Act introduced a new Part 26A in the UK Companies Act with provision for restructuring plans that add additional features to the previously existing schemes of arrangement procedure under Part 26 of the Companies Act. The 2020 Act makes provision for cross-class cram-down so long as certain conditions are satisfied.[112]

Under a restructuring plan, a company is enabled to bind dissenting classes of creditors or shareholders, provided at least one class approves the plan by at least 75 per cent by value of those voting. A scheme of arrangement under Part 26, however, has to be approved by each class. Moreover, a scheme, unlike a restructuring plan, contains a

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[107] See generally G Ballerini, "The priorities dilemma in the EU preventive restructuring directive: Absolute or relative priority rule?" (2021) 30 *International Insolvency Review* 34, text accompanying footnote 157.

[108] See Directive (EU) 2019/823 at recitals 55 and 56.

[109] *Idem,* at art 11(2).

[110] For a general discussion of the issues see J Payne, "Debt Restructuring in English Law: Lessons From the United States and the Need for Reform" (2014) 130 *Law Quarterly Review* 282.

[111] For a comprehensive analysis see INSOL International *Special Report* by Gerard McCormack, "Permanent changes to the UK's corporate restructuring and insolvency laws in the wake of Covid-19" (London, INSOL International, October 2020).

[112] See generally S Paterson, "Rethinking Corporate Bankruptcy Theory in the Twenty-First Century" (2016) 37 *Oxford Journal of Legal Studies* 697; S Paterson, "Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards" (2014) 14 *Journal of Corporate Law Studies* 333.

"numerosity" requirement, that is, a majority in number of persons within each relevant class.

Typically, there are two hearings in relation to a restructuring plan or scheme of arrangement. The first is known as the convening hearing where the court principally considers whether the proposed classes have been properly constituted and meetings of those classes ought to be convened to vote on the plan / scheme. There is a second (sanctioning) hearing where the court hears the result of the votes and has to decide whether to sanction the plan / scheme.

In a plan, any creditor or member whose rights are affected by the plan must be permitted to participate in the process, but those who have no genuine economic interest in the company may be excluded. Affected members and creditors must be given sufficient information to be able to vote.[113] A restructuring plan (or scheme) sanctioned by the court is binding on all creditors / shareholders of the relevant classes and the company. Valuation issues are likely to be particularly important at the sanction stage (and possibly even at the initial convening stage), including consideration of what is the likely alternative if confirmation is refused,[114] and whether those with a genuine economic interest have been excluded from participation in the process.[115]

Traditionally in the scheme jurisprudence, the court had to be satisfied that the scheme proposed was a reasonable one such that a reasonable member of the class concerned and acting in respect of its own interests could have voted for it.[116] While the court was not a rubber stamp[117], it need not be satisfied that the scheme proposed was the only fair one.[118] Thus, the court must be satisfied that not only the statutory provisions have been observed, the relevant class must also have been fairly represented by those who attended the meeting and that the statutory majority were acting *bona fide* and not coercing the minority in order to promote interests adverse to those of the class they purport to represent.

While dissenting creditors within a class may be "crammed down", in Part 26 schemes there is no scope for dissenting classes of creditors in their entirety to be "crammed down". This fact makes the composition of creditor classes very important in the context of a

[113] UK Companies Act 2006, s 901D.
[114] Possibly an alternative plan or a sale of the business rather than a liquidation / administration.
[115] See Parliamentary Explanatory Notes at para 205 "When determining the 'relevant alternative' the court should consider what would be most likely to occur in relation to the company if the restructuring plan were not sanctioned", available at https://publications.parliament.uk/pa/bills/lbill/58-01/113/5801113en.pdf.
[116] See *Anglo-Continental Supply Co Ltd* [1922] 2 Ch 723, 736.
[117] See in this connection the recent case of *Re All Scheme Ltd* [2021] EWHC 1401 (Ch) (24 May 2021) involving the Amigo loans company.
[118] It has been pointed out that the test is not whether the opposing creditors have reasonable objections to the scheme since a creditor might be acting equally reasonably in voting either for or against the scheme. In these circumstances, the English courts consider that creditor democracy should prevail: see *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621, [75].

scheme of arrangement. It also leads to more complicated strategies with a view to "squeezing out" dissenting creditors. To a certain extent, the courts have aided scheme proponents through their interpretations of the class composition rules. It has been held that questions on class composition should be determined at the convening hearing stage rather than later at the hearing to sanction the scheme.[119]

In addition, the relevant test to work out the constitution of classes is whether creditors have different legal rights rather than separate interests that may stem from these legal rights. It has also been held that small differences in rights do not prevent creditors being placed in the same class.[120] The courts take a "broad brush" approach to avoid the situation where a minority group of creditors have an effective veto on whether the scheme should be approved.[121] It is also the case that "lock-up" agreements – small financial inducements given to creditors who vote in favour of the scheme proposals before a particular date – do not necessarily require that the creditors who are bound by the lock-up agreement should be put in a separate class.[122]

Schemes might therefore be used to "squeeze out" creditors who are "out of the money" as in *Re MyTravel plc*[123] and *Re IMO Carwash*.[124] It has been held that it is only necessary to get the consent of those with an economic interest in the proposed restructuring. In such a scheme in broad essence, company assets are transferred to a "newco" together with some liabilities of creditors who are "in the money" but "out of the money" creditors are left stranded with claims against the "oldco" which no longer has any assets. Such schemes are usually implemented as part of "pre-packaged" administration and are generally referred to as "pre-pack" or "business transfer" schemes.

The UK administration procedure involves the appointment of an insolvency practitioner (an IP) and the displacement of the board of directors and the existing management team in favour of the IP. The administrator is mandated to address the rescue of all or part of the company's business, achieving a more advantageous realisation of the company's assets than could be achieved in a liquidation and making distributions to secured and preferential creditors. Despite the absence of any explicit statutory authorisation, the courts have given their blessing to "pre-packaged" administrations which involve the sale

[119] *Re Telewest Communications plc* [2004] BCC 342 (approved by the English Court of Appeal in *Re Telewest Communications plc* [2005] BCC 29).

[120] *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573 (a scheme class confined to those "persons whose rights are not so dissimilar to make it impossible for them to consult together with a view to their common interest").

[121] See Chadwick LJ in *Re Hawk Insurance Co Ltd* [2001] 2 BCLC 480, [33], suggesting that the relevant tests should not be applied in such a way that they become an instrument of oppression by a minority.

[122] See *Re Global Garden Products Italy SpA* [2016] EWHC 1884.

[123] See *Re My Travel Group plc* [2004] EWHC 2741 (Ch) and *Re Tea Corp Ltd* [1904] 1 Ch 12. For a general discussion, see C L Seah, "The Re Tea Corporation Principle and Junior Creditors' Rights to Participate in a Scheme of Arrangement: A View from Singapore" (2011) 20 *International Insolvency Review* 161.

[124] This case is also referred to as *Re Bluebrook* [2009] EWHC 2114 (Ch).

of all or part of the company's business, normally to a pre-arranged purchaser once the administrator has been appointed.[125]

Under the "business transfer" scheme, the assets or business of the company are normally transferred to a new creditor-owned company with the latter assuming an agreed amount of the company's existing liabilities, equalling to or exceeding the value of the business or assets being transferred. The transfer is carried out by administrators who are appointed once the scheme has been sanctioned. There is no need, however, to obtain the approval of junior creditors who no longer have any economic interest in the business, given the current value of the business. These junior "out of the money" creditors are left behind in the old scheme company with their rights unaltered but now essentially valueless since the "oldco" has been stripped of assets.

Business transfer schemes may be complex but they also give rise to questions of fairness and procedural propriety.[126] The courts consider the question of valuation at the sanction stage but there may be difficult questions about where in the debt structure the value "breaks"; how one assesses value; and what is the relevant comparator for assessing fairness and value – whether it is liquidation value, going-concern value or something else?[127]

Quite apart from the difficulties involving pre-packs, there were, however, a number of limitations with schemes of arrangement under Part 26 Companies Act 2006. The first limitation relates to the lack of a wide-ranging moratorium to allow the company the time to restructure its operations. There was no specific statutory moratorium on proceedings, or enforcement proceedings, against a company when scheme proposals are being considered, though a limited moratorium has been developed judicially.[128]

Second, the UK scheme remains more a dedicated debt restructuring procedure rather than a fully blown corporate / business rescue procedure. The scheme of arrangement lacks certain aspects of the US Chapter 11, such as an executory contracts regime – a facility to deal with contracts not yet performed by the debtor.[129] Many contracts contain so-called

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125 See generally P Walton, "Pre-Packaged Administrations: Trick or Treat" (2006) 19 *Insolvency Intelligence* 113; see also V Finch, "Pre-Packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains?" [2006] *Journal of Business Law* 568.

126 See generally M Crystal QC and R Mokal, "The Valuation of Distressed Companies: A Conceptual Framework Parts 1 and 11" (2006) 3 *International Corporate Rescue* 63 and 123; N Segal, "Schemes of Arrangement and Junior Creditors: Does the US Approach to Valuations Provide the Answer?" (2007) 20 *Insolvency Intelligence* 49.

127 In the UK, the Insolvency Service, *A Review of the Corporate Insolvency Framework: A Consultation on Options for Reform* (May 2016) states at 9.9: "The cram-down of a rescue plan onto 'out of the money' creditors is currently possible in the UK only through a costly mix of using a scheme of arrangement and an administration." The Government believes that developing a more sophisticated restructuring process with the ability to 'cram-down' may facilitate more restructurings, and the subsequent survival of the corporate entity as a going concern."

128 See *BlueCrest Mercantile BV v Vietnam Shipbuilding Industry Group* [2013] EWHC 1146.

129 For a detailed cross-country comparison of this issue, see D Faber, N Vermunt, J Kilborn and K van der Linde, *Treatment of Contracts in Insolvency* (Oxford, Oxford University Press 2013); for the classic definition

"*ipso facto*" clauses allowing, for instance, suppliers to terminate or modify a long-term supply arrangement if the counterparty enters formal insolvency or restructuring proceedings, or more generally experiences financial difficulties. Subject to certain protections for contractual counterparties, a Chapter 11 debtor may "cherry-pick" among outstanding contracts, rejecting financially disadvantageous ones.

The UK has now implemented many of these key features of Chapter 11 in the Corporate Insolvency and Governance Act 2020. The 2020 Act made various (permanent) changes to the UK Insolvency and Companies Acts and it has been presented as part of the UK response to the Covid-19 crisis.[130] In particular, it introduces the new Part 26A restructuring plan procedure with provision for cross class cram down.

The 2020 Act and the new restructuring plan procedure does not specifically address the policy, however, of absolute priority. The 2018 UK government proposals on reform of the corporate insolvency framework suggested that there may be very good reasons to deviate from absolute priority, for example where an essential supplier insists on payment ahead of others.[131] It said that US experience highlighted the potential for abuse of absolute priority whereby sophisticated parties seek to benefit at the expense of others. It said that "the trend of predatory market players cheaply acquiring junior secured debt as existing bondholders sell out, and then using restructuring negotiations to extract maximum value for themselves, regardless of the interests of other creditors or the rescue of the debtor, is well documented. Allowing opportunistic creditors to exploit restructurings by blocking restructuring plans that the majority of creditors support, until they are given unreasonably favourable treatment, would not assist the Government's aim of improving the prospects for company rescue."[132]

It was suggested that courts should be permitted to confirm a restructuring plan even if it did not conform to absolute priority where non-compliance was considered necessary to achieve the aims of the restructuring; and was just and equitable in the circumstances.[133] The 2020 Act does not explicitly contain this additional measure of flexibility, or indeed say anything about the matter at all. The assumption may have been that it would introduce too much uncertainty into the law and impact negatively on the cost and availability of credit, in particular secured credit.

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in the US, see V Countryman, "Executory Contracts in Bankruptcy" (1972) 57 *Minnesota Law Review* 439; (1973) 58 *Minnesota Law Review* 479.

[130] For a comprehensive analysis, see the INSOL International *Special Report* by G McCormack, "Permanent changes to the UK's corporate restructuring and insolvency laws in the wake of Covid-19" (London, INSOL International, October 2020).

[131] The original consultation is available at https://www.gov.uk/government/consultations/a-review-of-the-corporate-insolvency-framework and see the 2018 UK government response to the consultation at para 5.161, also available at https://www.gov.uk/government/consultations/a-review-of-the-corporate-insolvency-framework.

[132] *Idem*, at para 5.162.

[133] Paragraph 5.164.

On the other hand, it could be argued that a lot is left up to judicial interpretation and the developing practice on the new Part 26A. Matters depend on how the key expressions of "genuine economic interest in the company" and "relevant alternative" are interpreted and applied.

Initially the exercise of the cramdown power under the restructuring plan procedure was considered by Trower J in *DeepOcean*[134] and by Snowden J in the sanctioning hearing in *Re Virgin Active*.[135] The latter addressed, in particular, the restructuring surplus and how this should be distributed among "in the money" creditors. The term "restructuring surplus" refers to the excess over liquidation or alternative values produced by the restructuring process. Essentially the judge took the view that "out of the money" creditors were not entitled to any share in the surplus and it was up to the "in the money" creditors to decide on how it should be divided up. He said:[136]

> "That established approach in relation to scheme cases reflects the view that where the only alternative to a scheme is a formal insolvency … business and assets in essence belongs to those creditors who would receive a distribution in the formal insolvency. The authorities take the view that it is for those creditors who are in the money to determine how to divide up any value or potential future benefits which use of such business and assets might generate following the restructuring …."

In the *Virgin Active* case dissenting creditors objected to the fact that the old shareholder class had been allowed to retain part of their ownership stake in return for putting up new capital, whereas this opportunity had been denied to the dissenting creditors. In support of this objection, reference was made to *Bank of America v 203 North LaSalle Street Partnership*[137] where the US Supreme Court refused to confirm a Chapter 11 plan that provided for the existing holders of equity in an insolvent entity to be able to subscribe for new equity in the reorganised entity. The Supreme Court held that the plan violated the codification of the absolute priority rule and the "new money" section in section 1129 of the US Bankruptcy Code because there had been no opportunity for anyone else to subscribe for the equity.

However, the judge in *Virgin Active* pointed out that the *North La Salle Street* case turned on the US statutory language and its codification of the absolute priority rule. He added, in relation to the UK, that it was "important to note that although it had been contemplated in the consultation process, an equivalent absolute priority rule was not enacted in any form as a principle for the exercise of the discretion in Part 26A."[138]

[134] *Re DeepOcean 1 UK Limited* [2021] EWHC 138 (Ch) (28 January 2021).

[135] *Re Virgin Active Holdings Ltd* [2021] EWHC 1246 (Ch) (12 May 2021).

[136] *Idem*, para 242. See also R Mokal in two articles on Part 26A in *Butterworths Journal of International Banking and Financial Law* in December 2020 ("The two conditions for the Part 26A cram down") and January 2021 ("The court's discretion in relation to the Part 26A cram down").

[137] (1999) 526 US 434.

[138] *Re Virgin Active Holdings Ltd* [2021] EWHC 1246 (Ch) (12 May 2021), para 289.

Part 26A of the Companies Act 2006 provides that two conditions must be satisfied to enable the Court to exercise cram down:

- Condition A: the Court must be satisfied that if the plan is sanctioned, none of the members of the dissenting class would be any worse off than they would be in the "relevant alternative". The "relevant alternative" is "whatever the court considers would be most likely to occur in relation to the company if the compromise of arrangement were not sanctioned…"; and

- Condition B: that the plan has been approved by at least one class who would receive a payment or have a genuine economic interest in the company in the event of the "relevant alternative".

Provided these two gateway conditions were satisfied, the court then had discretion as to whether to impose cram down.

Snowden J accepted that for the purposes of Condition A, he need only consider the relevant alternative as at the date of the sanction hearing. It is not relevant if the plan companies (or their directors) might have acted differently or if the plans were negotiated in a way that was unfair to certain creditors, or inappropriately elevated shareholder interests at the expense of certain creditors. The conduct of the directors or the negotiations they conducted were only relevant to the discretionary part of the cram-down test and could not be used to argue that the relevant alternative should have been more favourable to creditors had the directors approached matters differently.

In his view, it did not matter if the "most likely" alternative was not itself probable (that is, more than 50 per cent likely) to occur. The court simply had to assess which of the alternatives was most likely to occur if the restructuring plan were not sanctioned.

Snowden J did not accept that there was a rebuttable presumption that a restructuring plan will be sanctioned where Conditions A and B are met. These comments go in a slightly different direction from the suggestion of Trower J in *Re DeepOcean*,[139] that there would be a "fair wind" behind sanction for such a plan. Moreover, whilst Snowden J noted that the explanatory notes to the 2020 Act CIGA refer to the discretion to cram-down only being exercised where "just and equitable", these should not be read into Part 26A and there was no justification for the court to impose its own views of what is (or is not) fair or just and equitable, particularly in relation to the destination of any potential upside should the company return to good health (and in what proportions).[140]

Snowden J found, as a matter of fact, value broke in the secured debt.[141] The business and assets of the plan companies therefore in essence belonged to those secured creditors. In

[139] [2021] EWHC 138 (Ch)
[140] *Re Virgin Active Holdings Ltd* [2021] EWHC 1246 (Ch) (12 May 2021) at paras 210-221.
[141] Paragraph 254.

his view, it was for those creditors to determine how to divide up any value created by the restructuring.

He concluded that the secured lenders had acted in a commercially rational way in seeking to obtain the best terms from the shareholders. Moreover, those terms appeared to be better than any terms available in the market. While there may be cases in which incentives offered to shareholders (but not unsecured creditors) could be a disproportionate financial advantage or "bounty" for that stakeholder, this was not such a case. If value were to break in the unsecured debt, there would have been a need to look closely at whether the share of the restructuring surplus was proportionate or comparable to the compromise that each group was asked to make.

In this particular case, commercial landlords objected to a restructuring plan that saw existing shareholders retaining 100 per cent of the equity of the restructured group, albeit as part of a package in which they would provide new money on a lower ranking basis relative to the existing secured lending and write off, or capitalise, substantial inter-company loans. The argument was that this was contrary to the basic principles of insolvency law in that the shareholders, who would be at the bottom of the priority hierarchy waterfall in an administration or liquidation of a plan company, would receive the so called "restructuring surplus" at the expense of the unsecured creditors.

Snowden J held found that it was for the "in the money" creditors (those with a "genuine economic interest") to determine how the "restructuring surplus" was to be divided and that the allocation of that value to the existing shareholders in this instance was permissible. Accordingly, the objections of landlords, all of which were "out of the money", carried no weight. Consequently, any complaint about the way negotiations were conducted prior to the plans being launched were of little significance.[142] Notably, however, while acknowledging that plans may legitimately provide for differential treatment of creditors, and such treatment could be justified by reference to factors such as commercial importance and profitability, the door was left for plan challenges where landlords were "in the money" but were nevertheless treated differently.

The 2020 Act contains certain provisions that facilitate debt-for-equity swaps. This includes facilitating a new issue of shares by disallowing the pre-emption rights of existing shareholders if there is an allotment of shares pursuant to a Part 26A plan. In *Re Hurricane Energy PLC*[143] a restructuring plan was proposed that would increase the interest rate payable to bondholders and provide them with a fresh allotment of shares in the company. In consequence, the plan would also leave existing shareholders with only 5 per cent of the equity in the restructured entity.

Interpreting the relevant legislation, Zacaroli J held that "the rights of shareholders (who are taken to have an economic interest in the company) to participate in the capital and

[142] Paragraph 277.
[143] [2021] EWHC 1418 (Ch) (Convening hearing, 25th May 2021).

profits of a company are "affected by" a Plan that would dilute such participation. This construction ensures that the views of shareholders whose economic interest in the company is directly and potentially significantly affected by the Plan are taken into account in the process mandated by Part 26A."[144]

It was argued that the contractual rights of the shareholders were not altered by the dilution of their shareholding under the plan, and it was merely their economic value that had changed. The court concluded that "affected by" was a phrase of much broader ambit than "amended by" or "altered by". In accordance with what was now section 901C(3) of the Companies Act, every creditor or member of the company "whose rights are affected by the compromise or arrangement" must be permitted to participate in a meeting ordered to be summoned under section 901(C)(1). Even if the class of shareholders voted against the plan, the plan could still be sanctioned if the conditions for the exercise of the cram-down power were satisfied.

Ultimately, the court per Zacaroli J refused to sanction the plan[145] since one of the conditions for a cross-class cram-down was not met. The existing shareholders, who still had an economic interest in the company, were judged to be better off in the event of the likely relevant alternative to the restructuring plan before the court which would see them lose 95 per cent of the equity in the company. In the likely alternative scenario, the existing shareholders would retain 100 per cent of the equity and the company would continue to trade. There was no immediate cash flow crisis and there was a realistic prospect of the company being able to repay the bonds in full on maturity.

The restructuring plan was being advanced by a board of directors that the existing shareholders wished to see replaced. This was their right under company law since the shareholders had rights under the company's articles of association to appoint and remove directors. In contrast, the judge pointed out that the bondholders had contracted on terms which gave them rights as unsecured creditors only, without security and with no rights to control appointments to the board.[146]

Company voluntary arrangements

Apart from the restructuring plan (and the scheme), there is an alternative business restructuring procedure available in the UK, that is, the company voluntary arrangement (CVA).[147] Traditionally, the usage of CVA has been low for various reasons. It is an Insolvency Act procedure with the implicit insolvency stigma[148] and, moreover, it does not

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[144] *Idem*, at para 34.
[145] *Re Hurricane Energy PLC* [2021] EWHC 1759 (Ch) (Sanctioning hearing, 28th June 2021).
[146] Paragraph 131.
[147] For the definition of CVA see Insolvency Act 1986, s 1(1), which requires a proposal by a company for a composition of its debts or a scheme of arrangement in respect of its affairs.
[148] See N Cooper, "The Death of the CVA? Landlord Compromises and the Restructuring Plan" [2020] *International Corporate Rescue* 270 at 273 who suggests that CVAs are "frequently misunderstood by the press, customers and suppliers. Being a procedure under IA 1986, reporting on large retail CVAs invariably

bind secured or preferential creditors without their consent.[149] Therefore, it only seems appropriate for companies with less complicated capital structures. On the other hand, the CVA is quite flexible since creditors are not divided into classes and neither are creditors divided into impaired and unimpaired categories. The CVA only needs approval from 75 per cent in value of those voting. This means that impaired creditors might find that the statutory threshold has been achieved through the votes of unimpaired creditors. Moreover, the CVA does not have to come before the court for approval. Necessarily, the CVA will only come before the court if it is challenged within tight time limits and either on grounds of failure to disclose adequate information or on the basis of unfair prejudice to an interested party.[150]

In recent years, however, CVAs have become more popular as a restructuring vehicle for businesses in the service sector, particularly in the retail and casual dining sectors, and there have been a number of high profile uses of CVAs in this respect. These CVAs invariably involve the differential treatment of creditors and a reduction in leasehold liabilities, depending on the popularity (and profitability) of a particular leasehold location.

In *Lazari Properties v New Look*[151] the court rejected a root and branch challenge by a number of landlords to CVAs. According to Zacaroli J, differential treatment of different creditor groups was not necessarily unfairly prejudicial. Moreover, obtaining the statutory majority through the votes of unimpaired creditors was also not necessarily unfairly prejudicial.

In his view, there were four key factors when considering whether unfair prejudice exists and this will depend on all the circumstances. Firstly, whether there was a fair allocation of assets available within the CVA between impaired compromised creditors and the other sub-groups of creditors. Secondly, the nature and the extent of any different treatment, its justification and its impact on the voting outcome was relevant. Thirdly, also relevant was the extent that others in the same positions as objecting creditors approved the CVA. Fourthly, a finding of unfair prejudice was not precluded merely because the same result might have been achieved in a Part 26A restructuring plan. Zacaroli J said:[152]

> "The process under part 26A contains important safeguards for creditors that are absent from the CVA process. Most importantly, there is significant court oversight *before* the scheme becomes effective. In particular, the court is closely involved with identifying whether the class meetings are

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refers to the 'insolvency' of the company and this does nothing to aid customer and supplier confidence at an already difficult time for a business, despite the valorous efforts of PR departments and company press releases."

[149] J Payne, "Debt Restructuring in English Law: Lessons from the United States and the Need for Reform" (2014) 130 *Law Quarterly Review* 282 at 289.

[150] See the high profile challenge in the CVA involving Debenhams Stores – *Discovery (Northampton) Ltd v Debenhams Retail Limited* [2019] EWHC 2441 (Ch).

[151] [2021] EWHC 1209.

[152] *Idem*, at para 199.

> properly constituted before they are convened. Creditors know at the outset, therefore, with whom they are to consult and are able to negotiate with the company and other groups of creditors with clarity as to the strength of their position."

In *Carraway v Regis UK Ltd,*[153] the same judge set some clear parameters for how far CVAs can go without being deemed unfair. In this case it was held that the CVA should be revoked on the basis that it favoured shareholders at the expense of landlord creditors. Under the terms of the CVA, landlords' rights were significantly impaired since rents were reduced by between 25 per cent and 75 per cent and arrears compromised at just 7 per cent of their value. By contrast, a long list of "critical creditors" – including debt owing to a related company – were left entirely unimpaired by the CVA. The ultimate owner of the business was a global private equity firm and, to the extent that the company's debt burden, in particular to landlords, was reduced, the equity holder stood to benefit.[154]

The judge held that compromising the related party debt would not have jeopardised the effectiveness of the CVA, so there was no sufficient justification for leaving this debt unimpaired. It appeared to have been given favourable treatment only because it was debt owing to the shareholder, rather than for any objectively justifiable reason. This was unfairly prejudicial against the impaired creditors and, on this basis, the judge held that the CVA should be revoked, meaning that it should be treated as never having taken effect.

In addition to the preferential treatment of shareholders, the landlords complained that long-term lease modifications imposed on them by the CVA, including rent reductions, were unfair. Echoing, however, his earlier decision in *Lazari v New Look Retailers*[155] Zacaroli J said that where a CVA introduces a lease termination right for landlords, it gives the landlord a chance to "get off the bus" rather than bear the effect of lease modifications under the CVA. The termination right can therefore negate the unfairness of any lease modifications in the CVA, on the basis that the landlord can exercise the termination right and avoid such unfairness.

7. Conclusion

The US has the longest experience of a statutory framework for corporate restructurings and the most well-developed jurisprudence. The restructuring process is intended to produce a greater value than would be achieved in a liquidation – a so-called liquidation surplus. Chapter 11 provides the framework for determining how that "surplus" should be divided. Liquidation entitlements set the baseline for the carve-up. Secured creditors should get the value of their collateral, at least over time, and senior creditors are intended

[153] [2021] EWHC 1294 (Ch).

[154] See also *Young v Nero Holdings Ltd* [2021] EWHC 2600 (Ch) where the court rejected a challenge to a CVA on grounds of material irregularity and unfair prejudice.

[155] [2021] EWHC 1209 (Ch).

to be paid ahead of junior creditors and of shareholders. But the value of a restructured entity is difficult, if not impossible, to work out with precision even a couple of years down the track, especially with supervening events such as a possible global pandemic. Negotiations over a compromise solution alleviates the scope for lengthy and messy valuation battles and dissipation of goodwill.

The Chapter 11 landscape has changed over the years but there are still disagreements over the potential reach of "gifting plans" that tip value to lower ranking creditors and shareholders at the expense of intermediate or "mezzanine" creditors.[156] On one interpretation, this is merely the senior "in the money" creditors making a gift of their share of the surplus to others, and gift making should be seen as perfectly legitimate on the basis of general legal principles. A contrary interpretation sees, however, "gifting plans" as priority skipping and suspicious, if not downright illegitimate. The argument is that it involves an infringement of the absolute priority rule and impermissible discrimination. The American Bankruptcy Institute (ABI) report on Chapter 11 enhancement and improvement was sympathetic to these latter concerns.[157]

The ABI report also addressed the "new value" corollary to the absolute priority rule. The rule requires that senior classes of claims or interests should be paid in full before junior classes receive any distributions under the Chapter 11 plan. As the US Supreme Court has said simply in the *Boyd* case, creditors were entitled to be paid before the shareholders could retain equity for any purpose whatever.[158]

In the *LaSalle* case,[159] the US Supreme Court held: "A debtor's pre-Bankruptcy equity security holders may not, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized entity, when that opportunity is given exclusively to the old equity security holders under a plan adopted without consideration of alternatives." A new value corollary to the absolute priority rule has been recognised, however, under which reference is made to whether the purported new value is new; substantial; in money or money's worth; necessary for a successful reorganisation; and reasonably equivalent to the value of the equity interest being retained or received. Nevertheless, the *LaSalle* case appears to require that the "new value" should be market tested in some way.

The Covid-19 crisis demonstrates the need for continued evolution in the business restructuring world and that Chapter 11 will continue to be tested in the years to come. Legal and business models, as well as other models, will be tested across the entire world in the years to come.

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[156] See *American Bankruptcy Full Report* at p 238: "Courts are divided as to the permissibility of class-skipping transfers in chapter 11 cases."
[157] *Idem*, at pp 239-240.
[158] *North Pacific Railway Co v Boyd* (1913) 228 US 482.
[159] *Bank of America v 203 North LaSalle Street Partnership* (1999) 526 US 434.

It is only recently that Singapore and now the UK have adopted legal models on corporate and business restructuring that consciously mirror the US Chapter 11 antecedent. The UK provisions in particular contain less statutory guidance for the courts. There is no explicit absolute priority rule, never mind a "new value" corollary and, moreover, the court in the *Virgin Active* case refused to read one into the legislation.

The UK legislation leaves more room for judicial discretion and an open textured approach rather than rigidly fashioned statutory principles. Creditor democracy also appears to have a greater sway in terms of cram-drown solutions, though talk of a "fair wind" may be going too far. *Prima facie*, it is for the "in the money" creditors to decide whether value should be allocated to "old equity" in the restructured entity, whether for goodwill, hold-up value or the provision of new finance. Contrary to the perceived position in the US, the allocation of value is not necessarily dependent on any "market testing" element. The case law in the UK is continually evolving and it may be that as this process develops we will see a further refinement and strengthening of the guidelines on restructuring and cram-down. Perhaps there may be a move, in complex restructurings, to focus on expert valuation evidence at the outset of the process. This puts dissenting creditors in the unenviable position of needing to incur significant costs in what is likely to be a short space of time to consider and, where appropriate, to challenge the company's valuation evidence. The (potentially) dissenting creditors face an uphill battle to obtain the necessary information from the company to prepare an alternative valuation or any alternative assessment of the "relevant alternative".

It is also the case that the UK continues to have a number of different restructuring possibilities still on the table, such as the scheme of arrangement and the company voluntary arrangement (CVA), as well as the restructuring plan. These different options come with slightly different access requirements and confirmation conditions. In insolvency and restructuring cases, however, the UK has a highly specialist judiciary with well developed expertise and working against a background of long established precedents even if they do not bear directly on the new statutory frameworks. This bodes well for the UK remaining a restructuring venue of choice for larger international companies with cross-border operations.

The UK has been an attractive shopping venue both for individual bankruptcies and for corporate insolvencies and restructurings. It remains to be seen whether this state of affairs will continue after the UK's departure from the European Union (Brexit) which jeopardises the prospects of UK proceedings receiving straightforward recognition throughout Europe. Brexit leaves a large question mark over the continued recognition of UK proceedings.[160] The UK government can take unilateral steps to mitigate any adverse consequence of Brexit and it has taken some such steps, but it cannot legislate for the EU institutions or for the 27 EU Member States.

[160] But see *Re DTEK Energy BV* [2021] EWHC 1551 (Ch) (8th June 2021).

The UK government wishes to maintain the UK's pre-eminent position; certainly for high-end cases, and is taking steps to keep UK law up to date and in line with international best practices. But, certainly, the Netherlands and Ireland at least see themselves as stronger competitors for international restructuring business.[161] The European Union, as well as individual Member States, are also taking steps to put in place modern restructuring and corporate insolvency frameworks. Therefore, despite the familiarity and expertise that the UK has to offer, the need to forum shop cases to the UK may be less.

The European Restructuring Directive can be seen as Europe's answer to Chapter 11 of the US Bankruptcy Code. It contains old Chapter 11 favourites such as debtor-in-possession, a moratorium on creditor enforcement action and a restructuring plan procedure with the "best interests of creditors" test and provision for cross-class cram-down. However, the Directive is very much a minimum harmonisation directive with considerable discretion left to EU Member States in translating the provisions of the Directive into their national laws. It may be that even after national implementation we are still left with 27 rather different restructuring and insolvency laws in the EU States.

One area with considerable divergence may be in relation to the absolute priority rule. The Directive certainly does not require the absolute priority to be adopted as an overarching principle permeating national laws. In fact, it seems to express a slight preference for an alternative principle of "relative priority" than "absolute priority", though both principles are kept on the table as choices for Member States in implementing the Directive. The choice between these possibilities, and various intermediate or compromise positions, may help to drive business and investment decisions as between the different EU Member States, or at least the decision in respect of particular restructuring venues. But with so many variables at play it is questionable whether this will be the decisive factor.

[161] See Netherlands Commercial Court (NCC0 "Pioneering English language dispute resolution in a civil law jurisdiction" and for information see https://www.rechtspraak.nl/English/NCC/Pages/default.aspx (last accessed: 10 February 2021) and M Murphy and D O'Dea, "Ireland: An International Restructuring Destination" (2019) 16 *International Corporate Rescue* 276 and the report by the Law Society and Bar Council of Ireland, "Promoting Ireland as a leading centre globally for international legal services", available at https://www.lawlibrary.ie/media/lawlibrary/media/Secure/Promoting-Ireland-as-a-leading-centre-globally-for-international-legal-services.pdf.

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