Deviating from Absolute Priority

Amsterdam, 24 Feb. 2020

—— Conference Report* ——

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* Please note that this report is an approximation of what was said during the conference and it does not seek to provide ad verbatim coverage.

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OVERVIEW

On 24 February 2020, prof. Rolef de Weijs, prof. Enrico Perotti and Maryam Malakotipour co-organized the conference on deviating from Absolute Priority. The event was a joint initiative of the Amsterdam Centre for Law and Economics (ACLE), the Amsterdam Centre for Transformative Private Law (ACT) and the Amsterdam Center in Risk and Macro Finance (ACRM). The main purpose of the conference was to understand better the priority rules in EU Directive on Preventive Restructuring Frameworks. By June 2021 (with a possible delay), EU member states must have implemented the Directive, which requires the national legislators to make a choice between the Absolute Priority Rule (APR) or adopting a new European Relative Priority Rule (EU RPR). The conference brought together nearly 60 eminent law and economic scholars, practitioners and policy makers from around the world to discuss possible implications of deviating from the benchmark APR from legal and financial stability perspectives. The event started by a lead introduction by prof. D.G. Baird, followed by short presentations of other panel members.

AGENDA

Morning Session: The 'three-body problem' in the capital structure

09:30 – 10:00 Coffee

10:00 – 10:20 Introductory speech by D.G. Baird

10:20 – 10:45 Panel I: Plan content and allocation of value: APR vs EU RPR

Panel members: D.G. Baird (Chicago Law School), A. Bornemann (Min. of Justice Germany), S. Madaus (Halle University), chair R.J. de Weijs (University of Amsterdam)

10:45 – 11:00 Debate

11:00 – 11:30 Coffee

11:30 – 12:00 Panel II: Secured Creditors under plan procedures

Panel members: V. Vig (London Business School), N.W.A Tollenaar (RESOR), R.J. de Weijs (University of Amsterdam), chair E. Perotti (University of Amsterdam)

- *Incentive effects of secured credit*
- *Meaning of 'No secured creditor worse off"*
- *Gifting under APR and RPR*

12:00 – 12:30 Debate

12:30 – 13:30 Lunch

Afternoon Session: Governance and Macro Economic Effects

13:30 – 14:00 Panel III: Governance of reorganization procedures

Panel members: A. Mennens (University Nijmegen), J. Seymour (Duke University), chair A.E. de Vos (Supervisory Judge, Court of Amsterdam)

- *Opening procedure, offering a plan and competing plans, required consent*
- *SME debtors and SME consent and scope of SME's*

14:00 – 14:30 Debate

14:30 – 15:00 Coffee

15:00 – 15:30 Panel IV: Macro-economic repercussions: Benefits and costs

Panel members: S. Aramonte (BIS) and E. Perotti (University of Amsterdam), chair I. Arruga Oleaga (ECB)

- Impact of enhanced reorganization over the risk cycle
- *Effect on loan securitization at a time of weakening covenants*
- *Potential liquidity mismatch in bond funds*
- *International legal competition on bankruptcy laws: a race to the bottom?*

15:30 – 16:00 Debate

16:30 Drinks

OPENING

Following the welcome address by de Weijs and Perotti, de Weijs briefly explained the APR inspired by US Chapter 11. He also informed the audiences about the recent Dutch proposal providing for court confirmation of extrajudicial restructuring plan, the so called "Wet homologatie onderhands akkoord" (WHOA). The proposed draft bill has engendered heated debates and critics qualify the proposed rule as being an RPR. As a final remark, de Weijs analogized the relation between i) the shareholder, ii) the secured creditors and iii) the unsecured creditors, to the three-body problem in physics: if there are three moving bodies, there are no ways of calculating or predicting how they influence each other. In the context of reorganization, therefore, it is crucial to be specific which relation we are discussing. Following this, the official opening of the Deviation from Absolute Priority conference was declared.

MORNING SESSION: THE 'THREE-BODY PROBLEM' IN THE CAPITAL STRUCTURE

Introductory speech

The introductory speech was delivered by renowned US scholar, **Douglas Baird** (University of Chicago). Baird shared the American experience with Chapter 11 that emerged in the US at the end of the 19th century. The absolute priority in its modern form entitles each class of creditors in reorganization to insist upon being paid in full before anyone junior to them receives anything. In his presentation, Baird made the three following observations about the APR.

I. The three core rationales for the APR

Firstly, the APR keeps the focus of the procedure on what matters. The APR respects priority established outside of bankruptcy; the rights of each of the players is known and comparatively easy to assess. In Baird's view, bankruptcy law is procedural and reshuffling substantive rights only in bankruptcy invites unnecessary troubles and leads to opposite effects. On the one hand, you give some people incentive to start bankruptcy even if bankruptcy itself does not serve any larger purpose. On the other hand, if you decide to offer special protections to anyone in bankruptcy, you give some people an incentive to avoid bankruptcy even if it makes sense. Baird's reference to an extreme US experience in 1970s, the era prior to the enactment of the APR in the US bankruptcy code, elucidated how some parties in a reorganization procedure took advantage of the special treatment in bankruptcy. He referred to a case that the firm had emerged from bankruptcy. In the case, the management who used to operate building still operated the building and the tenants that used to live in the building were still there. The only thing that changed was that the default disappeared and investors owed the bank less money. Learning from the experience, the bankruptcy code reputed that odd bankruptcy regime and restored the APR.

Secondly, the APR makes it easier for good entrepreneurs to thrive. In Baird's view, the stronger the priority rule, the easier it is for good entrepreneurs to thrive. Generally, successful entrepreneurs are liquidity-constrained. This liquidity constraint has an inverse relationship with payout percentage of investors in bankruptcy: the less you give investors in bad state of world, the more they demand higher rates of interest or refuse to lend in the first instance.

Lastly, the APR promotes the reorganization process. The APR makes negotiations simpler and provides a clear benchmark that everyone can see. In principle, the APR gives the people (ie. senior creditors as a group) the right to come first but they do not have to come first if it is not in their interest.

II. Discomfort of American bankruptcy professionals and judges with the APR

Baird raised several reasons for the discomfort of American bankruptcy professionals and judges with the APR, none of which go to the merits of the rule. In the first instance, the virtues of APR are hard to see because of when they enter the picture. The high investor protection guaranteed by the APR facilitates entrepreneurs' effort in raising capital, but bankruptcy professionals enter the scene when investors have already done it.

Secondly, it is possible to undercut the APR by asserting that in the US it is honored in the breach. What is, however, crucial to notice is that paying off someone who happens to be a critical vendor or paying prepetition wages to keep

workers working are sensible business decisions and reflect the implicit or explicit blessing of the senior creditors as a group.

Finally, bankruptcy professionals still use language developed from earlier incarnations of bankruptcy law, based on which, secured debt could not be touched and the only bargaining was among the general creditors. However, nowadays, in many large reorganizations in the US all that is at stake is a financial restructuring at the holding company level. The workers are paid in full, suppliers are paid in full and the only ones that are affected by reorganization are private equity funds and hedge funds. Large corporations are not like an honest, but unlucky man; rather everyone in this sandbox is an adult who choose to play there and should look after themselves.

III. Three legitimate criticisms of absolute priority

Having said the above, Baird emphasized that he does not want to end here with the impression that the APR is perfect. One problem that absolute priority brings with it arises from a distinctive feature of US law that can be traced back to an Elizabethan statute passed in 1571. In the US, priority rights are usually tied to obtaining property rights in the discrete assets of a corporation and there are very often going to be some gaps. However, the gaps are trivial. For instance, large firms tend to consist of corporate groups. When institutional debt is at the holding company level, their collateral consists of the holding company shares in the operating company, which is easy to foreclose upon.

The second qualification that one can make to the APR is that it collapses all future possibilities to the present. In an APR regime the option value of out-of-the-money junior investors is vaporized. Those who suggest relative priority as an alternative to absolute priority are not pressing for a vague mandate to share the hurt, but rather for a way of implementing priority that respects option value and prevents fire sale.

Another potential danger of the APR is denying the entrepreneur a stake in the reorganized firm, which might lead to a loss of value. The firm may be worth more with the existing entrepreneur, therefore, everyone may be better off if she remains in place. However, it is crucial to note that the APR does not prevent entrepreneur from staying in the firm. What the APR does, is it puts that decision in the hands of senior investors when there is not enough to pay them in full. There is no guarantee that those senior creditors will keep the good firms open. There is also no guarantee that junior investors will shut down the bad firm if the decision is left to them. Hence, you have to be aware of the trade-offs.

The keynote speaker finalized his speech with a salient lesson from the several decades of experience in the US with Chapter 11. Firms in financial distress are the firms about which tough decisions have to be made. The first question that has to be asked in any reorganization regime is whether it forces to make right decisions at right time. The biggest risk of departure from the APR is that it introduces uncertainty rather than confronting the hard decisions; over the long run, this is in no one's interest.

Panel I: Plan content and allocation of value: APR vs EU RPR

Panel members: D.G. Baird (Chicago Law School), A. Bornemann (Min. of Justice Germany), S. Madaus (Halle University)

The first panel concentrated on the debt to equity divide and the allocation of value based on the APR and EU RPR.

The panel began with a presentation by **Alexander Bornemann**. Prior to starting the presentation, Bornemann stated that his remarks should not be understood to be reflective of the position of the German government, which is about to finalize a discussion draft for a law transposing the Directive's provision on preventive restructuring. In respect of the debate over APR vs. EU RPR the starting point in Germany is the APR, as current reorganization law follows a strict variant of APR modeled after the US law.

Bornemann remarked that the EU RPR was a last-minute stopgap solution in the legislative process, intended to accommodate the concerns of delegations that had opposed the APR and/or the concept of cross-class cram-down. The proposal came in late September by the Austrian presidency and was included within a few days into the document that

formed the subject of the political agreement in the Council in early October. Consequently, there had not been time for a meaningful debate on the nature of the rule and its operation in practice. It was, in particular, not meant to be a ready-to-apply-rule, but rather a means to provide Member States with more flexibility, when designing their cross-class cram-down regimes.

Bornemann suggested to distinguish two levels of operationalization of the EU RPR. First, EU RPR requires the determination of a ceiling for the treatment of the junior class. Secondly, a choice needs to be made out of the broad range of possibilities between such ceiling and the treatment of juniors under the absolute priority test. As to the first level, Bornemann presented four possible approaches for determining the ceiling.

The first possible interpretation of the RPR is that a junior class gets something less in value than dissenting senior class. In other words, if junior class receives x, the senior class would have to receive a position worth $x + \varepsilon$ ($\varepsilon > 0$). The questions that arise in that context are as follows: may ε actually be infinitesimally greater than 0 – or would it have to be substantially greater, and if yes, by what standard would the determination of such substantiveness be measured? Does ranking of the position(s) matter? Does it matter how much (in absolute terms) the senior class has to sacrifice (in relation to what the juniors have to sacrifice or will retain (in absolute terms))?

The second approach is that juniors are impaired by at least the same ratio by which seniors are subjected to a haircut. This approach is, however, problematic in relation to shareholders because they do not have a claim to subject to haircut. One may, thus, translate haircut into dilution ratio and argue that shareholders may not retain more than (C-H)/C of the share capital, where C is the creditors' original claim and H the haircut imposed on creditors' claims. Bornemann remarked that this approach involves much more mathematics, as one would also have to account for the portion of equity that juniors would have to sacrifice (i.e. H/C). As the same issue will arise at any level of the calculation the ceiling would have to be calculated recursively as $\lim_{n\to\infty} \frac{a_n}{C} H, where\ a_0 = \frac{C-H}{H} H$.

The third solution is inspired by writings on US reorganization practice in the early 20th century and is intended to preserve relative priorities in the capital structure prior to reorganization. Thus, no stakeholder should be placed in a class (post reorganization) that ranks below a class that hosts stakeholders with equal or lower (pre-reorganization) rank.

The fourth potential solution to comparing the treatment of classes is imported from current discussions in the US, which focuses on the option value of the juniors' position.

As to the second level of the operation of EU RPR, Bornemann claimed that EU RPR does not, of itself, provide any guidance on how to make the choice within the range of possible treatments of juniors. Absent such guidance national legislators are required to make their own choices from a broad range of possible solutions to make sense of EU RPR. Uncertainty would follow, in particular, but not limited to, the calculation of the loss given default (LGD) or the concept of rank in financial regulation. Bornemann concluded that a preferable path to address deficiencies of the APR is to think of tailor-made exceptions to the rule: controlling how and under which circumstances exceptions will be made from the APR. Bornemann closed his presentation by citing an article by Bonbright and Bergerman from a 1928-issue of the Columbia Law Review, in which it was claimed that a formula had yet to be developed to make the concept of relative priority less ambiguous and less subject to the arbitrary or self-interested decisions of those parties who are able to dominate the reorganization process. According to Bornemann this statement, which is now more than 90 years old, still seems to be valid.

The second presentation was held by **Stephan Madaus**, one of the creators of the EU RPR. Madaus explained why it is a good idea to rethink an alternative to the APR. The speech started with an overview of the priority rules across European jurisdictions, stating that the reality is that we do not really have the APR in Europe except in Germany. In some other European jurisdictions, the veto of the class may be ignored if some preconditions are fulfilled. In the UK, for instance, the determinative element is whether the class has an economic interest; if this is not the case, their veto has no meaning.

He briefly explained the history of the EU RPR. He mentioned that in the initial draft of the Directive there was no alternative to the APR and two EU-funded research projects, namely the CoDire project on restructuring best practices and the European Law Institute (ELI) report, came up with solutions.

Madaus, as a co-author of the ELI report, explained why the APR does not seem to be a good fit to distribute the going concern surplus. Firstly, the APR from the US chapter 11 practice is not right for European jurisdictions that have a substantially different market from the US market—the majority of companies in Europe have a very simple capital structure and little or no market value in distress. The speaker emphasized that the restructuring Directive was started as an effort to secure restructuring chances for European economy, where 99% of all enterprises are SMEs and it never intended to force restructuring for corporate groups.

The second unease with an absolute version of the APR relates to the treatment of preferential creditors, such as tax agents. If one transfers the preferential rankings into the APR, then an additional body to the three-bodies problem has to be introduced. In this case, given that we always have to pay the preferred creditors in full before paying any junior class, the latter would free-ride in any restructuring.

Madaus also noted that the best interest of creditors' test (BIT) as understood in the Directive, seem to emanate from the proposal in the CoDire project. The BIT in the European context requires that creditors do not get a value lower than the next best alternative scenario, which for a solvent firm is likely to be a going-concern sale.

If every creditor gets what he deserves based on the economic value of the claim against the struggling firm, then the question that arises is how to distribute the reorganization surplus. To answer this question, the priority rules come into play and make sure whether the plan is fair in the restructuring plan. Considering that the going concern surplus is something that is only realizable by cooperation, it should not be subjected to the BIT. To clarify this point, he made a simplified example to illustrate how the RPR works in practice. In the context of the EU RPR, the tax authority was simply ranked as an unsecured claimholder and the going concern surplus was distributed to the old equity holders before fully paying unsecured creditors.

Madaus concluded his presentation by highlighting that what we find in the Directive is a restructuring approach with too many options. The application of RPR leads to no deviation from basic principles of civil law, provides flexibility and enough protection as long as the BIT is applied correctly.

Panel discussion

The first panel discussion started with Tollenaar's question for Madaus asking how it is possible to determine a less or more favorable treatment with respect to creditors and equity. He added that looking at absolute numbers is meaningless. Following the discussion, Perotti noted there would be enormous ambiguity and disagreement on equity value in distress. In his reply, Madaus stated that the distribution to equity is based on agreement on numbers. The questions addressed are already solved by the majority decision. If you do not have an agreement you do not come to the cross-class cram-down stage.

Panel II: Secured creditors under plan procedures

Panel members: V. Vig (London Business School), N.W.A Tollenaar (Resor), R.J. de Weijs (UvA), chair E. Perotti (UvA)

Subsequent to the vibrant discussion on the allocation of value based the APR and EU RPR, the focus of conference shifted to the role of secured creditors under plan procedures. The incentive effects of secured credit, meaning of 'no secured creditor worse off' and gifting under APR and EU RPR were the points of interests addressed by the speakers in the second panel.

The second panel began with a presentation by **de Weijs** discussing the debate on the position of secured creditors—another branch of the three-body problem. The topics of the discussion were: 1) underlying presumptions of reorganization 2) 'no creditor worse off' with respect to secured creditors 3) gifting.

De Weijs referred to the basic rules of reorganization (i.e. class formation and voting, rights to offer and competing plans, cross class cram down and no creditor worse off) and noted that in all of the mentioned rules, there is a presumption that not all or most of the value would go to shareholder anyway. In Netherlands, however, secured shareholder loans are respected by trustees and supervisory judges. In *Thermophos*, the most recent Dutch case, the full amount of the subordinate shareholders' loans was eventually accepted by the court. Similarly, in the case of V&D, Sun Capital could revive €70 million as a secured shareholder loan provider. De Weijs argued that the Dutch bill should only be adopted if we address this issue because by allowing secured shareholder loan the whole debt-equity divide will be distorted and the basics rules of a reorganization procedure no longer make sense.

As to the application of the no creditors worse of principle with respect to secured creditors, de Weijs raised the following question: Who is entitled to surplus if all assets are encumbered? He presented two different views in this regard: while the underlying rationales are different, both Tabb's paper and Jonkers and van Moorse are skeptical about the distribution of the surplus value exclusively to secured creditors.

The final topic of the presentation was gifting. The concept of gifting reflects priority jumping activities that initially distribute value to creditors senior to dissenting claimants, and the latter redirects a part of the distributed value, from his *own* share, to a class junior to the dissenting class (ex. junior creditors or shareholders).

It might be argued that gifting is not problematic because it is coming from the bank's own share. However, gifting could be very toxic. To illustrate this, De Weijs uses an example. Imagine the bank and equity holders have the following background (LBO scenario):

- LBO with initial debt of 10 and equity of 2.
- After 4 years, the bank gets 15% annually, then the interest is accumulated to 17, then they write down to 13.
- Also, after 4 years there is 10 in trade debt. The going concern value is only 15.
- The bank consents as a secured creditor to a reorganization plan under which it receives out of the available value only 13. The trade creditors do not receive anything. The shareholder do retain 2.
- The outcome for the different parties is that the trade creditors have lost 10. The shareholder is back to its initial position of 2. The bank receives only 13 on its claim of 17. The compound interest for the bank is still 4.6%, however.
- Even if this outcome is not explicitly agreed upon up front, the outcome is still problematic.
- Especially because Private equity is a big player and a repeat player in its dealings with the bank.

De Weijs remarked that with gifting, there is also a potential distortion of valuation of assets (undervaluation) and secured debt (overvaluation). Furthermore, gifting may pave the way for a possible collusion between secured creditors and the debtor where they use insolvency procedures to keep control of the ball while first luring in creditors and then writing them off.

He addressed the other argument in favor of gifting which is the importance of retaining old shareholder. On this point, he stated that retaining old shareholders might be crucial with respected to some small companies. In his view, instead of allowing gifting in general, we could develop a tailor-made true SME equity retention regime. The American Bankruptcy Institute (ABI) stated that potential abuses of gifting outweighed any benefits in class-skipping, class-discriminating, and intra-class discriminating cases. In addition, the leading US supreme court case, *Jevic*, which is not exactly on gifting, also held against the general idea of class skipping in the case at hand.

De Weijs concluded his presentation by asking the following: Do we allow the parties responsible for setting up the overleveraged structure (banks and shareholders), to divide the value amongst themselves? If we allow two parties to negotiate to the detriment of a weak third party, opportunistic use is to be expected.

The final presentation in the second panel was delivered by **Nicolaes Tollenaar**. He noted that freedom of contract is defined by the ability to enforce contracted rights; otherwise, the right would be meaningless. Tollenaar stated that the collective procedure as a mechanism enables creditors to enforce their rights more efficiently. If you give secured creditors strong rights to pursue individual action, they will rip out the business. In a collective procedure, however, you resolve the common pool problem and enable creditors to also realize the enterprise value.

In order to enhance the ability of (secured) creditors to enforce their right in a collective process the following key rights should be respected: firstly, the priority over other creditors and/or shareholders to enable them to contract ex ante in a meaningful way for those priority rights. Secondly, the right to exit (liquidate).

Tollenaar elaborated distributional rules in plan procedure and the importance of respecting priority rights. Priority rights, once afforded should be respected- this ought not to be controversial. If a legal system allows party to have freedom even about admitting prioritieism, then the legal system must enable parties to enforce that. Otherwise, affording those rights in the first place would be entirely meaningless if you cannot enforce them. The debate having today is not about whether or not to enforce those pre-allocated rights, what we are talking about is the right to contract for a certain level of priority and over which portion of value.

Rules for distributing “reorganization surplus” appear less clear in Europe. Various approaches towards distribution of reorganization surplus are conceivable. The first approach is freedom of contract based on which contracted distribution rights are entirely respected. The second approach is the hybrid model (US system). In that system, departure from the liquidation priorities is allowed only with the consent of the class. The final approach is a to provide no freedom of contract: having statutory distributional rules that determine how that value is to be divided. For instance, a statute may require distribution of at least X% of the going concern surplus to unsecured creditors and allow freedom of contract for the remaining percentage.

The relative priority rule seems to him the rule in the last category. It eliminates essentially freedom of contract with respect to the distribution of the reorganization surplus and puts in place a vague notion of fairness because the outcome of the statutory distributional rule is unpredictable. You may contract to be paid in full before anyone junior to you, but it is impossible to enforce that rule because value can always be distributed to junior and equity. The resulting unpredictability, makes it impossible to finance any value above liquidation value and has an adverse impact on welfare and macroeconomic level.

Panel discussion

The second panel discussion started with a remark by van den Sigtenhorst (Florent) noting that the distribution of value is a political question and relates to the social structure (capitalism etc.). If for political reasons, one wants to alter the distribution, that should be done properly through granting or changing preference/priority of claims. Bankruptcy rules on distribution, in contrast, should be clear cut and protect what parties have contracted for in light of existing preferences and priorities, instead of interfering therein on the basis of political sentiments as to how welfare should be divided. Doing so complicates the system and adds uncertainty and risk to business by certainly changing the rules of the game in insolvency. Perotti disagreed to some extent and stated that the freedom of contract is not always optimal; we have externalities, tort and uncoordinated runs. Bankruptcy law it is an example of limiting such freedoms in contract to eliminate lack of coordination. Moreover, a gifting contract may reflect an unrecorded agreement among some of the parties with hidden transfers.

The second question was asked by Ruud Hermans (Radboud University Nijmegen) concerning a mandatory distribution of restructuring surplus to the ordinary trade creditors and bondholders. De Weijs replied that the issue is related to the issue addressed by Tollenaar whether or not secured creditors should be able to contract for the full surplus value. De Weijs is concerned that weak trade creditors will be taken advantage off still if we would allow these parties not receive anything. De Weijs thinks a better finance structure is for secured creditors to ‘put their finance structure where their mouth is’. Put simply, to act on what they say. The distribution of the whole going concern surplus to secured creditors is not problematic in the holding level because there are no suppliers at that level — at that level we would only have bondholders as financial creditors. In that way, the full going concern value would be

encumbered by pledging shares in the operating companies and there would not be the possibility to act opportunistically in relation to trade creditors. Nevertheless, we should also be aware of another issue, which is gifting—in this context. Gifting occurs when secured creditors skip over the bondholders and allocate value to shareholders. We should protect bondholders if we are sincere in our aspiration to develop of functioning bond market in addition to a bank-credit market. Therefore, we should not allow banks and equity holders to jump over them.

Tollenaar is skeptical towards introducing a statutory rule that always mandates distribution of value to specific classes such as trade creditors. In his view, there is no need for such a statutory provision because if trade creditors need to get a part of the going concern surplus, other classes would consent to them being paid in full, as it very often happens.

The final remark was made by Madaus stating that there should be as much freedom of contract as possible. APR assists to have a fixed exit and if you do not agree, there is less room for freedom of contract compared to the EU RPR, where you actually have to define what each class gets. Aart Jonkers (University of Amsterdam) agreed with Madaus that contracting around bankruptcy should not be fully allowed, but he disagreed with the solution. He stated that if you talk about secured creditors, there are two things to be concerned about: the first concern is that in many cases a lot of creditors do not go to vote; there is in fact only one large creditor that effectively plays a role in the reorganization. RPR does little to mitigate this. The second concern is that secured creditors may together with shareholders hide value for themselves. If you have a system with strong secured creditor right and very strong limited liability rights, then effectively secured creditors and shareholders together decide what would happen in bankruptcy. Freedom of contract is deceptive in this context, as limited liability and security rights cannot be justified from a contractual perspective given the effects on third parties that are no party to the contract. Limited liability and security rights are all created by lawyers and enforced by states. Jonkers then made a reference to Pistor's book on Code of Capital, which focuses on limited liability, priority rights and property in general as examples of complex ways to ensure capital growth to detriment to others.

AFTERNOON SESSION: GOVERNANCE AND MACRO ECONOMIC EFFECTS

Panel III – Governance of reorganization procedures

Panel members: A. Mennens (University Nijmegen), J. Seymour (Duke University), chair A.E. de Vos (Supervisory Judge, Court of Amsterdam)

The first panel in the afternoon focused on governance of reorganization procedures. The core topics that were addressed in that panel related to SME debtors and procedural aspects of reorganization such as opening procedure, offering a plan and competing plans and required consent.

Jonathan Seymour began the third panel. Seymour and his co-author, Steven Schwarcz, are the first US academics that reacted to the EU RPR in their paper on "Corporate Restructuring under Relative and Absolute Priority Default Rules: A Comparative Assessment". Their paper places Chapter 11 APR as a base line and it is in large part a critique on the EU RPR. Seymour, in his presentation, focused on the negative effect of EU RPR on governance in insolvency proceedings. He stressed that the APR and RPR are default rules and the legislators' choice between the rules is influential on the way that parties approach deciding on the distribution of value and also have strong effects on the governance of insolvency procedures. The speaker analyzed the impacts of the EU RPR on reorganization cases from three perspectives.

The first point of consideration was how the EU RPR might affect incentives of parties to settle or litigate a case. To answer this question, Seymour shared the US experience with the APR. On Chapter 11 it is more common for a plan to be confirmed consensually than following a cram-down hearing. There are two reasons for this: firstly, as Baird mentioned, APR is simple to understand for parties and easy function as a background for negotiations. Secondly, applying priority rule requires judicial valuation, which is expensive and uncertain; it is a battlefield of experts. As a result, parties are incentivized to accept a settlement in bankruptcy cases rather than pursue an adjudication by a judge to see how it (APR) applies. It does not, however, look like that the EU RPR will work in the same way. It is also not

clear whether EU RPR requires precise valuation of debtor as a going concern. One effect of RPR would be substitution of resolution of cases by parties from resolution of cases by judges.

The second point of discussion was how the EU RPR may affect the behavior of the debtor or the debtor's prepetition shareholders during a reorganization case. He referred to the US governance rules and briefly described the impact of the APR on debtors' incentives. Bankruptcy in the US gives the shareholder (the debtors) the first chance to propose a plan; hence, creating correct incentives to avoid strategic behaviors by plan proposers is crucial. He considered the APR as a more appropriate tool for this purpose. The APR has a disciplining effect on the plan that debtors propose and it incentivizes shareholders to come up with an offer that attract more votes to avoid the application of APR by a court. In his view, the EU RPR is likely to be captured by prepetition shareholders: If EU RPR, which is more generous towards shareholders than APR, combines with the governance rules such as the exclusivity of time process, it would give the debtor a veto and it would increase the opportunities for misbehavior.

The third perspective was the impact of the EU RPR on the basic dynamics of making a plan. He referred to de Weijs and Baird's speech and noted that the EU RPR increases the chances of collusion between senior creditors and shareholders. The distribution of value under relative priority is different than under gifting but it is a similar dynamic: the debtor's incentive (Shareholder incentive) would be to structure the plan in a way that offers the most favorable terms to the senior classes, a minimum possible value to the intermediate classes and to take the rest for itself.

Finally, the speaker stated that there are different perceptions of SMEs in the US and the Directive. He addressed the discussion as to the distribution of value in exchange for sweat equity and noted that it makes more sense if you are talking about a business that really represents the efforts of single person or a family (mom or pop business). He then referred to the recent US legislation on Small Business Reorganization Act (SBRA) as an example that allows debtors to keep value for themselves or keeping them in control of the reorganization process, but the rule tightly restricts the content of the plan.

Seymour concluded his speech by remarking that he is not advising member states which priority rule to adopt and views his role more of looking at what would be the consequences of deviating from APR. Their paper is skeptical about whether relative priority is the right approach for the member states, but, eventually, member states may conclude that the shortcomings outweigh the benefits. In principle, the BIT based on piece meal liquidation is minimally protective of secured creditors in the US, but if you do BIT based on next best alternative scenario that might offer a better protection.

The third panel continued with a presentation by **Anne Mennens** focusing on the governance structure proposed within the WHOA. She noted that the new Dutch bill is shaped in a way to provide an efficient, cheap and flexible procedure. For this reason, the procedure is not necessarily collective or public and the court is not necessarily involved from the beginning of the case, but will in any case be involved when a request for confirmation of plan is filed (in a very late stage).

The debtor can offer a plan when he sees fit and does not require prior court approval. Creditors can also offer a plan indirectly via the appointment of an independent restructuring expert. The court shall grant the request unless there is evidence this is not in the interests of the general body of creditors. When appointed the expert has the exclusive right to offer a plan. The debtor may still prepare a plan but has to ask the expert to put this to vote.

As it can be implied from the Directive, an SME debtor should approve the plan that is being prepared by the restructuring expert. This rule would be applicable to most of companies in the Netherlands. However, the Dutch legislator has provided for a workaround. It takes the form of early determinations. The court can be asked to make early binding determinations on matters such as classification, valuation and compliance with the WHOA priority rule. To avoid delay in the process, creditors cannot request such early determination. However, creditors can complain about any objections they foresee in the confirmation stage. If creditors do not raise objections upfront, they do not have the right to complain about this matter in the confirmation stage. Creditors can also do something else when they see the plan does not comply with the WHOA-priority rule and there are no reasonable grounds for deviating from

priority: they can request the appointment of an independent third-party expert. The request might be granted by the court provided that aforementioned thresholds are met.

In the confirmation stage, there are *some* grounds for refusal of confirmation ex efficio. Dutch courts do not ex officio assess compliance with the norms on cross class cram down and WHOA priority rule. This implies that creditors should actively request the court to deny confirmation on the basis that the plan deviates from the priority rules. That seems odd, at least in theory: the fact priority needs to be respected is the most substantive safeguard in the WHOA procedure. Dutch courts should take example from the high courts in London. The English courts stress that even if there is an overwhelming majority for the scheme, judges still have discretion to refuse confirmation of the plan. Lord justice Snowden refused to call meetings for schemes, cause the debtor didn't provide enough information; and this refusal had a major effect on the proceedings.

Mennens, in her final remarks, noted that restructuring experts should strive for plans that are supported by all classes and highlighted the crucial role of Dutch courts for the well-functioning of the WHOA; judges should not be afraid to refuse a plan violating the WHOA-priority rule.

Panel discussion

Bornemann asked Seymour for more elaboration on the treatment of SMEs based on the new SBRA. Seymour noted that the Act went into effect in February 2020 and it is not exactly clear how that is going to be implemented. Considering that the SBRA tracks Chapters 13 and 12, it can be inferred that the new legislation is applicable to debt reorganization procedures for individual consumers and families/farmers. In order to provide sufficient protection to the mentioned categories of debtors, the SBRA puts away some chapter 11 rules that empower creditors and provides some assurance to creditors. For instance, secured creditors have the right to be paid up to the value of their collateral. Also, the plan will specify a monthly payment to those prepetition creditors on the basis of the debtor's disposable income, which has to be calculated according to a formula.

Madaus wondered what Mennens' opinion is regarding the potential delay that may be caused as a result of appointing an expert. Mennens noted that although valuation is time consuming, it is important that judges have the opportunity to appoint an expert. It would also pressure the parties negotiating the plan taking into account that the court may grant appointment of an expert. As the chair of the panel, de Vos, in her individual capacity, stated that problem only arises if the valuation is challenged. If that is not challenged during the confirmation, then judges would not appoint an expert. She stated that a blunt challenge of the valuation might not be a reason for appointing an expert. A challenge must be – in some way – be substantiated. In case it is a small class and they substantiate their comments with credible evidence or a valuation, then a court will have to appoint an expert.

Afterwards, the topic of debate shifted to gifting. De Weijs was wondering whether gifting is allowed under the current Dutch Bill. In her reply, Mennens stated that the Dutch priority rule does not stipulate that a senior class should be paid in full before any distribution can be made to a lower ranking class. The Dutch priority rule provides that the reorganization value distribution should be in accordance to the rankings. So, if you do not touch upon the relative part that a class has in a reorganization value, a plan can be confirmed. If gifting results in class skipping, deviation from that relative share in reorganization value, then you should look whether there is any reasonable ground for deviations from the rule that priority needs to be respected.

Subsequently, de Weijs asked Baird's view on *Jevic* case— in that case the US Supreme Court held against class skipping. Baird explained the background of the case. In *Jevic*, the debtor had no assets, and a bunch of workers that had not been paid. The workers did potentially have a cause of action against the private equity (PE) funder of the acquired firm through LBO. The debtor did not have any asset, the only thing it had was a potential cause of action against the PE. The debtor and PE settled the case with $2 million on the condition that this settlement fund does not go to one specific class of creditors, namely workers (truckers). A judge noted that there were two possibilities: you either reject the deal and nobody would get anything, or alternatively, you can take the deal, apply distribution rule and at least someone gets something. However, the Supreme Court held that it does not matter whether the deal makes the creditors better off or worse off—class skipping is not authorized under the statute.

Tollenaar had difficulty understanding the fuss about gifting. He believed the senior class has the freedom to do whatever it wants to do with the share/money that it is entitled to: instead of giving it to their grandmother, she may help the plan to get through by transferring some value to junior classes. As long as there is absolute full disclosure of the gift, and the court knows which classes are consenting because they are receiving the gift, there does not seem to be any remaining objection against gifting.

Baird replied to Tollenaar's statement and stated that he does not exactly know about senior creditors in the Netherlands; they might just be simply nice and generous towards junior classes. In the US, when there is gifting, it becomes easier to suspect that something is going on. There are also number of cases where courts say they are suspicious. In Baird's view, the problem of information is much greater than one may suspect. It can be the case the manager knows information about the dying of the company. It can be that in the plan the firm is massively undervalued and secured creditors end up getting the firm at a bargain price. The tax collector may not have that information.

Perotti pointed out the risk of manipulation through gifting. He stated that in this context there may be connected contracts, with an initial construction of security interest with an intention to build additional space in that contract. On that understanding, the initial contract is granted in favor of a return to shareholders.

Tollenaar further stated that in the context of the Dutch scheme when a party buys the process by giving a side deal there is a ground for refusal ('Sluipakkoorden'). He argued that provision should be a relevant provision to deal with side deals.

Perotti then asked who has the burden to prove that ground of refusal. In his reply, Tollenaar noted that it is all about disclosure. He also thinks the risk of collusion is overstated in the Dutch system because there is an independent expert that has access to the management and makes an independent valuation.

De Weijs remarked that we do not know what kind of plans will be presented. If we allow for gifting, there will be allocation of equity under the plan to the old shareholders. Why would you put a lot of money to solve the debt overhang when you can strike a deal with the secured creditors (collusion). So, it will very much influence the procedures. In his opinion, the best structure is to keep old shareholders away from insolvency, unless allowed in by the creditors. If we are going to be exporting the new Dutch act throughout Europe, we should have the best procedure (most scrutiny and clear rules) and not compete on relaxed priority rules.

Panel IV: Macro-economic repercussions: benefits and costs

Panel members: S. Aramonte (BIS), E. Perotti (UvA), chair I. Arruga Oleaga (ECB)

The last panel discussion was on the benefits and costs of macro-economic repercussions. In that panel, the impact of enhanced reorganization over the risk cycle was explored. Arruga Oleaga noted that the ECB, in its Opinion on the preventive restructuring Directive (the ECB is asked under the Treaty to give advice on EU legislation within its fields of competence), asked for preventive restructuring to integrate balancing of interests and for ensuring its technical compatibility with the Banking Package (EU legislation which was on-going relatively in parallel).

He further raised a few points regarding the Directive and the choices which had been made in it. The first thought was that member states that choose the RPR could consider the articulation of caveats foreseen in the Directive along the same lines and make the highest possible sense from RPR. One thing that we expect the Directive, like any directive, to do is to harmonize the matter in Europe. One might fear that we may not have so much harmonization at the end. A concerted effort should be made in this sense.

Arruga Oleaga also made a reference to an ECB working paper, which demonstrates that equity investment is greener than credit since it takes place in areas where there is more innovation. And innovation tends to be greener and, therefore, much more in line with the European Green Deal strategy. From that point of view, relatively favoring shareholders over creditors through the RPR would then not be problematic, rather on the contrary. On other hand, with the RPR moving away to something that may bring uncertainty; that is something that the capital market union does not want. Legal certainty is of the essence. Finally, some of the participants in the conference say: do not overburden

bankruptcy or preventive restructuring with so many objectives because it is not about all this, it is only about procedures. A similar debate has taken place in the ECB, saying do not overburden the monetary policy with green. Yet, the ECB strategy will now expressly consider environmental sustainability.

Perotti started his speech by describing the leverage trend. Historically, debt has been the source by which investment is financed, because debt is considered safer. Since the last few years, in most OECD countries the corporate sector has become a net lender on a flow base—firms deleverage and hold more cash. However, what might be true for an average firm may not be true for many firms. As de Weijs stated, credit is now concentrated in high leverage transactions and buyouts expansion. After discussing about the leverage trend, Perotti moved the discussion further and stated that as an economist you ask whether you want to have soft or hard bankruptcy. In his view, the choice depends on the costs of accessing debt as well as the incentive created for strategic leverage. In case of external bad market condition, i.e. Eastern Europe (immediately after the wall came down), then clearly the burden of all debt is inappropriate and soft bankruptcy rules are helpful.

However, if the debt is deliberately build up by shareholders with an interest to go for negotiation it is crucial to favor restructuring but not rewarding the choice of excess debt. APR seems to be a better approach than the EU RPR because it serves to protect dispersed, unsecured debt. One may argue why do not we just allow EU RPR and avoid encourage the pull of excess debt by a claw back option? Perotti believed this would not really likely to happen.

The speaker also raised stability concerns about the EU RPR. He noted that it is clear that the EU RPR will lead to greater risk for unsecured debt. No matter how much space you leave for negotiation, it encourages to withdraw equity while secured creditors become kingmakers. People may say why is that a problem, if the risk can be priced! Perotti states that risk is underpriced in nonmarket debt such as trade, labor, tax, pension claims.

The similar question may be asked with respect to bonds: are bonds really well priced? To answer this question, Perotti referred to the modern research over the credit cycle: when you have a long period of no recession (abundant credit) and long period of credit without recession, there tends to be compression in risk premium. There will be steady deterioration of credit standards regarding the quality of covenants the extent of them, and the definition of EBIT. There is also increased tendency towards high leverage transaction. The consequences of the mentioned scenario would be high default and illiquidity risk in the next recession. However, Central Banks do not seem alert to the risk of a replacement of the APR with EU RPR as they are more concerned about non-performing bank loans (NPL's), the total volume of which is however likely to increase in case of EU RPR.

Every bankruptcy reform shifts risk taking from a financial stability point of view, and one needs to rethink the worst scenarios. When mortgage back securities (the CLO of 10 years ago) proved to be worth less than thought, there was panic and massive intervention through fiscal and monetary measures.

Perotti's biggest concern is illiquidity risk once investors realize that there is a problem with unsecured debt but do not know where or how bad it is. EU RPR is likely to raise liquidity risk. If you create new uncertainty on the rates of repayment in case of default that could take off some bottom from the bond market and lead to steep drops.

The final presentation of the conference was delivered by **Sirio Aramonte**. The speaker noted that the views expressed in this presentation do not reflect those of the Bank for International Settlements. Initially, Aramonte highlighted a couple of characteristics of the European debt market. Firstly, most of the European debt market is comprised of senior unsecured bonds; those are in fact the securities that are going to be affected the most by a reform. Secondly, there has been a compression of credit quality during the last few years, with a larger share of investment-grade issuers receiving ratings just above junk status. Finally, a significant increase in high-yield bond outstanding both in the US and Europe since the financial crisis can be observed. However, since 2014-2015 a decline in high yield bonds has been offset by the rapid growth of leveraged loans. Both in US and Europe, leveraged loans are increasingly used to collateralize loan obligations (CLOs).

CLOs are backed by a pool of loans with different seniorities. The specifics of how losses go from the underlying pool of loans to individual notes can obscure a little bit the assessment of the actual loss suffered by investors when things go wrong. For this reason, CLOs are interesting channel of transmission from financial stability perspective.

In Europe, investment funds own about more than 10% of corporate bonds market. Mutual funds (MFs) engage in liquidity transformation, which is facilitated by holding a small amount of liquid assets. However, the moment that there is a high outflow, there is a risk of run and the mechanism may not work any longer, possibly leading to the suspension of redemptions in extreme circumstances. Issues related to liquidity transformation are more likely to emerge in the face of shocks that make investors redeem their holdings quickly. For investment grade bond MFs, this could happen after significant bond downgrades to junk status.

Aramonte talked about loss uncertainty and CLOs by making a comparison with what happened during the financial crises with Collateralized Debt Obligations (CDOs). In this context, he referred to the complexity aspect of CLOs. During the financial crisis one of the reasons that CDOs had a major financial impact was the uncertainty about the loss waterfall of CDOs. Investors, especially in super senior tranches, did not have good idea how much they were going to lose. This uncertainty contributed to wholesale funding problems for banks.

As a final remark Aramonte stated that it is unlikely that the similar dynamics repeat in future regarding CLOs because there is more transparency, CLOs are simpler and not used as collateral for Repos. With respect to banks for instance, relative to the crisis, the assessment of bank exposure to CLOs is less foggy because now banks have to put their exposure to CLOs in their balance sheet. Even so, we need to be mindful of developments that could increase complexity, like the rise of synthetic CLOs. Furthermore, we have to look for possible effects on investors that hold a lot of CLOs and face losses, especially if they engage in liquidity transformation.

Panel discussion

Subsequent to Aramonte's presentation, Perotti shared some of his final thoughts. He agreed with Aramonte's view to the extent that CLOs do not necessarily produce run on banks. However, he noted that we cannot reach such conclusion simply by referring to the difference between CLOs and CDOs. CLOs will possibly affect the banking sector, but the negative impacts would be mitigated through Central Bank's intervention. In case of a run on bond MFs, the Central Banks should not intervene because we do not want to further over burden monetary policy. Aramonte agreed with Perotti on the point that the differences should not lead us to be less concerned about banks.

CLOSING REMARKS

The conference was closed by de Weijs and Perotti. De Weijs restated that the EU RPR was not fully developed and introduced, but the Directive has to be implemented. At this stage, we have to consult with each other when we do things because there is an open economy; whatever we do in the Netherlands will also affect debtors and creditors across the EU.