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Deviating from Absolute Priority

Secured creditors under plan procedures

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Overview

- Nature of a plan procedure – collective debt enforcement
- Enforcing priority rights
- Enforcing exit rights

Nature of a plan procedure

- Collective debt enforcement device

- Where the debtor operates a business, a secured creditor invariably has to resort to a collective process to enforce its rights

- Strengthening of secured creditor's rights should take place through inclusion in an efficient collective process, <u>not</u> by exempting them from a collective process

Key rights that (secured) creditors must be able to enforce through a collective process:

- Priority (over other creditors and/or shareholders)
- The right to exit (the right to liquidate)

Distributional rules in plan procedure

- Priority rights, once afforded, should be respected – this ought not to be controversial (let us please speak of “respecting priority” rather than “Absolute” priority)
- The question is rather to what extent priority rights exist or should be permitted to exist and over which portions of the value
- Rules for distributing liquidation value are clear: existing priority is respected without exception (“best interest of creditors test”)
- Rules for distributing “reorganisation surplus” appear less clear

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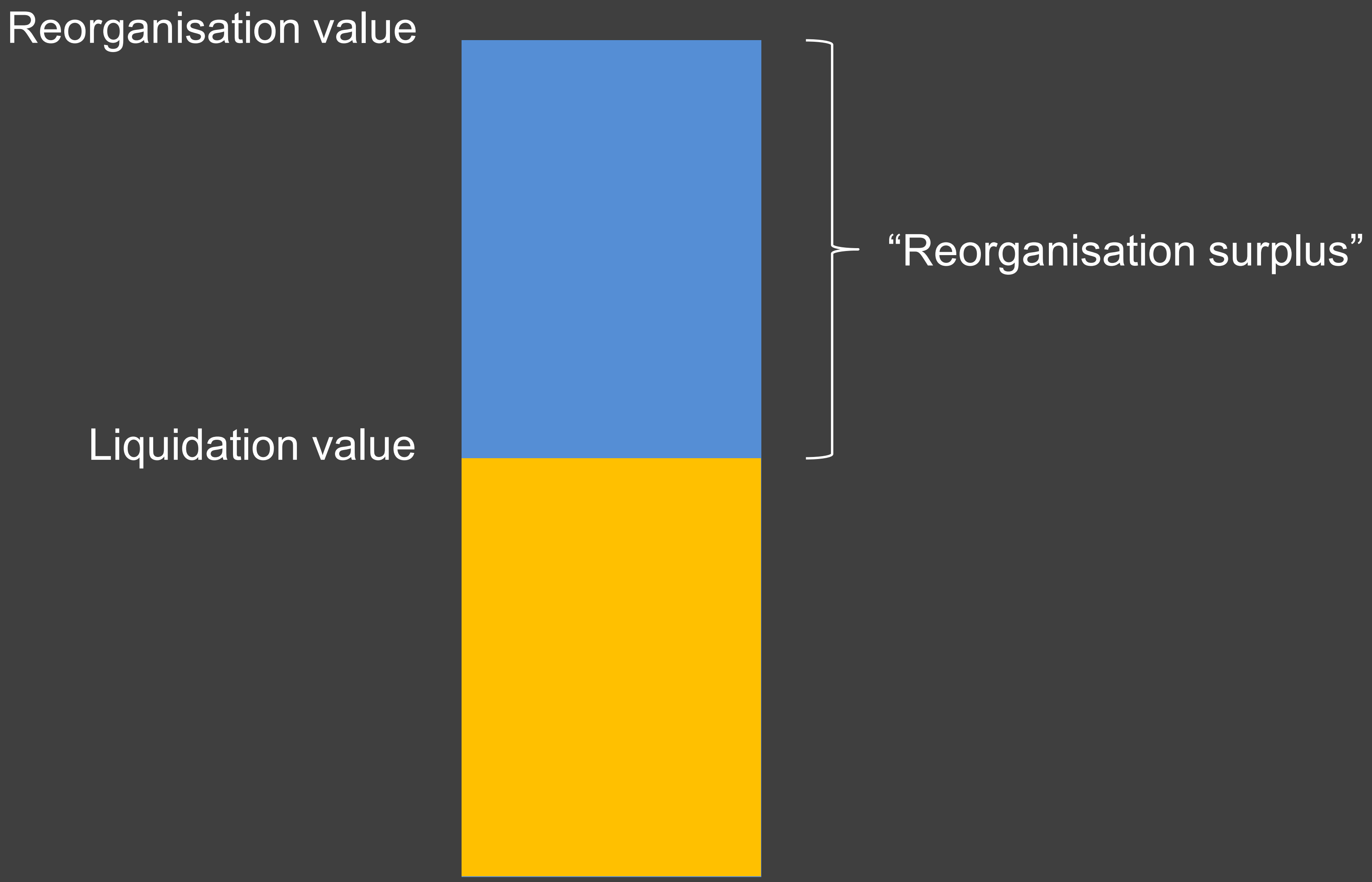
Reorganisation value
Liquidation value
“Reorganisation surplus”

Distribution of reorganisation surplus - various approaches conceivable

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- Freedom of contract – contracted distributional rights entirely respected
- Hybrid model (US system): liquidation priorities applied unless class consents to a different distribution (limited infringement of freedom of contract)
- (New) statutory distributional rules (no freedom of contract)

Personal view (endorsing views of others)

- The priority rules in liquidation and reorganisation (and inside and outside a collective process) should be equivalent to avoid harmful strategic behaviour (Baird & Jackson)

- A large degree of contractual freedom is economically beneficial (increases the availability and lowers the cost of credit)

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Co-panelist Vikrant Vig (2013)

“The law and finance literature presents a strong case for strengthening creditor rights, arguing that strong creditor rights reduce borrowing costs and thus relax financial constraints. The economic justification for stronger creditor rights is that they expand the space of debt contracts that can be written between the borrower and the lender.” (Vig, 2013)

- The finding that “strengthening” creditors rights can lead to premature liquidations appears to concern a system that allows secured creditors to bypass the collective process and seize and liquidate the firm’s assets through individual enforcement action.
- Bypassing the collective process should not be permitted. The efficiency of the collective process should be optimized.

Seymour and Schwarz (2020)

"There is abundant evidence that lenders' expectations of their potential recovery in the event of a liquidation affects their willingness to lend. When Sweden, for example, experimented with a rule that permitted secured creditors to recover only 55% of the value of the collateral encumbered by floating liens, the ability of the business to take on long term debt quickly reduced."

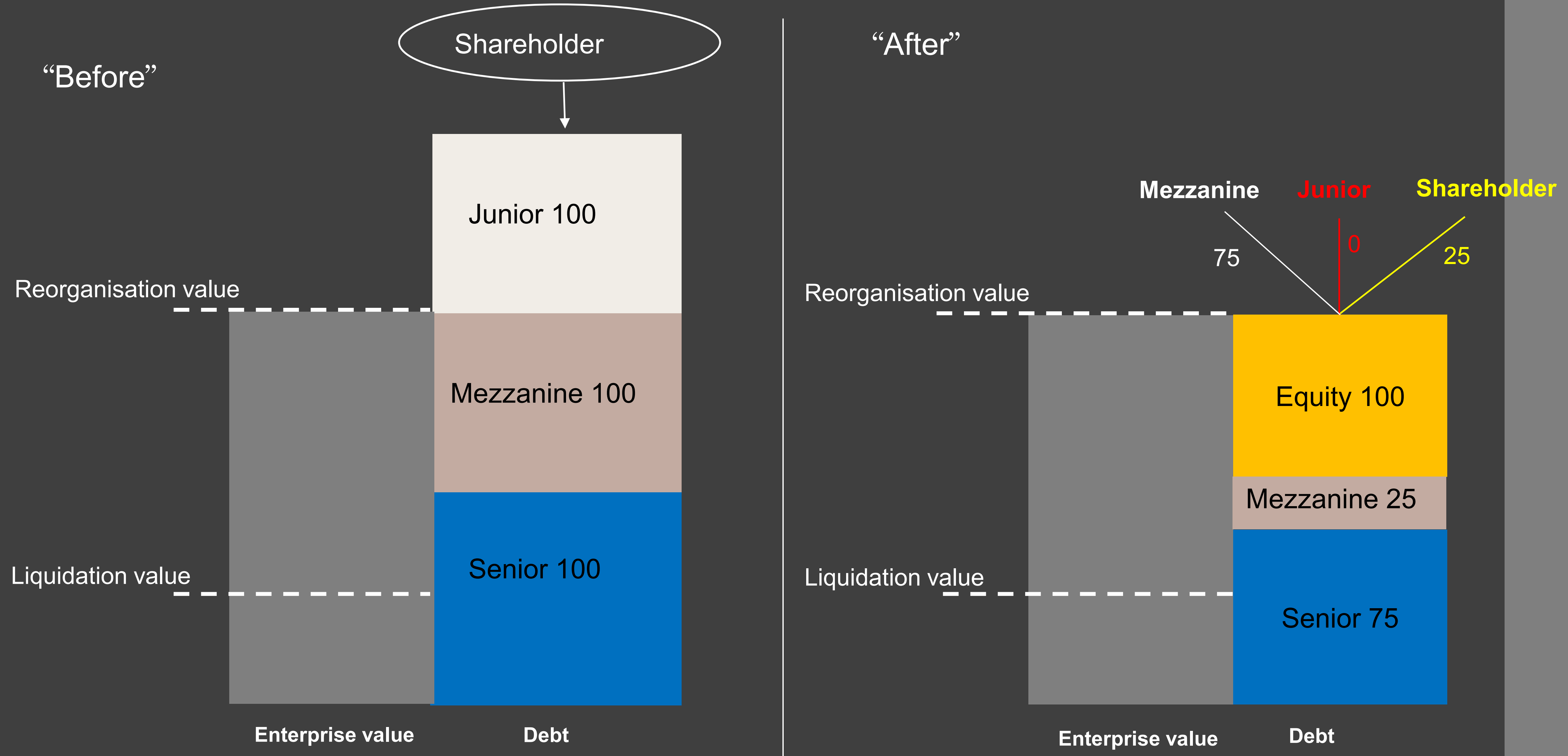
Relative Priority Rule

- A difference between the distributional rules in a preventive procedure and another sort of procedure could lead to undesirable strategic behaviour

- RPR appears to be a statutory distribution rule that eliminates the freedom of contracting with respect to the distribution of the reorganisation surplus

- The outcome of the statutory distributional rule is unpredictable, making it impossible to finance any value above liquidation value (dead capital)

Gifting – why should this not be permitted?



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Safeguards for gifting

- Full disclosure – it must be clear to the court that a class is not consenting to the plan on the basis of its merits but on the basis of a "gift"

- It would be acceptable to strictly sanction this disclosure requirement, for example by providing that, where full disclosure has not occurred, the plan is void and unenforceable

- When assessing the plan, the court could assume that the class receiving the gift would have opposed the plan, had it not been offered the gift.

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Respecting exit rights

- The right to repayment in cash at a certain time, i.e. the right to exit the investment, is a key creditor right. The limited time horizon of the investment, is one of the key distinctions between debt and equity.

- Debt/equity bargain: equity obtains the right to leverage the debt. In return it accepts that if the debt is incapable of being repaid at the agreed time, liquidation will take place and any value above liquidation value may be lost.

- There is no justification for interfering with this bargain or rendering such an agreement unenforceable (freedom of contracting).

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Safeguarding exit rights in a plan procedure

- Where a class consents: dissenting creditors can be forced to accept payment in the form of non-cash (no exit right)

- Where a class dissents: the members of the dissenting class should have the right under the plan to opt for a payment in cash equal to the amount in cash that they would expect to receive upon liquidation (exit right).

Cram down of secured creditors