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EDITORIAL

Guest Editorial

EU Member States must implement preventive restructuring processes in accordance with the provisions of the Preventive Restructuring Directive (Directive 2019/1023; PRD) by July 2021.[1] During the same period in which the Directive was being considered, the JCOERE research project began its work.[2] JCOERE focuses on the co-operation obligations imposed by the EIR Recast (848/2015) in the context of restructuring. Two questions were asked. First, whether substantive rules arising in a restructuring process such as a stay and cram down presented added challenges for co-operation. Second, whether certain procedural rules would pose similarly exacerbated challenges in cross border restructuring. Such rules could include approval processes as envisaged by the Directive. This editorial will focus on the debate surrounding implementation of the cram down provisions of the PRD and related protections for creditors.

It is clear that there are significant variations in approach to restructuring across the Member States. It seems that, since the 1990s, Ireland,[3] relative to other member states, has developed an important body of jurisprudence in restructuring procedures reflecting many of the key legislative principles in the Directive. This is not surprising, as the Irish Examinership process was modelled on Chapter 11 of the US (Federal) Bankruptcy Code, as is the PRD (in many, but not all respects).[4] Restructuring processes do not dominate the insolvency landscape in any jurisdiction. Rescue is not suitable for every company but, when it works, the figures available from Ireland indicate it is obviously beneficial to a range of stakeholders and to creditors.[5]

One of the most controversial substantive rules appearing in the Directive are the cram down provisions contained in Article 11. The consequent debate on Absolute Priority Rules, Relative Priority Rules, and their meaning and effect has become quite heated in academic and policymaking circles. Practical experience from Irish practitioners, courts, and academics could inform this debate.

First, unpicking what is understood by APR and RPR, Mennens[6] describes the development of the Directive insofar as these rules are concerned:

[1]Article 34, PRD, which provides some extensions for particular provisions.
[2]The JCOERE projects is funded by EU Commission DG Justice (No. 800807) and is co-ordinated by the School of Law at University College Cork, with UNIFI, UTM Bucharest, and INSOL Europe as partners. See <www.ucc.ie/en/jcoere>.
[3]For clarification, this is the Republic of Ireland, a common law jurisdiction separate from the jurisdictions of the United Kingdom. The relevant legislation is the Companies (Amendment) Act 1990 (as amended in 1999 and 2013) now contained in Part 10, Companies Act 2014.
[4]Title 11 of the US Code is known as the US Bankruptcy Code. Chapter 11 of this code deals with Reorganization. See <https://www.govinfo.gov/app/collection/USCODE>.
[5]Vision-net.ie has provided figures indicating that, in the recessionary period 2007–2016, 720 companies petitioned for examinership and of these, 56% are continuing to trade, with 20% dissolved and a further 23% in liquidation. See <https://www.irishtimes.com/business/economy/majority-of-companies-entering-examinership-since-crash-survived-1.3141055>.
[6]Anna Mennens with Michael Veder: Oxford Business Law Blog (25 March 2019).

> "The 2016 proposal contained an "absolute priority rule" (APR), which is similar to its US counterpart. This rule essentially requires that a dissenting class of creditors is paid in full before any value can be distributed to a lower ranking class. The APR ensures that priority is respected."

1 | DOES THE US HAVE AN APR?

It seems there is some transatlantic misunderstanding as to whether US Chapter 11 does indeed have an APR rule. Obviously, Title 11 has an APR as this deals with distributions on insolvency. Both the Irish Examinership process and US Chapter 11 have intra and cross cram down provisions.[7] In Chapter 11 reorganizations, APR as a distribution rule for bankruptcy generally operates *as a starting point* from which creditor agreements and compromises begin. And similarly, the APR applies as a default floor from which the question of "unfair prejudice" or "creditors' best interest" applies. It is not possible to have a robust rescue process without a departure from the APR. This view is supported by Lubben reiterated in a European context by Mokal.[8] Lubben argues that

> there is no absolute priority rule of the kind described in the literature under current law. It is not clear there ever has been such a rule … [And] even if there were, adopting such a rule would be inconsistent with chapter 11, or any other sensible system of reorganization. That is, chapter 11 will not work under the kind of rigid absolute priority rule many academic commentators promote, and thus the rule would be certainly flouted.[9]

Lubben's observations are reflected in this editorial. A compromise on pre-existing priorities is part and parcel of any robust preventive restructuring framework. This is illustrated by reference to significant Irish case law which includes decisions of the Irish Supreme Court.

2 | WHAT DOES APR MEAN?

Second, it is not clear that the use of the term APR is entirely agreed upon. The principle description of APR is that dissenting classes which are more senior than classes which agree to the compromise must be paid off in full before a compromise is reached.[10] Accordingly, the best possible scenario is that a senior class has a complete veto over a restructuring process based on an unlikely expectation of being paid *in full.*

It is argued here that the proper approach to APR is that assuming all domestic frameworks have a system of priorities which are applied in post insolvency distributive systems (liquidations for

[7]See below for the Irish Rules. Section 1126(c), Bankruptcy Code, states that an entire class of claims is deemed to accept a plan if the plan is accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims in the class. Under section 1129(a)(10), if there are impaired classes of claims, the court cannot confirm a plan unless it has been accepted by at least one class of non-insiders who hold impaired claims. See <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics>.

[8]See further Riz Mokal, "The New Relative Priority Rule" (paper presented at the International Insolvency Institute, 17 June 2019, slide 4). This point was repeated by Mokal at the INSOL Europe Copenhagen Conference (2019).

[9]Stephen Lubben, "The Overstated Absolute Priority Rule" (20 March 2015), available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2581639>.

[10]"The APR requires that no claimant class ranking below the dissenting one should receive or retain anything under the plan unless each member of the dissenting class has been paid the full-face value of its outstanding claim." Riz Mokal and Ignacio Tirado, "Has Newton had his Day? Relativity and Realism in European Restructuring" (2019) *Butterworths Journal of International Banking and Financial Law* 233.

example), the issue is to what extent domestic preventive restructuring frameworks move from the accepted ground rules as it were to facilitate rescue. As Garcimartin observes, APR is "the shadow under which the compromise is made."[11]

The Irish insolvency rules regarding priority of payment on liquidation mirror the normal priorities found in other member states. In addition, the system specifically allows for the enforcement of receivership rights[12] (based on significant rights *in rem* created by secured creditors on foot of a loan agreement). However, departure from the agreed priority rules is facilitated by the rescue legislative framework. A good illustration of this is found in the *Holidair* litigation.[13] Allied Irish Banks appointed a receiver and manager to Holidair (which was the holding company of a specialised construction group called MF Kentz) on foot of a pre-existing loan agreement. The debtor company successfully applied to the High Court for an examiner to be appointed, following which the receiver was ordered by the court to cease to act within the terms of the legislation. The *Holidair* examinership process proceeded, during which permission was also obtained from the court allowing the examiner to avail of assets which had been subject to the charges imposed by AIB. The company was successfully rescued and, many years later, it has recently been sold to a Canadian conglomerate. *Holidair* is an excellent example of how the secured creditors' rights were affected from the outset and compromised all through the preventive restructuring process.

3 | PRIORITIES AND RESCUE

The core question remains as to how the accepted priority system can be compromised during a rescue. Mennens goes on to describe:

> the final text of the Restructuring Directive contains an APR with somewhat softer edges, allowing for derogations from the priority rules when (i) necessary to achieve the aims of the restructuring plan and (ii) such derogations do not unfairly prejudice the rights or interests of any affected parties.

She continues to observe that it is accepted that

> at a fairly late stage of the legislative process, in addition to the APR a "relative priority rule" (RPR) was introduced. This standard was advocated by the ***Codire*** research group in their final report dated July 2018.[14]

[11]Stated at the INSOL Europe Copenhagen Conference (2019).

[12]Unlike the United Kingdom, where the ability of a charge holder to provide for the appointment of a receiver and manager over all of the assets of a company on foot of a charge has been abolished under the Enterprise Act 2002. The right of a secured creditor to appoint a receiver and manager continues to be available in other common law jurisdictions in addition to Ireland, such as Australia and New Zealand.

[13]*Re Holidair* [1994] 1 I.R. 416.

[14]The CODIRE research group provides the following definition of the RPR in its Final Report July 2018: "The relative priority rule provides a more realistic alternative, ensuring fairness for dissentients by protecting their relative position against all other affected stakeholders but without creating hold-out incentives. The relative priority rule also makes it more feasible for plans to be approved that permit equity holders to retain a stake in the debtor or its business, which in turn is likely to incentivise greater and more timely use of restructuring proceedings and the option of drawing on equity's debtor-specific knowledge, expertise, and goodwill. The rule also provides a measure of protection against improper 'loan-to-own' strategies by which acquirers of distressed debt seek to acquire a share of debtor's equity greater than the present economic value of their debt claims."

The introduction of the RPR has been criticised and treated reluctantly:[15]

"RPR enables the redistribution of value, allowing for the reshuffling and curtailing of pre-existing rights in a manner that is unpredictable. This is incompatible with the desire to create legal certainty for investors. This uncertainty will hamper the free flow of capital, thereby undermining the Commission's pursuit of a true capital markets union".[16]

4 | INTRA AND CROSS CLASS CRAM DOWN

The PRD provides for intra class cram down, but more importantly provides in Article 11 for cross class cram down. Article 11 states that Member States shall provide for a rescue process where there are dissenting classes following approval by "a judicial or administrative authority" which will "become binding upon dissenting voting classes" as long as certain conditions are met which are described in the Article, namely, where Article 10(2) and (3) are satisfied which includes the best interests of creditors test,[17] that the classes are appropriately constituted,[18] the compromise satisfies one of two conditions outlined in Article 11(1)(b) and finally where the restructuring plan:

> ensures that dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class.[19]

However, even though Member States are now free to opt for the APR or RPR, there is more. There is a general derogation provided for in sub para 2 of Article 11 which in fact mirrors the Irish legislation:

> Member States may maintain or introduce provisions derogating from the first subparagraph where they are necessary in order to achieve the aims of the restructuring plan and where the restructuring plan does not unfairly prejudice the rights or interests of any affected parties.

5 | IMPLEMENTING THE PRD

The Examinership legislation requires that, before a compromise is approved, there must be consent from at least one class of impaired creditors (consent is obtained by simple majority); that the court is satisfied that the compromise is equitable as regards any class of members or creditors that have not accepted the proposals; and that the scheme does not unfairly prejudice any interests. Every

[15]See, generally, <www.codire.eu/materials>; Rolef de Weijs, Aart Jonkers and Maryam Malakotipour, "The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)" (11 March 2019) (Centre for the Study of European Contract Law Working Paper No. 2019-05), available at <https://ssrn.com/abstract=3350375>; or <https://doi.org/10.2139/ssrn.3350375>. See also Mokal and Tirado, above note 10.

[16]Mennens, above note 6.

[17]Article 2(6), PRD: the "best-interest-of-creditors test" means a test that is satisfied if no dissenting creditor would be worse off under a restructuring plan than such a creditor would be if the normal ranking of liquidation priorities under national law were applied, either in the event of liquidation, whether piecemeal or by sale as a going concern, or in the event of the next-best-alternative scenario if the restructuring plan were not confirmed.

[18]Ibid., Article 11(1)(a).

[19]Ibid., Article 11(1)(c).

compromise under the legislation must be approved by the High Court.[20] Any decision of the High Court can be appealed to the Court of Appeal and ultimately to the Supreme Court on points of law.

An application of this test by the Irish Supreme Court in *McInerney* where the court approved the High Court's *refusal* to approve the compromise is instructive:[21]

> 12. In essence, the issue on the confirmation hearing was whether the proposal was unfairly prejudicial to the banks. In this regard the judge adopted a test with which the parties agreed. He considered (at para. 4.3) that "it would require exceptional circumstances before a court could approve a scheme of arrangement where secured creditors could be shown to be worse off under the scheme than under the alternative methods by which the value of the secured creditors' security could be realised."

The court continued, in citing the lower court with approval:

> The judge pointed out that under this proposal, as under many, if not all examinership proposals, the unsecured creditors would be paid an amount which was calculated as being more than that which they would receive under a liquidation. He suggested that if such a proposal nevertheless required that another class of creditors (in this case the secured creditors) receive something less than they would receive under receivership or liquidation, then that would by itself be a reason to conclude that there was unfair prejudice to the creditors, unless the disparity was justified by strong reasons. This approach was not contested on this appeal.[22]

In contrast,in terms of outcome only, in the Irish decision in *SIAC*,[23] the High Court and the Supreme Court approved the scheme despite objections from a Polish creditor and others that they were being unfairly prejudiced:

> 71. I would also approve the following helpful passage in Corporate Insolvency and Rescue, by Irene Lynch-Fannon and Gerard Nicholas Murphy (2nd Ed. Bloomsbury Professional 2012) at paragraph 13.43:

[20]Article 11, PRD, provides for the approval of a compromise involving a cram down by an administrative or judicial authority. The involvement of the Irish superior courts in examinership has been crucial in terms of oversight and implementation and so it is important that there are cross border equivalences in implementation of this article.

[21]The Irish legislation provides as follows: Section 24: "(3) At a hearing under subsection (1) the court may, as it thinks proper, subject to the provisions of this section and section 25, confirm subject to modifications, or refuse to confirm the proposals. (4) The court shall not confirm any proposals—(a) unless at least one class of members and one class of creditors whose interest or claims would be impaired by implementation of the proposals had accepted the proposals, or (b) if the sole or primary purpose of the proposals is the avoidance of payment of tax due, or (c) unless the court is satisfied that—(i) the proposals are fair and equitable in relation to any class of member or members or creditors that has not accepted the proposals on whose interests or claims would be impaired by implementation, and (ii) the proposals are not unfairly prejudicial to the interests of any interested party."

[22]*Re McInerney Homes Ltd.* [2011] IESC 31 (per O'Donnell J). This is a judicial description of the best interests of creditors test and how the "unfair prejudice" test operates.

[23]*Re SIAC Construction Ltd.* [2014] IESC 25. The survival proposals involved a EUR 10.5 million investment in the company, with about EUR 5 million going to secured banker creditors—Bank of Ireland, Bank of Scotland and KBC Bank, owed some EUR 42 million. The companies had 1,255 creditors and most of those got between 5% to 10% of what they were owed. See also Irene Lynch Fannon, "Examinership: Approval of Schemes: *Re SIAC Construction Ltd* [2014] IESC 25" (2015) 22(1) *Commercial Law Practitioner* 3-6.

> "While the court can take into account the prejudice an individual may suffer if the scheme is implemented, the prejudice must be unfair; the court will also consider the prejudice that will be caused to other creditors and employees if the scheme is not approved by the court and weigh both considerations in the balance when deciding whether or not to confirm the scheme of arrangement."
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> 72. The court will need to assess any claim of a creditor to be unfairly prejudiced by proposals from all angles. … . As can be seen from the cases, a court will take note of the fact that some creditors, while losing heavily in the write-down of their debts, are likely to benefit if the company is able to resume trading. A party may claim to be prejudiced by the loss of an advantage, right or benefit. On the other hand, it may be relevant to note that the same party is in a position to retain a right or benefit which is not available to other creditors.

In conclusion, the PRD provides some options to member states. It remains to be seen which states adopt a robust restructuring process. However, if rescue is considered to be an important policy objective, as it has been in Ireland, the states cannot adhere to pre-existing priority rules except insofar as these are used to assess the compromises of each class of creditors against criteria of "best interests," "equity," and "unfair prejudice," as indicated in the Directive itself.

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