Chapter 4: Context of Preventive Restructuring in the EU

4.1 The Evolution of Corporate Rescue and the European Rescue Culture

The modern concept of corporate rescue has existed in some Member States for many decades, since the 1960s in some places. This development is associated with a realisation that, in terms of resolving corporate financial distress, what actually mattered for the benefit of national economies was the continued existence of a viable company or its business and the associated benefits to individuals and communities.[1] Today, corporate rescue is associated with the rehabilitation of companies that are on the brink of collapse in order to salvage individual undertakings, restore production capacity, preserve employment, and ensure the continuation of investment and capital rewards.[2] The idea of corporate rescue has, however, been met with controversy and debate as to what the ultimate benefit of rescuing a company might be. Issues include whether rescue 'works' in the long term, the extent to which the rights of pre-existing creditors' are abridged, and the anticompetitive effects of rescue.[3] Nonetheless, rescue is now accepted in many jurisdictions and has been identified as a specific policy goal in the European Union, reflected in the PRD.[4]

This Chapter will explore the conceptual development of preventive restructuring and pre-insolvency procedures; it will examine the arguments supporting these ideals, and their conceptual problems. The views presented hereunder are not necessarily the opinions of the JCOERE Project Team, unless otherwise stated, rather the chapter represents the attempt of the project to canvas academic opinions. The Chapter will continue by exploring the evolution of preventive restructuring in the European Union, which will connect with the content of Chapter 5. The provisions that may present obstacles to judicial co-operation, either because of their implementation or because of conflict with underlying legal principles in individual Member States, will be explored, providing a clear link to Chapters 6-8. More specifically, the academic commentary surrounding the stay; majority rule in voting; and the concept of the cross-class cram-down, including absolute and relative priority, will be considered. The theoretical issues surrounding the priority for interim or rescue financing during a restructuring plan will also be explored. In addition, this Chapter will consider the typical tests that form part of the confirmation process under the PRD~~,~~ namely the 'best interests of creditors' and the 'unfair prejudice' standards. Finally, this Chapter concludes with a transition into Chapter 5, which discusses the evolution of the PRD since the 2014 Recommendation on a New Approach to Business and Insolvency.[5]

4.2 Preventive Restructuring: Principles and Context

4.2.1 Insolvency Theory

The objective of traditional insolvency law which relies on collective processes is based on the idea that all (unsecured) creditors are treated proportionately, and a collective execution is directed against all of the property of the debtor for the common benefit, while at the common expense of all creditors.[6] If all

[1] Paul Omar, *European Insolvency Law* (Ashgate 2004) 11.
[2] *idem* 13.
[3] I Lynch Fannon and GNM Murphy, *Corporate Insolvency and Rescue* (Bloomsbury Professional 2012) chapters 12 – 14.

[4] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and the amending of Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] OJ L 172/18 (the "PRD").
[5] Commission Recommendation C(2014) 1500 final of 12 March 2014 on a new approach to business failure and insolvency OJ L 74/65.
[6] Louis Edward Levinthal, 'The Early History of Insolvency Law' (1918) 66(3) U Penn L Rev 223, 225.

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creditors acted in a purely self-interested manner, rushing to satisfy their claims before others, the result would be the destruction of collective value.[7] In the context of rescue this can lead to the desstrunction of a potentially viable business.[8] In the absence of co-ordination and information, the best option for a rational creditor would be to exercise its individual enforcement rights as soon as possible.[9] A collective system, which controls the assets of a debtor as part of a common pool for the benefit of all stakeholders is required.[10] This collective system addresses the "failure of collective autonomy" afflicting a company in financial crisis and supplies the "reflective capacity" that the company would otherwise lack. It also aims to limit the ability of individuals to enforce their legal rights against the debtor and the exertion of "authority and practical leverage."[11] As noted by Jay Westbrook:

> "Only a single system operating under a single set of overall rules can achieve…unified results. A single system cannot be legally effective unless it controls assets and binds stakeholders throughout the market."[12]

Therefore, the insolvency mechanism limits the ability of creditors to reach assets in specific situations to the benefit of the collective of creditors, providing a mechanism whereby creditors can act in concert.[13] However, this limitation must be balanced with the need to ensure credit markets are not undermined, which requires that there is a reliable mechanism of execution in the event that a debtor fails to meet its obligations.[14] There are a number of theories which have attempted to explain and justify the use of collective procedures to determine or resolve a company's financial distress.

The classic theory that has underpinned the development of insolvency law frameworks and the measure of fairness in the apportionment of distributions is the Creditors' Bargain Theory. This theory takes the view that the objective of insolvency law is to provide a collective debt mechanism for the creditors of an insolvent entity and therefore, the legitimacy of an insolvency procedure depends on its ability to maximise the value of the debtor's estate for distributions.[15] The creditor's bargain also claims that pre-insolvency entitlements should be impaired in insolvency, only when necessary to maximise the net asset distribution to the collective of creditors, but not to accomplish strictly distributional goals.[16] Insolvency laws based on the creditors' bargain tend to be hostile toward the redistribution of wealth post-insolvency.[17] It could be argued, therefore, that there is inherent tension between the creditors' bargain and modern regulations on corporate rescue and restructuring.[18] As a result, a number of other theories have been developed over the past four decades.

Jackson recognised that insolvency rules often require the sharing of assets with other creditors, in some cases with shareholders, and other third parties, justified often on the basis of equity, wealth redistribution, or appeals to communitarian values. This led him to introduce a richer version of the creditors' bargain, in which all participants share the risks of business failure attributable to certain 'common disasters.' The theory is nuanced by the presumption that these common disasters and the redistributional influence that they have had on the development of insolvency rules would be explicitly included in the hypothetical *ex ante* bargain, as long as the costs of implementing these redistributional rules would not outweigh the benefits to creditor wealth maximisation.[19] Where the simple creditors' bargain was premised on the idea that redistribution of wealth in insolvency is inconsistent with maximising the objectives of the collective by strictly adhering to pre-insolvency entitlements, the

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[7] Rolef J de Weijs, 'Harmonisation of European Insolvency Law and the Need to Tackle Tow Common Problems: Common Pool and Anticommons' (2012) 21(2) IIR 67, 69; This has the hallmarks of a common pool problem as in insolvency, a debtor's assets are a part of a common pool of assets which, without certain controls over creditors who lay claim to them, would be dissipated: Jay Lawrence Westbrook, 'A Global Solution to Multinational Default' (2000) 98 Mich L Rev 2276, 2285; T H Jackson, 'Of Liquidation, Continuation, and Delay: An Analysis of Insolvency Policy and Non-Insolvency Rules' (1986) 60 ABLJ 399, 402.
[8] Donald R Korobkin, 'Rehabilitating Values: A Jurisprudence of Insolvency' (1991) 91(4) Columbia L Rev 717, 718.
[9] Nicolaes Tollenaar, *Pre-Insolvency Proceedings: A Normative Foundation and Framework* (OUP 2019) 12.
[10] Jay Lawrence Westbrook, 'A Global Solution to Multinational Default' (2000) 98 Mich L Rev 2276, 2289; see also Thomas Jackson, *The Logic and Limits of Insolvency* (HUP 1986) 11.
[11] Donald R Korobkin, 'Contractarianism and the Normative Foundations of Insolvency Law' (1993) 71 Tex L Rev 541, 549.
[12] Westbrook (n 10) 2285.
[13] Douglas G Baird, 'The Uneasy Case for Corporate Reorganisations' (1986) 15(1) J Legal Studies 127, 133.
[14] Douglas G Baird, 'A World without Insolvency' (1987) 50(2) Law and Contemporary Problems 173, 176.
[15] Jackson (n 10) 2-3.
[16] Robert E Scott, 'Through Insolvency with the Creditors' Bargain Heuristic' (1986) 53 U Chi L Rev 690, 692.
[17] Carlson (n 16) 457.
[18] Karen Gross, *Failure and Forgiveness: Rebalancing the Insolvency System* (Yale University Press 1999) 138. See also Scott (n 17) 691.
[19] Thomas H Jackson & Robert E Scott, 'On the Nature of Insolvency: an Essay of Insolvency Sharing and the Creditor's Bargain' (1989) 75(2) Virginia L Rev 155, 157.

enhanced theory accepts rules that provide for redistribution to shape the insolvency process. Distributional objectives are entirely congruent with the goal of maximising the welfare of the group.[20] This is, however, still limited to a few specific types of creditors and continues to ignore the more idiosyncratic insolvency stakeholders.[21] Insolvency is a messy business and involves far more stakeholders than those contractually connected to the business in difficulty. As Carlson notes:

> "The debtor is not the only exile from the bargaining table. Non-creditors who experience disutility are also not permitted into the bargain. For example, employees at will who lose their jobs have no status in the bargain. Neither do shopkeepers and restaurateurs who served these fired employees. Families and friends have no status. And public outrage over the spectacle is worth nothing.[22]
>
> The universe of those with legally cognizable claims in no way conforms with the universe of those who are harmed by an insolvency. In wealth maximisation, all preferences backed by wealth are honoured, whether or not those preferences are reflected in a cause of action recognised by state law."[23]

Elizabeth Warren recognised that the distributional issues arising in insolvency have an inherent give-and-take character; for example, when a secured creditor enforces against an insolvent estate, this often defeats, at least partially, the collective rights of unsecured creditors who will not get their full contractual due.[24] Warren's "traditionalist" approach considers issues of fairness in the treatment of creditors and whether a creditors' bargain style of approach is really the right approach to the policies informing insolvency law. She challenges the creditors' bargain, redefining it as an argument about economic rationality, in which the aim of the policies underpinning insolvency law are to make sure assets are dealt with to achieve the highest value in their use.[25] Warren argues that the central job of insolvency law should be to apportion the losses of the debtor's default, and that "a variety of factors impinge on the difficult policy decision of where to let those losses fall."[26] Warren also claims that neither the simple nor enhanced creditors' bargain could justify or account for corporate rehabilitation, restructuring, and rescue.

4.2.2 Shifting from Liquidation to Rehabilitation, Restructuring, and Rescue

Given the focus on corporate rescue over the last several decades, there are now clearly two separate goals when one considers resolving financial distress: to rescue the economic entity, or to ensure an equitable distribution of the company's assets upon liquidation. The former relies on the ability to 'rehabilitate' a company, which implies a reorganisation rather than a liquidation; the success of the procedure is defined in terms of particular economic outcomes, with the economic entity surviving as a going concern or continuing long enough to maximise dividends to creditors.[27] In contrast the criteria against which the success of a process such as liquidation is measured are more stratightforward and ascertainable.

It could certainly be argued that, given the many competing interests in a restructuring procedure, a more nuanced and thoughtful approach is more appropriate than a straightforward and, ultimately, economic framework. The traditional approach described by Warren allows for the consideration of 'non normal' stakeholders such as workers, which Baird agrees are not always protected adequately, though he considers that their protection is something that should sit outside of an insolvency framework.[28]

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[20] *idem* 202.
[21] *idem* 204.
[22] Carlson (n 16) 475. "Employment at will" refers to the employment relationship in the United States in which the employer and employee are entitled to walk away at any time. European and UK employment relationships are regulated, requiring in most cases a written set of employment terms at the least as well as certain requirements for giving notice and notice periods. That said, employees will still not find themselves at the bargaining table in many European jurisdictions so will still fall into the category of "non-creditors who experience disutility" in the insolvency of a company.
[23] Carlson (n 16) 476.
[24] Elizabeth Warren, 'Insolvency Policy' (1987) 54(3) U Chi L Rev 755, 789-790.
[25] *idem* 802.
[26] *idem* 810.
[27] Korobkin (n 8) 772-773.
[28] Douglas G Baird, 'Loss Distribution, Forum Shopping, and Insolvency: A Reply to Warren' (1987) 54 U Chi L Rev 815, 815.

Warren suggests that an insolvency law should also be designed to keep viable businesses from closing even though certain stakeholders with legitimate legal interests may want it to close.[29] In other words, an insolvency framework should also provide for rescue, rehabilitation, and restructuring where relevant, to protect the greater interests of the company and its stakeholders. Further, the rules that govern a failing business should also be crafted such that the process of saving the business has a limited effect on the value of that business.[30] In other words, insolvency and rescue rules should not be overly onerous or costly.[31] Maximising value for the collective also means reducing strategic behaviour associated with individual creditors and debtors pressing whatever advantage they may have in the process, creating "prisoners' dilemmas" by the exploitation of superior information or greater bargaining power.[32] While these characteristics are undoubtedly key to an efficient system that retains value in the debtor for maintaining itself as a going concern or at least maximising distributions in a liquidation, the policies underpinning these characteristics do not fully explain how to achieve the aims in practice.

4.2.3 Communitarianism in Insolvency and Restructuring

Donald Korobkin offers a competing normative explanation of insolvency law that is a value-based account.[33] In his view, this is necessary because the creditors' bargain model is "limited by the economic account's vision of insolvency law as a mechanism for achieving superior economic returns,"[34] which limits choices to economic outcomes only.[35] Insolvency law has, however, emerged as a system with varied contours and dimensions that satisfy interests that go well beyond simple wealth maximisation.[36] Further, a purely economic account does not explain the provision for reorganisation that is present in most insolvency systems. Rather, the economic account he argues "…demonstrates only that its own economic model is incapable of recognising noneconomic values essential to a vindicating explanation of corporate reorganisation."[37]

Korobkin begins by altering how one should view the estate of an insolvent entity to include rehabilitative opportunities. Rather than viewing it solely as an economic object, he maintains that the view should also include the dynamic character of the estate. Essentially, the insolvent estate is the potential of the corporation as it exists. It provides the framework within which the future of the corporation can be debated, shaped and determined.[38] Rather than viewing the enterprise solely as a profit-making entity, Korobkin takes into account its individual character reflected in the choices of decision-makers. "Through these decisions, the enterprise is realised as a moral, political, social, and economic agent."[39] If one considers the enterprise in these terms, it becomes difficult to then justify a pure creditor wealth maximisation aim for corporate insolvency.

Korobkin offers an alternative to the economic account in his value-based account, which also includes noneconomic outcomes. Where the economic account views insolvency law as a response to an economic problem of debt collection, the value-based account is founded on the concern to which insolvency law is actually addressed: "[i]nsolvency law is a response to the problem of financial distress – not only as an economic, but as a moral, political, personal, and social problem that affects its participants."[40] This alternative view easily encompasses reorganisation and restructuring, and by extension, preventive restructuring. It recognises that the outcomes of financial distress, such as a foreclosure by a secured creditor, has more than just an economic impact on the company involving also moral, political, personal and social issues. These conflicts tend to be intractable as they involve the competition of "diverse human values that are fundamentally incommensurable."[41] These human

[29] *idem*, 828.
[30] Elizabeth Warren, 'Insolvency Policymaking in an Imperfect World' (1993) 92 Mich L Rev 336, 344.
[31] *idem* 346.
[32] A prisoner's dilemma is a theory that says that rationally acting individuals will not act in a manner that is in their collective interest if they are not able to communicate with each other and co-ordinate their actions. See A Rapoport and AM Chammah, *Prisoner's Dilemma* (University of Michigan Press 1965).
[33] Korobkin (n 8) 721.
[34] *idem* 737.
[35] *idem* 738.
[36] *idem* 739.
[37] *idem* 740.
[38] *idem* 770.
[39] *ibid*.
[40] *idem* 762.
[41] *idem* 765.

values cannot be reduced to purely economic terms and are thereby at odds with basic assumptions of economic theory, upon which the economic account of insolvency is based.[42] Given the higher level of complexity that reorganisation and restructuring present procedurally, a purely economic account does not explain fully or justify the use of such procedures. Reorganisations and restructurings aim to rehabilitate a company, rather than to liquidate it, with the success of such a procedure predicated on the corporation surviving as a going concern or at least existing long enough to maximise distributions to creditors.[43] Financial distress forces participants to make difficult choices between values that cannot be fully reduced to pure economic terms and corporate rehabilitation (reorganisations or restructurings) attempts to correct financial distress and resolve those choices.[44]

Korobkin's "insolvency choice" theory is a similar communitarian approach to the creditors' bargain model based on a hypothetical situation in which the principles of an insolvency system are selected by participants. The participants in the insolvency choice model are not limited to creditors, but include all persons in a society impacted by an insolvency.[45] The aim is to define a "procedure of choice that satisfies basic notions of fairness" while ensuring that these principles do not "offend our most strongly considered judgments about how society ought to respond to the problem of financial distress."[46] All of the parties to the agreement stand equally with each person holding only a potential interest in the principles by which society responds to enterprises in financial distress.[47] This approach argues that insolvency should respond to more than the exclusive problem of collecting debt[48] and consider problems associated by other parties affected by financial distress. For example, creditor wealth maximisation would often lead to the sale of the business to distribute proceeds to creditors. This outcome would not necessarily satisfy the needs of employees or their dependents.[49]

Korobkin adopts a principle of rational planning, which aims to maximally satisfy the parties' aims by applying rational guidelines to regulate the aims of those represented in the bargain when an enterprise is in financial distress.[50] When it becomes impossible to satisfy one stakeholder without frustrating another, the principle of rational planning benefits the parties in a worse off position (more vulnerable) over those who are in more advantageous positions.[51] To a certain extent, Korobkin's approach better explains the current insolvency and restructuring frameworks in most modern legal systems. The preferential treatment of some parties in both insolvency frameworks and social policy regulation is a clear departure from normal priorities, but meets a social need to protect more vulnerable parties.[52] While this concept does not fit neatly within the definition or collective principles of insolvency law, it does allow such a framework to satisfy a broader set of needs than strict adherence to contractual entitlements and priorities and embraces rehabilitation.

4.3 Rehabilitation of Companies in Financial Distress

This section discusses the many competing viewpoints within the European insolvency academy on the purpose and value of rehabilitation and restructuring as well as their underlying theoretical principles. These discussions should lend context to some of the conflicting viewpoints amongst different Member States on the more controversial provisions of the PRD.

Some European commentators are overly resistant to corporate rescue. These commentators present the following argument: The rehabilitation of a company aims to reduce the economic effect of a financial

[42] *ibid*; see generally, Jeffrey L Harrison, 'Egoism, Altruism, and Market Illusions: The Limits of Law and Economics' (1985) 33 UCLA L Rev 1309, 1329-1330: "Conventional Economic theory assumes that needs or wants are reducible. Essentially there is some common denominator – utility – that can be used to compare all wants or needs. If all wants and needs are reduced to a single component, on can easily assume infinite interchangeability".
[43] Michael J Roe, 'Insolvency and Debt: A New Approach to Corporate Reorganisation' (1983) Colum L Rev 527, 534-536.
[44] Korobkin (n 8) 773.
[45] Korobkin (n 11) 554.
[46] *idem* 553-553.
[47] *idem* 554.
[48] *idem* 556.
[49] *idem* 579.
[50] *idem* 582.
[51] *idem* 584.
[52] For other theories of corporate insolvency that have not been discussed in this report, see for example: Barry E Adler, 'A Theory of Corporate Insolvency' (1997) 72 New York University L Rev 343 and 'The Creditors' Bargain Revisited' (2018) 166 Uni Pennsylvania L Rev 1853; Lynn M LoPucki, 'A Team Production Theory of Insolvency Reorganisation' (2004) 57(3) Vanderbilt L Rev 741; Thomas H Jackson, 'A Retrospective Look at Insolvency's New Frontiers' (2018) 166 U Pa L Rev 1867; and see the "Authentic Consent Model" proposed by Riz Mokal in Chapter 3 of *Corporate Insolvency Law: Theory and Application* (OUP 2005) 61-90.

disaster.[53] A fundamental justification for reorganisations and restructuring is that an entity is usually worth more if kept intact than if sold piecemeal. One of the common justifications for restructuring over liquidation is the achievement of a going concern sale. It has been argued, however, that the same outcome can be achieved in liquidation, as the businesses of an entity are often sold on as going concerns as a part of the liquidation process. The argument continues that the only difference between this and a reorganisation is that a liquidation involves an actual sale of the assets to a third-party buyer, while a reorganisation only involves a hypothetical sale.[54] Therefore it is argued that sale as a going concern is not necessarily a valid justification for opting for a restructuring over liquidation.[55] But equally it is our view that this is not an argument *against* restructuring.

The proposition that a going concern sale can be achieved as easily through liquidation ignores a few possibilities. The first is the forced sale aspect of liquidation; a restructuring has the advantage of avoiding a discount in value that would be inherent in a forced sale. A liquidation process aimed at converting assets into cash within a fixed timeframe will often generate less than what one would expect for the same assets at market value. As Tollenaar observes, prices during a liquidation are reduced due to compressed timelines, inadequate information, and negative publicity.[56] He goes on to state, therefore, that the added value of a restructuring is not a going concern surplus, rather it is the difference between the value that creditors attribute to the enterprise and the price that a third party is actually prepared to pay for it as a going concern. Essentially, supporting liquidation over restructuring relies on a hypothesis that the assets are worth more to the claimant creditors than they would be to third parties.[57] Again, this is not an argument against restructuring. Furthermore, it ignores a second and important possibility that restructuring will allow for additional value to be extracted from the assets or business through new investment and new management.

Rehabilitation, reorganisation, and restructuring may all have the benefit of protecting jobs and job security. While workers may be repaid as a priority in a liquidation, they may also be out of a job. "Those who have nothing to sell but their labour remain in the weakest possible bargaining position."[58] A significant benefit of maintaining a company as a going concern is the protection of workers and maintenance of job security. Tollenaar, however, maintains that neither the rescue of a business nor the preservation of jobs should be the objective of a restructuring plan, which in some views is simply considered an alternative instrument aimed at debt enforcement.[59] The continuation of the business is rather a consequence of a restructuring plan allowing the creditors to preserve and realise the value of the business as a going concern when that leads to the best recovery outcome.[60] While there are arguments on both sides of this complex and lively debate, the EU has definitively endorsed rescue and has developed a preventive restructuring framework that aims to protect jobs, preserve viable businesses, encourage harmonisation, and protect the common capital markets.

As outlined in Chapter 1 of this Report, the EU policy objectives included the goals of preventing unnecessary liquidations, avoiding unnecessary job losses and a number of capital related objectives such as preventing the build-up of non-performing loans. It is this latter interface with capital markets that is re-iterated by Commission spokespeople – "reducing the risk of loans becoming non-performing in cyclical downturns and mitigating adverse impacts on the financial sector."[61]

4.4 Defining Preventive Restructuring

Restructuring and insolvency (liquidation) proceedings address different problems. Insolvency law responds to the insufficiency of the debtor's assets by providing a collective debt enforcement mechanism in the interests of all creditors aimed at preventing disorganised dissipation of assets by creditors acting in their own self-interest. A pre-insolvency restructuring procedure deals with a

[53] Nathalie D Martin, 'Noneconomic Interests in Insolvency: Standing on the Outside Looking In' (1998) 59 Ohio State L J 429, 436.
[54] Baird (n 13) 139.
[55] Tollenaar (n 9) 47.
[56] *idem* 48-50.
[57] Jackson (n 10) 214.
[58] E F Schumacher, *Small is Beautiful – A Study of Economics as if People Mattered* (first published 1973, Vintage 2011) 67-68.
[59] Tollenaar (n 9) 69-70.
[60] Tollenaar (n 9) 70.
[61] PRD, recital 2. See also remarks made by Assistant Commissioner Salla Saastamoinen, Director for Civil and Commercial Justice at DG Justice and Consumers, at EIRC – INSOL Conference, Brussels June 7th, 2019.

situation in which assets may be, but are not necessarily, sufficient to satisfy all creditor debt. Academic debate seems to differ in the understanding of what is entailed in a pre-insolvency restructuring with some assuming there is a sufficiency of assets in all cases. This leads to a theoretical proposition that states that a collective procedure that impairs creditors' rights in a restructuring is unjustified. In Germany where a restructuring plan can occur within a formal insolvency procedure, this has led to a distinction being made between restructuring post (formal) insolvency and restructuring pre-insolvency;[62] the former is where all creditors have already been locked into a collective proceeding and are unable to exercise individual enforcement rights against the collective assets of the debtor and in the latter, it is assumed (perhaps wrongly by those making this distinction) that the debtor is solvent.[63] This leads to an overemphasis on a not very controversial rule, namely a majority rule principle, which ensures that assets can be used efficiently without the need for unanimous agreement, as unanimity would give each party a veto right to a restructuring plan and potentially leading to assets being left unused.[64] For effective restructuring to occur, jurisdictions will include at least a majority rule criteria in order to overcome hold-out creditors.

The assumption that restructuring involves a non-insolvent situation contrasts with the position in other jurisdictions; for example, in France, Ireland, and the UK, restructuring is available where the company is insolvent (but not in liquidation) or *tending* towards insolvency. Therefore, the EU reframed the EIR to ensure that rescue and restructuring frameworks can also be subject to the procedural rules of the EIR Recast. (This is already the case with some restructuring processes including the French *sauvegarde* procedure and the Irish Examinership, amongst others). This aligns with the developments of the rescue culture over the last decade or so. The EIR Recast specifically includes:

> "…public collective proceedings, including interim proceedings, which are based on laws relating to insolvency and in which, for the purpose of rescue, adjustment of debt, reorganisation, or liquidation…
>
> Where the proceedings referred to in this paragraph may be commenced in situations where there is only a likelihood of insolvency, their purpose shall be to avoid the debtor's insolvency or the cessation of the debtor's business activities."[65]

By including restructuring procedures as a part of insolvency law, the EIR Recast, can stretch to include the new restructuring tools that will be developed subsequent to implementation of the PRD.[66] By including tools that can be used outside of formal insolvency, the legislator appears to be accepting that the definition of insolvency now extends beyond what has been traditionally accepted as insolvency. It has been argued that this approach defines insolvency proceedings instead as "not the material insolvency of the debtor, but rather whether the proceedings attempts to solve a common pool problem of the creditors."[67] An alternative approach which resonates with the view of the CJEU is that rescue and restructuring proceedings can operate in a situation where the company is technically but not formally insolvent – i.e. in an insolvency process – or is likely to be insolvent. The nature of a particular proceeding was at issue in a relevant CJEU case that actually revolved around the application of Article 5(1) of the Acquired Rights Directive,[68] which exempts liquidation proceedings from the automatic transfer of employment contracts upon the transfer of a business. The decision clearly differentiates between insolvency proceedings that result in the liquidation of the business and those insolvency related proceedings that allow the business to continue operating while undergoing reorganisation or restructuring.[69] The key difference is that the business continues in the latter circumstances.[70] Thus, there

[62] Stephan Madaus, 'Leaving the Shadows of US Insolvency Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law' (2018) 19 Eur Bus L Rev 615, 633.
[63] Stephan Madaus, 'Leaving the Shadows of US Insolvency Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law' (2018) 19 Eur Bus L Rev 615, 633.
[64] *ibid*.
[65] EIR Recast, art 1(1). Art 1 of the original EIR included "collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator." It is unusual, therefore, to find the Irish Examinership included in Annex A, as is the Italian *concordat preventivo*.
[66] Madaus (n 64) 616.
[67] Horst Eidenmuller, "What is an Insolvency Proceeding?" (2018) 92 Am Bankr L J 53, 68.
[68] Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses OJ L82/16.
[69] C126/16 *Federatie Nederlandse Vakvereniging v Smallsteps BV* [2017] ECLI:EU:C:2017:489 paras 48-51.
[70] Madaus (n 64) 617.

appears to be a different understanding among the legislature and the courts, as well as among academic and professional commentators, of the meaning of insolvency, how broadly it should be defined and whether it should include restructuring, particularly if that is taking place in a pre-insolvency situation. Nevertheless, the PRD has provided for an inclusive framework which envisages a range of restructuring tools.

As previously articulated, reorganisations and restructurings aim to rehabilitate a company, with success of such a procedure predicated on the corporation surviving as a going concern.[71] Arguably, this does not consider the distinct possibility that the interested parties might be better off as a group if the firm's assets were put to a different use.[72] Douglas Baird, has questioned whether the complicated nature of restructuring and the risks for under-compensation and strategic game-playing by the parties are worth the benefits.[73] Financial distress forces participants to make difficult choices between values that cannot be fully reduced to pure economic terms and corporate rehabilitation … attempts to correct financial distress and resolve those choices.[74] As Madaus observes, modern restructuring frameworks offer more than traditional liquidation procedures; they offer planned solutions in which debtors may, for example, offer payments from future income or shares to creditors in exchange for debt.[75] He goes on to state that, while giving access to creditors based on their unpaid claim is not unjustified or difficult to construct, the practise does deviate from liquidation priorities. It abandons the restrictions on the current collective assets; the mechanism at play is not dependent on insufficient available assets, if payments are predicated on future available income.[76] While perhaps startling to some commentators, this reality is generally the purpose of restructuring pre-insolvency.

A debtor-centric view of corporate reorganisation is that corporate reorganisation procedures should provide a "breathing space" for entities in financial difficulties by preventing creditors serving their individual interests by destroying a firm by selling it off piecemeal resulting in job and asset dissipation.[77] This has been viewed as giving a debtor certain substantive rights in insolvency that they did not have outside of the procedure, i.e. to delay repaying its creditors.[78] The PRD defines restructuring as:-

> "measures aimed at restructuring the debtor's business that include changing the composition, conditions or structure of a debtor's assets and liabilities or any other part of the debtor's capital structure, such as sales of assets or parts of the business and, where so provided under national law, the sale of the business as a going concern, as well as any necessary operational changes, or a combination of those elements;"[79]

In addition to financial restructuring of a corporate entity that retains its full integrity, the wording of the PRD appears to include a process that aims to adjust the business (going concern) of a corporate entity through either financial restructuring or reorganisational activities, which includes the sale of assets or parts of businesses with the objective of enabling the enterprise to continue.[80] Another crucial technique in a financial restructuring is a debt for equity swap, which reduces a distressed firm's fixed liabilities while strengthening its equity base.[81]

The PRD also offers some guidance on what it means by the term, "preventive":

> "Preventive restructuring frameworks should, above all, enable debtors to restructure effectively at an early stage and to avoid insolvency, thus limiting the unnecessary liquidation of viable enterprises. Those frameworks should help to prevent job losses and the loss of know-how and skills, and maximise the total value to creditors — in comparison to what they would receive in

[71] Roe (n 64) 534-536.
[72] Baird (n 13) 34
[73] *idem* 139.
[74] Korobkin (n 8) 773.
[75] Madaus (n 64) 621.
[76] *ibid*.
[77] Baird (n 13) 133. The phrase 'breathing space' has been consistently used in the Irish context, where the legislative framework was borrowed from Ch 11 of the US Bankruptcy Code. See further Lynch Fannon & Murphy (n 3) chapters 12 and 13 for a description of the case law.
[78] Douglas G Baird & Thomas Jackson, *Problems and Materials on Insolvency* (Little & Brown 1985) 31-35.
[79] PRD, art 2(1)(1).
[80] Horst Eidenmuller, 'Contracting for a European Insolvency Regime' (2017) 18 Eur Bus Org L rev 273, 281.
[81] *ibid*; see also Jonathan McCarthey, 'Something Old, Something New? The Potential Impact of the EU Preventive Restructuring Directive through an Irish Case Study' (2019) 16(6) ICR 1, 2.

the event of the liquidation of the enterprise's assets or in the event of the next-best-alternative scenario in the absence of a plan — as well as to owners and the economy as a whole.”[82]

Thomas Jackson notes that preventive restructurings are in no way different than restructurings that occur during an insolvency procedure, as they have to meet the same objectives and deal with the same problems.[83] If insolvency proceedings are characterised by the co-ordination of the collective of creditors, rather than the actual insolvency of the debtor, then preventive restructuring frameworks will clearly satisfy the same goal.[84]

“Regardless of their form, public or confidential, with or without the debtor’s dispossession, concerning all or only some of the creditors, if the contemplated proceedings provide an answer to the problem of co-ordination, then preventive proceedings are but a variation on the same theme. It follows that they are justified only with respect to the same objectives, that is, maximising the value of the company’s assets in the interest of all stakeholders and promoting the efficient distribution of resources in the economy”[85]

The EU has, through the PRD, introduced a restructuring framework that should be available during (what has been often described as) “pre-insolvency”, as it refers to ~~a~~ “likelihood of insolvency”:

“This Directive lays down rules on: preventive restructuring frameworks available for debtors in financial difficulties where there is a likelihood of insolvency, with a view to preventing the insolvency and ensuring the viability of the debtor.”[86]

The PRD leaves “likelihood of insolvency” and “insolvency” to be defined by reference to the national law of the Member States.[87] The PRD aims to catch firms at a stage that precedes formal insolvency, but it is not entirely clear how far in advance restructuring procedures should be made available. The PRD stipulates that a restructuring framework should be available:

“…when it appears likely that their insolvency can be prevented, and the viability of the business can be ensured. A restructuring framework should be available *before* a debtor becomes insolvent under national law, namely before the debtor fulfils the conditions under national law for entering collective insolvency proceedings, which normally entail a total divestment of the debtor and the appointment of a liquidator.” (emphasis added)

The further “upstream” that procedures are accessible, however, the greater the possibility that restructuring frameworks could be misused. The PRD attempts to resolve this matter in Recital 24:

“In order to avoid restructuring frameworks being misused, the financial difficulties of the debtor should indicate a likelihood of insolvency and the restructuring plan should be capable of preventing the insolvency of the debtor and ensuring the viability of the business.”

This does not, however, inform debtors how the likelihood of insolvency is to be determined, only that it should be circumstances in which the debtor is still outside of functional insolvency. European commentators have made much of these issues and have argued that pre-insolvency and preventive restructuring may, in reality, just refer to what are functionally insolvency proceedings as the circumstances are broadly the same, requiring the facilitation of collective enforcement. Further, it is argued that these proceedings should perhaps be available at a time when the insolvency of a debtor is so predictable that any other alternative is pointless. It may be reasonable to suggest that the time to initiate a restructuring procedure is when the debtor’s management is constrained by the company’s indebtedness to such a degree that they begin to favour short term over long term solutions, with

[82] PRD, recital 2.
[83] See Jackson (n 10) 210.
[84] Eidenmuller (n 68) 19: “What matters therefore is not the material insolvency of the debtor, but rather whether the proceedings attempts to solve a common pool problem of the creditors.”
[85] Vasile Rotaru, ‘The Restructuring Directive: a Functional Law and Economics Analysis from a French Law Perspective’ (2019) Working Paper published by Droit et Croissance 15.
[86] PRD, art 1(1)(a).
[87] PRD, art 2(2)(a&b).

detrimental effects on the long-term sustainability of the company.[88] In reality, however, preventive restructuring can be used in less constrained circumstances.[89]

The term "pre-insolvency" could therefore be a misnomer, as such proceedings are not usually used unless a company is already in financial difficulties. Accordingly, a pre-insolvency proceeding may still be regarded as an insolvency proceeding. The term is often used simply to refer to proceedings taking place outside of what would be considered traditional and formal insolvency procedures, essentially identifying it as different in a procedural sense.[90] This is distinct from a situation where the debtor is not in financial difficulty to the extent that it could amount to insolvency in the near future.[91]

4.5 Preventive Restructuring in Europe

As will be described in detail in Chapter 5 of this report the PRD had a long and arduous journey through EU institutions and experts' groups to becoming a Directive. The Commission began with a Recommendation[92] in 2014 on A New Approach to Business Failure and Insolvency which was made following a range of consultative documents including a report from INSOL Europe on the desirability and practicability of harmonising national insolvency laws in Europe.[93] This Report surveyed seven Member States – France, Germany, Italy, Poland, Spain, Sweden, and the UK, but interestingly not Ireland which had a fully developed restructuring process along the lines of what became the PRD – to identify the differences in current restructuring procedures. These included when formal reorganisation procedures could be initiated and how reorganisations or restructurings were proposed, voted on, and sanctioned. The differences between Member States created an uneven playing field, in which some debtors had better prospects of restructuring than others, thereby incentivising forum shopping. Further, it was reported that the differences in frameworks also acted as a barrier to the adoption of restructuring plans in cross-border cases.[94] The INSOL Europe report went on to recommend a number of areas to harmonise. A parliamentary Resolution reflecting many of the INSOL Europe Report's recommendations was passed on 15th November 2011.[95] Insolvency law harmonisation then found its way into the Commission's second Communication on the Single Market Act, identifying it as a priority action for "the strengthening of the internal market".[96] This was quickly followed by the Commission's first substantive response in the Communication on "A New European Response to Business Failure and Insolvency", which is explored in detail in Chapter 5.[97] Post-2014, a Commission funded project based at the University of Leeds surveyed Member States' legislative frameworks providing information to the Commission on the existence of national restructuring frameworks.[98]

It should be noted that the Commission's activity in this area came against the backdrop of the financial and sovereign debt crises of the late-2000s.[99] This is evident from the wording in the introduction to the Communication of 2012, in which it called for a "European response to create an efficient system to restore and reorganise a business so that they can survive the financial crisis…"[100] This placed the emphasis more on recovery and rescue, than on liquidation and dissolution.

[88] Rotaru, (n 86) 16.
[89] See for example Kristin van Zwieten, *Goode on Principles of Corporate Insolvency Law* (5th edn, Sweet & Maxwell 2018) and Jennifer Payne, *Schemes of Arrangement: Theory, Structure and Operation* (Cambridge University Press 2014). See also for example, Examinerships as described by Lynch Fannon & Murphy (n 3).

[90] Tollenaar (n 9) 4.
[91] Tollenaar (n 9) 4.
[92] Recommendation (n 5).
[93] Giorgio Cherubini, Neil Cooper , Daniel Fritz, Emmanuelle Inacio, Katarzyna Ingielewicz, Guy Lofalk, Miriam Mailly, David Marks, Anna Maria Pukszto, Barbara FH Rumora Scheltema, Robert Van Galen, Miguel Virgos, Bob Wessels & Nora Wouters (INSOL Europe Authors) *Harmonisation of Insolvency Law at EU Level* (PE 419.633 European Parliament, Directorate General for Internal Policies: Policy Department C: Citizen's Rights and Constitutional Affairs, Legal Affairs 2010).
[94] *idem* 17.
[95] *Report with Recommendations to the Commission on Insolvency Proceedings in the Context of EU Company Law* (A7-0355/2011, European Parliamentary Committee on Legal Affairs 2011).
[96] Communication from the Commission COM(2012) 573 final to the European Parliament, the Council, the European Economic and Social Committee, and the Committee of the Regions of 3 October 2012 Single Market Act II – Together for New Growth.
[97] *ibid*.
[98] See Gerard McCormack, Andrew Keay, and Sarah Brown, *European Insolvency Law: Reform and Harmonization* (Elgar 2017) for a full accounting of the outcomes of the Leeds project.
[99] Horst Eidenmuller and Kristin van Zweiten, 'Restructuring the European Business Enterprise: the European Commission's Recommendation on a New Approach to Business Failure and Insolvency' (2015) 16 Eur Bus L Rev 625, 636.
[100] Communication from the Commission to the European Parliament, the Council, The European Economic and Social Committee COM(2012) 724 final of 12 December 2012 on a new European approach to business failure and insolvency 2.

While a number of Member States have introduced preventive restructuring procedures over the last few decades, few of them were introduced as a result of the 2014 Recommendation. Ireland had already been using its Examinership procedures since the 1990s and France had been formulating preventive restructuring frameworks at a rate of two or three reforms or new procedures per year.[101] The aim of the 2014 Recommendation was to encourage Member States to put in place frameworks to efficiently restructure viable enterprises to promote entrepreneurship, investment, and employment, while reducing obstacles to the smooth functioning of the internal market.[102] Despite this, the response of Member States was both inconsistent and incomplete; when evaluated by the Commission,[103] it concluded that the Recommendation had not succeeded in "facilitating the rescue of businesses in financial difficulty".[104] As a result, negotiations began on the development of a harmonising directive that would introduce a preventive restructuring framework to all of the EU Member States.

Following the Commission's evaluation of the Member States' response to the call for legislative action on the back of the 2014 Recommendation,[105] a new Action Plan on Building a Capital Markets Union was passed, which set out the legislative intention to pass a Directive that would deal with early restructuring, stating that "the initiative will seek to address the most important barriers to the free flow of capital, building on national regimes that work as well."[106] A year later the Proposal for a Directive[107] was published and began its journey through the EU institutions.

The Proposal aimed to:

> "Remove obstacles to the exercise of fundamental freedoms, such as the free movement of capital and freedom of establishment, which result from differences between national laws and procedures on preventive restructuring, insolvency and second chance. This Directive aims at removing such obstacles by ensuring that viable enterprises in financial difficulties have access to effective national preventive restructuring frameworks which enable them to continue operating."[108]

Although the Recital 1 was revised during the negotiations period, it encompasses the same themes, making an important statement about the problems associated with differences in national laws and the related effect on the proper functioning of the internal market. In addition, preventive restructuring frameworks were intended to "prevent the build-up of non-performing loans",[109] an aim that was maintained in the final Directive.

The PRD was influenced by 422 different inputs from a range of sources.[110] In 2015, a group of 22 experts was convened to assist the Commission in drafting the provisions and with coordinating the different inputs received.[111] There were also meetings with more than 250 representatives of national governments and Parliaments, workers unions, consumers' organisations, and other interested economic actors.[112] Given the high level of involvement from a broad range of stakeholders and experts, it is perhaps unsurprising that the result was what some regard as "a highly complex text".[113] For example, commercial and central banks tend to be in favour of harmonising insolvency proceedings and reducing

[101] McCormack, et al (n 101) 230-231.
[102] Recommendation (n 99) recommendation 1.
[103] 'Evaluation of the Implementation of the Commission Recommendation of 12.3.2014 on a New Approach to Business Failure and Insolvency' (Directorate-General Justice & Consumers of the European Commission 30 September 2015).
[104] Eidenmuller & van Zweiten (n 102) 625; See also Reinhard Bork, 'Preventive Restructuring Frameworks: A "Comedy of Errors" or "All's Well that Ends Well?" (2017) 14(6) International Corporate Rescue 417.
[105] Eidenmuller (n 81) 275.
[106] Communication from the Commission to the European Parliament, the Council. The European Economic and Social Committee and the Committee of the Regions COM(2015) 468 final of 30 September 2015 on an action plan on building a capital markets union 25.
[107] Proposal for a Directive of the European Parliament and of the Council COM(2016) 723 final of 22 November 2016 on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU [2016] 2016/0359 (COD) (the "Proposal").
[108] Proposal, recital 1.
[109] Proposal, recital 2; PRD, recital 3.
[110] For information on working groups, see the webpage on 'Transparency' (European Commission 2019) <https://ec.europa.eu/info/about-european-commission/service-standards-and-principles/transparency_en> accessed 7th January 2020.
[111] For information about the meetings, see the webpage on 'Convergence of insolvency frameworks within the European Union - the way forward' (European Commission: Justice and Consumers 2016) <https://ec.europa.eu/newsroom/just/item-detail.cfm?item_id=30874> accessed 7th January 2020. See also Annex 1 of this Report, where some of the Expert Group discussions are summarised.
[112] For the data and numbers, see the 'Public Consultation: Building a Capital Markets Union' (European Commission: Banking and Finance 2015) <https://ec.europa.eu/finance/consultations/2015/capital-markets-union/index_en.htm> accessed 7th January 2020.
[113] Rotaru (n 86) 57.

the length of statutory moratoria, while workers' unions and the representatives from SME organisations favoured harmonisation aimed at enhancing business rescue and diminishing the fixed costs of proceedings.[114] European institutions also adopted different positions during the negotiations; the Commission aimed at a high degree of harmonisation of restructuring frameworks based on Chapter 11 and the English Scheme of Arrangement.[115] The European Parliament took a more cautious approach with a view to preserving the interests of the affected workers, while the European Council tried to retain the greatest possible flexibility for national legislators.[116]

4.6 Specific Restructuring Provisions as Potential Causes of Conflict in Co-Operation

The PRD offers a restructuring framework with a range of options for the Member States among several obligatory provisions. Fundamentally, the PRD gives the debtor the right to propose a plan when there is a likelihood of insolvency, while protecting the debtor from creditors by staying enforcement actions. The PRD does not specify precisely what a restructuring plan can contain but it does give a general list of information that should be included.[117] The restructuring plan can bind all creditors or be limited to affected creditors, leaving the rest unaffected by the plan.[118] Voting takes place in classes that must be formed in accordance with a sufficient commonality of interest. A plan can then be adopted if the requisite voting majority is reached.[119] The PRD also provides for a cross-class cram-down, which essentially means that ~~a~~ dissenting classes can be bound by the plan if certain criteria are present.[120] While the PRD aims to reduce court and practitioner involvement, it requires this involvement in certain specified circumstances, providing a minimum level of protection against the moral hazard associated with a complex restructuring plan that is overseen only by the debtor and forced upon dissenting creditors.[121]

Many of these preventive restructuring provisions have controversial aspects relating to their effect on creditors' rights and may present points of contention and obstacles to co-operation where differences can be allowed to persist between Member States. Academic commentary emanating from the Netherlands, Germany and other Member States underlines this potential for a difference and dissonance. Among the more controversial provisions that will be discussed in the sections that follow are the stay of enforcement actions;[122] the ability to bind dissenting creditors and classes of creditors;[123] how to ensure dissenting classes are treated fairly (what rule to apply);[124] and the protection and priority afforded to interim or new rescue financing.[125] These concepts have garnered a great deal of academic debate and created significant controversy among the Member States, creating a wealth of literature presenting conflicting and contrasting view points on the benefits, disadvantages, and fairness justifications for the application of such provisions in a preventive restructuring situation. While the JCOERE Project has explored other provisions of the PRD with its contributors, they do not carry the same controversy than do those discussed below. The following subsections will examine each of these concepts in turn and the scholarly debate that surrounds them.

4.6.1 The Stay of Individual Enforcement Actions

A stay or moratorium refers to the halting of individual enforcement actions, as well as other claims in some cases. The full provision of the moratorium is set out under Article 6 of the PRD and will be discussed in more detail in Chapter 7 of this Report. The PRD Recitals set out the concept underlying the provision:

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[114] Gert-Jan Boon, 'Harmonising European Insolvency Law: The Emerging Role of Stakeholders' (2018) 27(2) IIR 150.
[115] See Mark J Roe, 'Three Ages of Insolvency' (2017) 7 Har Bus L Rev 187 and Sarah Paterson, 'Reflections on English Law Schemes of Arrangement in Distress and Proposals for Reform' (2018) 15(3) Eur Company and Financial L Rev 472.
[116] From the perspective of the French negotiators from the CIRI, Clément Tiret, 'Retour sur les débats intervenus autour de la directive Insolvabilité au sein des institutions européennes' (2019) 3(16) RPC as cited in Rotaru (n 86) 3.
[117] See PRD, art 8
[118] Tollenaar (n 120) 67.
[119] *idem* 68-69; PRD, art 9 details the mechanisms of class formation and majority voting.
[120] PRD, art 11.
[121] See PRD, art 5 in relation to practitioner involvement and art 10 for the criteria requiring court confirmation.
[122] PRD, art 6.
[123] PRD, arts 9-11.
[124] See in particular PRD art 11(1)(c) (the so-called "relative priority rule"), 11(2) (the "absolute priority rule"), and the last paragraph of the section following 11(2) specifying an "unfair prejudice test".
[125] PRD, art 17.

> "A debtor should be able to benefit from a temporary stay of individual enforcement actions, whether granted by a judicial or administrative authority or by operation of law, with the aim of supporting the negotiations on a restructuring plan, in order to be able to continue operating or at least to preserve the value of its estate during the negotiations."[126]

The stay is at the core of the ability to supplant individual creditors' contractual remedies with a collective system of distribution.[127] It is viewed as the "archetypal vehicle of rational planning" and as playing an "essential role in framing insolvency discourse."[128] When creditors enforce their rights unilaterally against the debtor's property, their actions may prevent the possible realisation of other aims that could be far more important than the satisfaction of the best interest of an individual creditor. While the better aims may be unknown at the outset, the stay allows those aims to be realised and articulated without risking the value of the business in the process. It could be uncertain in the beginning whether the corporation has a realistic prospect of survival and if it does, what the "relative importance is of the aims that may be frustrated by its demise." An automatic stay prevents creditors from determining the final content of a restructuring plan before all of the relevant facts have emerged.[129]

A stay also prevents the un-co-ordinated rush to grab assets through non-insolvency remedies. Without a stay, it would be impossible to co-ordinate between stakeholders if their separately rational actions resulted in an outcome that is suboptimal for the stakeholders as a whole.[130] The stay therefore allows for a collective approach to be taken.[131] A co-ordinated action could then hypothetically maximise the value of the debtor's assets to the benefit of the collective as a whole and ensure an efficient distribution of the value should liquidation be the end result.[132]

There are also those who recognise some potential for abuse within the stay. For example, a stay may not incentivise the use of a procedure in a case where a restructuring would not be value-maximising. Managers of a non-viable business may seek to use a procedure with a stay for some strategic purpose, or there may be an incentive for a viable debtor to use a procedure if it wishes to "shake-off" liabilities that it is currently capable of servicing.[133] Such abuse can be mitigated, however, by the ability for creditors to apply to lift the stay in certain circumstances, as well as the option for Member States to provide that authorities can refuse to grant the stay. Generally, though, the stay is considered a key provision that allows for the successful completion of preventive restructuring plans. Were it possible to continue actions during the negotiation of a plan, they could imperil the success of a restructuring by impairing the value of assets available.[134]

4.6.2 The "Intra-Class" Cram-Down (or Majority Rule)

The application of a majority rule within individual classes of creditors can allow for the maximisation of the debtor's assets in the interest of all creditors, which helps to justify interference with contractual rights for dissenting creditors. Creditors are viewed by some as being best placed to identify their best interests, therefore, applying a majority rule is a reasonable approach because it shows that creditors have been adequately protected in a way that is commonly accepted in democratic society. While not all creditors have the same interests, by placing them in classes where interests are aligned, the possibility of unfairly expropriating a group of creditors with a different set of interests is removed.

If unanimity is required to approve a plan, any individual voting creditor essentially has a veto right that can prevent a plan from coming into effect. If one or more creditors fail to consent in a situation of unanimity, then there will be a "hold-out" position, in which a creditor can try to leverage a higher

[126] PRD, recital 32.
[127] Thomas H Jackson, 'Of Liquidation, Continuation, and Delay: An Analysis of Insolvency Policy and Non-insolvency Rules' (1986) 60 Am Bankr L J 399, 412.
[128] Korobkin (n 8) 778.
[129] Korobkin (n 11) 598-599.
[130] Jackson (n 132) 412.
[131] The situation described here is an example of the "prisoner's dilemma" discussed within the Law and Economics academy. See Rotaru (86) 26.
[132] Douglas Baird and Thomas Jackson, 'Corporate Reorganisations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Insolvency' (1984) 51 U Chi L Rev 97 and Korobkin (n 8) 778.
[133] Sarah Paterson, 'Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century' (2014) LSE Law, Society, and Economy Working Papers 27/2014, 18 and Eidenmuller & van Zweiten (n 102) 633.
[134] Eidenmuller & van Zweiten (n 102) 646.

proportionate share in exchange for their consent to the plan.[135] As such a share is obtained at the expense of consenting creditors, every creditor has an incentive to withhold their consent to avoid the reduction of their proportionate share in favour of a hold-out creditor, preventing the plan from coming into effect.[136] Thus the application of majority rules in the confirmation of an insolvency plan helps to prevent "individualistic behaviour from harming the interests of the group." [137] In common insolvency law parlance, this majority rule is often called a cram-down or intra-class cram-down.

A key criterion that justifies a democratic approach to plan approval is that no party should be worse off under the plan than without it.[138] Further:

> "Plan approval should be based on clear criteria aimed at achieving fairness among similar creditors, recognition of relative priorities, and majority acceptance, while offering opposing creditors or classes a dividend equal to or greater than what they would likely receive in a liquidation proceeding."[139]

The PRD provides that if a creditor challenges a plan, it can be confirmed only if it meets the "best interests of creditors" test. This states that no dissenting creditor can be worse off under the plan than they would be in a liquidation *or* in the next best alternative, should a plan not be confirmed.[140] While concern is expressed that this fairness criterion is insufficient, the PRD mitigates this danger by requiring that voting rights and class formation can be examined by a judicial or administrative authority, if a request for confirmation is submitted.[141] In addition, Member States are required to have judicial or administrative confirmation of plans if they affect the interests of dissenting parties, embedding formal oversight in the process that can mitigate any potential unfairness.[142]

4.6.3 The Cross-class Cram-down

Arguably, the presence of the cross-class cram-down in article 11 of the PRD is a tremendous advance in European restructuring law as it potentially facilitates value- and employment-preserving restructuring of distressed but viable enterprises that might otherwise go into liquidation.[143] From an economic perspective, once the plan being imposed on dissenting classes ensures the maximisation of value of the debtors' assets and provided no creditors' interests are unjustifiably sacrificed, it is reasonable to accept its confirmation.[144] In the absence of a cross-class cram-down mechanism, classes of creditors would effectively be able to leverage to limit their losses to the detriment of other classes of creditors, for which the adoption of a plan may be more important, such as classes with a lower tolerance for losses. "It follows that the rejection of the plan by a class of creditors must not preclude its adoption as long as other safeguards against the unfair treatment of recalcitrant creditors…offers sufficient protection."[145]

There are also some significant conceptual issues with priority rules that aim to assess fairness within a cross-class cram-down. While the term "absolute priority" seems to have an accepted definition derived from American restructuring law, in practice this is viewed only as a starting point, which can be diverted from if the outcome would be better for the collective of creditors.[146]

The Commission's approach to the cross-class cram-down initially followed Chapter 11, requiring that the plan be approved by at least an "in-the-money" class other than the shareholders, where the value

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[135] This is termed in academic circles as the "tragedy of the anti-commons". See James M Buchanan and Yong Jo Yoon, 'Symmetric Tragedies: Commons and Anticommons' (2000) 43 J L & Econ 1, 4.
[136] Tollenaar (n 9) 14.
[137] *idem* 61.
[138] *idem* 65.
[139] World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes* Revised 2015, 26.
[140] PRD, art 10(2)(d) – "best interests of creditors" is defined in PRD, art 2(1)(4) as "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." See also Eidenmuller (n 81) 282.
[141] PRD, art 9(5).
[142] PRD, art 10(1)(a).
[143] Ignacio Tirado and Riz Mokal, 'Has Newton had his Day? Relativity and Realism in European Restructuring' (2019) Winter Eurofenix 20, 21.
[144] Rotaru (n 86) 36.
[145] *ibid*.
[146] Ignacio Tirado, Keynote Address "Relative vs Absolute Priority", INSOL Europe Academic Forum, 26th September 2019, Copenhagen Denmark.

breaks between a going concern sale and a liquidation. This test aligns the interests of all stakeholders as they benefit from all gains and suffer all losses connected to the decision that is at stake, although such a test also encourages a war on valuation.[147] The final PRD addressed some of the criticism from the Member States, leading to a cross-class cram-down based on the German model, which gave the provision some predictability.[148] This model does not preclude a majority rule over dissenting classes, which requires the provision of sufficient protection of creditors by reference to rules of fair treatment and respect for the order of priorities.[149] The derogations from Article 11 and its terms then allow for the application of the overriding test of unfair prejudice.[150]

The absolute priority rule "provides that in a reorganisation, senior owners are paid in full before junior owners are paid anything." This rule is common in all or most insolvency systems. Much has been made of the fact that this is a default position in the US Insolvency code, however, while absolute priority remains a fixed principle that forms the foundation of the American restructuring procedure, departures from this rule are commonplace in practice.[151] The procedure allows parties to negotiate a settlement that tolerates a deviation from the default position. As a result, the rule of absolute priority only comes into play when it is protecting a class that dissents from a plan.[152] This approach is also reflected in the Irish Examinership process.[153]

There are also economic efficiency rationales for respecting priority rules. All stakeholders have an interest in a company as they all participate in its financing in some fashion, whether directly or indirectly through labour. The order of priority ascribed to these interests defines the cost for the debtor of each layer of financing. Respecting priorities also avoids encouraging some stakeholders to engage in strategic activities to create conditions that favour themselves to the detriment of other stakeholders. It also increases the predictability of the treatment of all creditors with the concomitant impact of reducing the costs of financing. Finally, it ensures that the distribution in some way measure up to pre-insolvency entitlements by indicating default entitlements, but without impeding a negotiation for redistribution, if needed, to secure a plan to rescue a viable business.[154] The respect of priorities reflects the concept of the "absolute priority rule."[155]

There are also economic justifications for deviations from absolute priority. For example, if junior investors run the business and have private information and expertise, often described as firm-specific human capital, then a portion of the value of the business may be inextricably linked to their participation. This is particularly the case for small businesses. Allowing junior investors to participate in the distributions from reorganisation, even if they are technically out-of-the-money, appears to be a price that senior investors in the United States are willing to pay in order to ensure their co-operation.[156] This is not usually the case for the reorganisations of larger companies, however, in which equity holders do not have similar expertise or value to the company and are often wiped out. At times, junior investors can exercise enough power to reach a deal with senior investors in order to avoid unnecessary dissipation of value that can be caused by the delays in negotiation. It was noted by Baird that "a world in which absolute priority is not respected is one in which entrepreneurs have less access to capital."[157] This is clearly a criticism in the ability of parties to negotiate too far away from pre-contractual entitlements during a reorganisation, if it is not absolutely necessary to preserve value in the company.[158]

[147] Rotaru (n 86) 38.
[148] PRD, art 11(1)(b).
[149] Rotaru (n 86) 38.
[150] Article 11 in full sets out a number of criteria and provides for countervailing derogations. Bork (107) 422.

[151] Douglas G Baird and Donald S Bernstein, 'Absolute Priority, Valuation Uncertainty, and the Reorganisation Bargain' (2006) 115 Yale L J 1930, 1930; see also Allen C Eberhart, et al, 'Security Pricing and Deviations from the Absolute Priority rule in Insolvency Proceedings' (1990) 45 J Fin 1457 and Julian R Franks and Walter N Torous, 'An Empirical Investigation of US firms in Reorganisation' (1989) 44 J Fin 747.
[152] Korobkin (n 11) 622.
[153] See Irene Lynch Fannon, 'Guest Editorial' (2019) 27(3) IIR 1. See also Stephen Lubben, 'The Overstated Absolute Priority Rule (2016) 21(4) Fordham Journal of Corporate & Financial Law 580.

[154] Rotaru (n 86) 44.
[155] *idem* 43.
[156] Baird & Bernstein (n 159) 1937-1938.
[157] *idem* 1940.
[158] Baird goes on to discuss the intricacies of modern business practice and the application of absolute priority and its deviations. The depth of this discussion is outside the scope of this Report. See Baird & Bernstein (n 159) 1944 onward for more detail on how valuation uncertainty

Arguably, the academic debate regarding the retention of the absolute priority rule does not reflect the issues in practise. The PRD, in its description of the approval process and the provision of the cross-class cram-down in article 11, addresses both legal frameworks and practise in existence in Member States. It also reflects the concerns expressed in this regard by commentators and experts.

The European relative priority rule is seen as a means of facilitating restructuring negotiations, while the absolute priority rule is seen by some as being too rigid and counterproductive by giving certain classes of creditors a "harmful lever of extortion".[159] There are four further problems with the APR suggested by Mokal and Tirado. First, the APR subjects approval to a requirement that may be completely unrealistic; the debtor's estate may lack sufficient value to pay dissenting creditors fully, making the cram-down impossible and causing the plan to fail. Secondly, it incentivises dissent on the basis of a possible "free-ride"; members of a class may sufficient support elsewhere, thereby having an incentive to vote against the plan in the hopes of receiving full payment. Third, the aforementioned incentive to hold-out risks backfiring as creditors in multiple classes may have similar incentives to hold-out, potentially leading to rejection of the plan. Finally, it makes it difficult to give any value to equity holders, which is viewed as problematic for small and medium sized companies[160] as noted above.[161]

Unsurprisingly, the APR while operating as a starting point from which negotiations and bargaining begins, it does not feature as an absolute rule in any restructuring framework that operates as a genuine corporate rescue device.[162]

As noted by the CODIRE Project Team:

> "The relative priority rule is a preferred alternative to the 'absolute priority rule' familiar in US restructuring practice. The absolute priority rule makes it a precondition for confirmation of a plan rejected by one or more classes of affected stakeholders that members of each dissenting class would receive the full face-value of their claims before the members of a lower class receive, or retain, anything. This approach is defective. It incentivises dissent from the plan so long as the dissentients expect the plan to receive sufficient support from claimants in other classes. Such dissentients would expect to free-ride on others' sacrifice by being paid in full while those others accepted a haircut. This makes confirmation of the plan less likely, however, since each class might in this way have some such incentive to dissent."[163]

The European concept of the RPR reflects pre-existing practise in some Member States. As with the US Chapter 11, the starting point is an absolute priority rule pre-existing the relevant domestic processes. Negotiating the rescue plan and reaching agreement is done with full recognition and management of pre-insolvency entitlements. These domestic processes tend to include formal approval of the plan, before becoming effective. This stage is similarly envisaged in the PRD. It has been claimed, however, that there is a moral hazard in allowing for divergence from absolute priority, derived in part from allowing shareholders to retain shares while writing down creditors, upending priority rules. This is viewed as unfair; it should be noted, however, that in practice shareholders rarely benefit.[164] For these commentators, the question may be how to balance this moral hazard with the benefit to the economy of rescues of viable businesses and all of the associated benefits.[165]

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affects the ability to negotiate a reorganisation within the confines of absolute priority. See also Lucian Arye Bebchuck, 'Ex Ante Costs of Violating Absolute Priority in Insolvency' (2002) 57(1) J Fin 445.

[159] Lorenzo Stanghellini, Riz Mokal, Christoph Paulus, and Ignacio Tirado, 'Best Practices in European Restructuring: Contractualised Distress Resolution in the Shadow of the Law (CODIRE)' (Wolters Kluwer 2018) 46.

[160] Tirado & Mokal (n 150) 22.

[161] Baird & Bernstein (n 159) 1937-1938.

[162] See generally Lynch Fannon & Murphy (n 3) chapters 12 and 13. See also Payne (n 90).

[163] Lorenzo Stanghellini, Riz Mokal, Christoph Paulus, and Ignacio Tirado, 'Best Practices in European Restructuring: Contractualised Distress Resolution in the Shadow of the Law' (Wolters Kluwer 2018) 46.

[164] R J de Weijs, A L 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)' (2019) Centre for the Study of European Contract Law Working Paper Series No. 2019-05, 15. See generally O'Donnell and Nicholas: *Examinerships* (Londsdale Law Publishing, 2016)

[165] See further Bob Wessels and Stephan Madaus, *Instrument of the European Law Institute – Rescue of Business in Insolvency Law* (September 6, 2017) (ELI Project); Tirado & Mokal (n 150) 20.

The introduction of the European version of RPR has caused considerable consternation in some quarters, claiming that it will lead to arbitrary results and value destroying uncertainty.[166] These criticisms have been roundly rebuffed by the highly respected authors of two reports.[167] On the one hand, if the aim is to better safeguard the interests of all stakeholders negotiating a plan in an optimal setting for such negotiation, then an RPR in the way it is drafted in the PRD seems understandable. On the other hand, it has been viewed as blurring the initial bargaining positions of creditors. The argument continues that the existence of an RPR approach broadens the scope of agreements beyond what can reasonably be discussed under time pressures, as each creditor has an incentive to try and win a bit more from the agreement as the priority rules become negotiable.

Furthermore, the wording of the APR in the PRD has been viewed as providing enough flexibility to ensure the effective agreement of restructuring plans. There is leeway for national legislators to assess the meaning of "full satisfaction" and "equivalent means" according to Recital 55:

> "Member States should have discretion in implementing the concept of 'payment in full' including in relation to the timing of the payment, as long as the principal of the claim and, in the case of secured creditors, the value of the collateral are protected."

This should make it possible to pay junior creditors as soon as senior creditors have been given sufficient additional security or payment in kind that equates to what they are owed, in other words, not necessarily in cash.[168] In addition, the PRD allows for exceptions to the APR if they are equitable, which is reflected in recital 56:

> "Member States should be able to derogate from the absolute priority rule, for example where …essential suppliers covered by the provision on the stay of individual enforcement actions are paid before more senior classes of creditors."

If the aim of the PRD is to create proceedings that save companies, however, then a relative priority rule may be helpful, as it can allow a plan to be confirmed even when some creditors do not believe in the existence of the restructuring value and oppose the proposed plan. An application of the RPR as drafted in the PRD may help restructuring practitioners to reach an agreement that seems reasonable, while saving the debtors' company in spite of the opposition of creditors.[169] Fundamentally, this seems to be a remnant of the debtor or creditor focussed debate within corporate rescue.

The absolute vs relative priority argument presents a challenge for comparative law because it raises fairly serious reactions among academics in certain jurisdictions, which makes finding a compromise difficult.[170] Some of this is due to legal culture, which ascribes moral hazard to flexible debtor in possession restructuring procedures. This argument is associated with the debate described above between insolvency and pre-insolvency.[171] For example, some of the contributors to the JCOERE Questionnaire took a strict interpretation, discussing only pre-insolvency restructuring even if they had a basic restructuring procedure that essentially fulfilled the same purpose. This issue goes beyond the challenges of comparative law, to the challenge of debating new and largely untested concepts within the civil law systems of most of the EU. These concepts are often discussed at cross-purposes with common law jurisdictions, such as Ireland and the UK, which have-judicially developed standards for assessing fairness to dissenting creditors. It would seem, therefore, that the requirement in article 11 for approval of a plan by a judicial or administrative authority approval where the plan has not been accepted by every class anticipates difficulties and reflects practise. However, again we find in debates that scepticism regarding the judicial function emerges in this latter context. These issues, which we believe are reflective of legal culture will be considered in detail in the JCOERE Report 2.

4.6.4 Protection and Priority of Rescue Financing

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[166] de Weijs, Jonkers, & Malakotipour (n 173) 17.
[167] ELI Project (n 174) and CODIRE Project (n 171).
[168] Reinhard Dammann and Vasile Rotaru, 'Premières Réflexions sur la Transposition de la Future Directive sur les Restructurations Préventives' (Dalloz Actualité : Le Quotidien de Droit 2018) <https://www.dalloz-actualite.fr/revue-de-presse/premieres-reflexions-sur-transposition-de-future-directive-sur-restructurations-prev#.XdesK-j7QuU> accessed 22 November 2019.
[169] Rotaru (n 86) 49.
[170] This was discussed and debated in some detail by Reinhard Dammann, Christoph Paulus, and Francisco Garcimartin during the 'Directive on Preventive Restructuring Frameworks: Relative or Absolute Cramdown' session at the INSOL Europe Annual Congress on 27th September 2019, Copenhagen, Denmark.
[171] See section 4.4 of this Chapter.

The PRD presents a number of justifications for the protection and prioritisation of rescue financing. The PRD recognises that the success of a restructuring plan often depends on financial assistance: first, to support the operation of the business during the negotiations. Second, financial assistance supports the implementation of the restructuring plan following its confirmation. For this reason, the PRD aims to protect interim and new financing by making it exempt from avoidance actions in a subsequent insolvency proceeding.[172] In so providing, the PRD recognises that the availability of necessary financing could be jeopardised if national insolvency laws allow such financing to be subject to avoidance actions, or to civil, administrative, or criminal sanctions.[173]

Interim financing occurs prior to a restructuring plan being confirmed, therefore limitations should not be applied so as to encourage a fully successful restructuring process. It is defined explicitly as:

> "any new financial assistance, provided by an existing or a new creditor, that includes, as a minimum, financial assistance during the stay of individual enforcement actions, and that is reasonable and immediately necessary for the debtor's business to continue operating, or to preserve or enhance the value of that business."[174]

New financing is defined as "any new financial assistance provided by an existing or a new creditor in order to implement a restructuring plan and that is included in that restructuring plan."[175]

According to the PRD, both interim and new financing should be protected from avoidance actions and personal liability at a minimum. In order to encourage new lenders to take the enhanced risk of investing in a viable debtor in temporary financial distress may require other incentives, such as giving priority to financing over unsecured claims in subsequent insolvency procedures, at the least.[176] To reduce potential for abuse, the financing should at least be limited to that which is immediately necessary for the continued operation or survival of the enterprise, or to preserve or enhance value pending confirmation of a plan.

The availability of such financing can be justified by the fact that debtors in financial distress will find it difficult to acquire new financing if they cannot offer reliable security, thus offering priority or protection may incentivise rescue lending. It is unlikely that lending institutions will be prepared to lend new money if there is a risk of not getting that money back, should the restructuring plan fail. "Security can be provided by rights *in rem* but if the debtor has no assets in which it can offer a priority right, subsequent insolvency proceedings would suffice."[177] The concept of a super-priority for rescue financing raises certain complex questions, however, particularly if financing is coming from an existing creditor, which may benefit from an improved priority position in a pre-existing claim as part of the restructuring plan. [178]

Priority rights place some creditors in a better position than those already owed debts by the company. As the *pari passu* is a key tenet of insolvency law, deviance from this norm must be justified. This has been done by reference to the argument that restructuring efforts are worthy of being supported through fresh money and that there is an economic necessity to protect new financing.[179] The Directive resolved this in a number of ways, for example some protections are provided by requiring court or administrative approval for plans that include priority for new or interim financing.[180] While giving priority to new financing clearly interferes with standard priorities in insolvency and treats new financiers more favourably than other creditors, the rescue of viable businesses and the associated benefits~~,~~ is seen as an overarching justification.

4.7 Summary and Conclusion: Implementation and Conflicts

This Chapter explored the theoretical underpinnings of insolvency law as it has evolved to accommodate aims going beyond simple liquidation. Beginning with the creditors' bargain theory and progressing

[172] PRD, recital 66.
[173] PRD, recital 67.
[174] PRD, art 2(1)(8).
[175] PRD, art 2(1)(7).
[176] PRD, recital 68.
[177] Bork (n 107) 422.
[178] Horst and Van Zweiten (n 99) 633.
[179] *Ibid.*
[180] See Chapter 7 of Report.

through alternatives, such as traditionalism and communitarianism, which more closely reflect the evolution of insolvency and corporate rescue, rehabilitation, and now preventive restructuring. The conceptual evolution of preventive restructuring within the EU was then discussed in terms of contrasting academic and scholarly commentary on the subject. A brief discussion of the evolution of the PRD was then presented, which will be discussed in greater detail in the next chapter. Finally, the more controversial provisions, namely the moratorium, majority rule, cross-class cram-down, and priority of rescue financing, were introduced and discussed in terms of their worth, fairness to creditors and cost or benefit to rescue generally.

4.8 Chapter 5: Exposition of the Preventive Restructuring Directive

The next chapter will give a full exposition of the PRD, beginning with the 2011 report presented to the Commission by the Committee on Legal Affairs and continuing with the 2014 Recommendation on a New Approach to Business and Insolvency.[181] It considers the journey from these early communications to the PRD, as it is now. The next chapter will examine the various inter-institutional discussions and the Proposal's progress through the EU, focusing on the provisions, which resulted in the greatest compromises in the final text. These provisions will primarily include the stay, the cram-down and cross-class cram-down, and the protection of new financing. The work in Chapter 5 satisfies a key task of Workpackage 2 of the JCOERE project.

[181] Commission Recommendation C(2014) 1500 final of 12 March 2014 on a new approach to business failure and insolvency [2014] OJ L 74/65.