

International Insolvency Institute

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THE NEW RELATIVE PRIORITY RULE

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Outline

1. Textbooks \neq reality
2. Guiding principle
3. 'New' best interest test
4. Relative priority

1. Textbooks \neq Reality

Textbook descriptions ≠ Reality

- US system is not APR!
 - Eg Lubben (2015):
 - *“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.”*
- APR is like the pari passu / *par conditio creditorum* rule
 - **structures analysis, not practice**

US practice

- Supreme Court's *Jevic* decision (2016) seems to suggest APR only applies to Court's final determination: confirmation, conversion, or dismissal
- APR appears not to prohibit
 - “***interim distributions that violate ordinary priority rules***” but
 - which serve “***significant Code-related objectives***”
 - particularly ***successful reorganization*** and ***making even disfavoured creditors better off***
 - assumption of contracts requires cure and payment
 - ‘first day motions’
 - wage orders
 - ‘critical vendor’ contracts
 - ‘roll-ups’ to permit lenders to be paid on prepetition claims
 - certain customers paid ‘in ordinary course’, eg pre-petition warranties as in the automobile bankruptcies
 - settlements in ongoing litigation
 - only rump estate is subject to APR

UK does not even pretend to have APR

- Scheme jurisdiction is best known. Court:
 - confirms compliance with statutory provisions
 - considers whether classes fairly represented
 - tests whether scheme one that class member may reasonably approve
- Class composition is key: rights not so dissimilar that common interest consultation impossible
 - Rights, not interests
 - Material difference in rights (eg crossholdings, 3rd party guarantees) not sufficient to require separate classification
 - Nor is separate treatment in scheme process (eg inducement fees, lockup agreements)
- *Tea Corp* scheme: transfer of assets and novation of *some* liabilities to NewCo, leaving remaining claimants to claim against the OldCo shell

2. Guiding principle

So what is restructuring's guiding principle?

- Strike an appropriate balance between
 - respect for pre-existing rights
 - and
 - incentivising value-preserving/maximising restructuring by rewarding claimants whose contribution a restructuring requires

The new Directive

- Drafting not ideal
- Key lie in how it is implemented in MSs
- Not necessarily a problem: it is, after all, a framework directive, not (say) a regulation
- Can be implemented by learning

lessons, including from US Ch 11

and the UK

3. 'New' best interest test

‘New’ best interest test

- Traditional understanding (‘RIL’, permitted by Directive):
 - Dissentients receive at least as much as in liquidation
- ‘New’ understanding:
 - Dissentients receive at least as much as in realistic alternative to proposed restructuring
 - Goes back to at least *In re English, Scottish, and Australian Chartered Bank* [1893] 3 Ch 385 (CA)
 - Also supported by US practice, e.g. comparison may be with alternative plan or with terms realistically offered by another buyer

Mokal/Tirado (2019)

Getting 'REAL' about creditors' best interests

The problem with RIL is that it opens the door to plans under which some of the value that ought to go to the members of the dissenting class would be expropriated for others. As noted, RIL guarantees that dissentients would get at least as much under the plan as in liquidation. This is not good enough, however, where liquidation is not at all likely, regardless of whether the plan is approved or not. Consider a debtor who is balance-sheet insolvent but fully able to pay the debts as they fall due, from the revenues generated by its operations, i.e. it is cashflow solvent because of a 'going concern surplus'. If liquidated, however, it would not be able to

meet some of the repayment obligations because of value destruction through counterparty termination of contracts, erosion or refusal of trade credit, supplier discounts, customer confidence and associated willingness to pay for guarantees, departure of key employees, higher rates on financial credit and so on. The plan proposes to maintain the debtor as a going concern, then, but promises the dissenting class only their liquidation returns, which are significantly lower. Here, RIL clearly does not protect dissenting creditors' (best) interests.²

‘New’ best interest test

- Ensures that the plan:
 - may **not** reallocate baseline (ie non-plan) returns
 - **may** allocate **true** restructuring surplus
 - **true** restructuring surplus results from participant cooperation
- Dissident:
 - does not want plan, so:
 - cannot object to baseline return
 - whether it can or cannot be bothered is neither here nor there; it should not be permitted by holding out to:
 - destroy surplus
 - appropriate surplus

4. Relative priority

*“ Member States should be able to protect a dissenting class of affected creditors by ensuring that it is treated **at least as favourably as any other class of the same rank** and **more favourably than any more junior class.**”*

Cross-class cram-down

1. Member States shall ensure that a restructuring plan which is not approved by **affected parties, as provided for in Article 9(6), in every voting class**, may be confirmed by a judicial or administrative authority upon the proposal of a debtor or with the debtor's agreement, and become binding upon dissenting **voting** classes where the restructuring plan fulfils **at least** the **following** conditions:...

(ii) **at least one of the voting classes of affected parties or where so provided under national law, impaired parties**, other than an equity-holders class **or** any other class which, upon a valuation of the **debtor as a going-concern**, would not receive any payment or **keep any interest, or, where so provided under national law, which could be reasonably presumed not to receive any payment or keep any interest**, if the normal ranking of liquidation priorities were applied **under national law**,

(c) **it 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; and**

(d) **no class of affected parties can, under the restructuring plan, receive or keep more than the full amount of its claims or interests. ...**

2. **By way of derogation from point (c) of paragraph 1, Member States may provide that the claims of affected creditors in a dissenting voting class are satisfied in full by the same or equivalent means where a more junior class is to receive any payment or keep any interest under the restructuring plan.**

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.

Types of priority (Jacoby/Janger 2018)

- **asset based priority**, i.e. rights in rem in relation to specific assets
- **structural priority**, i.e. priority based on the allocation of assets, claims, and going concern value amongst members of a corporate group
- **waterfall priority**, i.e. statutorily preferred claims (such as certain of those vested in employees), with priority over general unsecured claims, with priority over preferred equity, with priority over equity

How to treat dissent

- For asset-based and structural priority holders
 - straightforward application of the (new) best interest test
 - gives secured creditors the full realisable value of their collateral, and
 - gives structural priority holders at least as much as they would have received in the absence of the plan

Relative priority – creditors I

- **'Bare' relative priority**
 - requires that senior dissenting class gets a higher proportion of their claim than the mezzanine and junior assenting classes, i.e. senior should get $x\%$ if mezzanine will get $y\%$ and juniors $z\%$, where $x > y$ and $x > z$.
 - maximally flexible, since the entire restructuring surplus is up for grabs.
 - greatest incentives for the seniors to sign up to the plan--by being cooperative, they can hope to negotiate their share up above $x\%$ --but also
 - creates least incentives for juniors to be reasonable--the latter can always seek to cram down the seniors at or close to the seniors' baseline returns.

Relative priority – creditors II

- **Liquidation returns-based relative priority**
 - If in an immediate liquidation, the seniors would receive 80%, the mezzanine 40%, and the juniors 20%, and the seniors dissent, that fixes their relative proportionate returns on this reading of the ERPR. That is to say, seniors should receive $2x\%$ if the mezzanine receive $x\%$, and juniors should receive $<2x\%$.
 - perhaps easier to apply, but
 - backward looking (it takes no account of the parties' relative contributions to the plan) and
 - unmotivated (why focus on liquidation unless that is the realistic alternative to the plan?)

Relative priority – creditors III

- **Baseline returns-based relative priority**
 - As above, except that the relative returns are fixed by reference to parties' relative proportionate returns in the realistic alternative scenario.
 - still backward looking (it takes no account of the parties' relative contributions to the plan) but
 - now fixes relativity by reference to realistic alternative

Relative priority – Equity

- Guiding principle
 - only those stakeholders should benefit from restructuring who contribute in some appropriate way to the restructuring surplus (or else by consent of other stakeholders)
- If equity is underwater, therefore, it should not receive anything if the junior-most creditor class is to be crammed down.
 - this result follows mathematically from the second and their readings of the RPR on previous slides, read together with the best interest test. Other reading would need supplementation along the aforementioned lines.

Likely outcome

- Some restructurings in which equity would receive / retain something under the ERPR (+ new 'best interests') where it would not do so under the APR (+ old 'best interests').
- Useful tool in relation to small and medium enterprises in particular, where for a variety of reasons it is not appropriate for residual ownership to be split from control and where some of the restructuring surplus results from the continuing involvement of the (pre-restructuring) equity holders.

Practicalities

- The entire RPR + new best interests test places a lot of weight on being able to figure out the realistic alternative to the plan and the relevant parties' returns in them.
 - That, however, is what schemes routinely do (albeit for class formation purposes)
 - Also, APR-based litigation suffers similarly
- The burden of proof is on the debtor (or whoever is pushing for the cramdown), so that if they fail to establish the alternative scenario and the relevant returns, then the plan is not effective.

Thank you!
Comments and questions welcome.