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Business Restructuring Law in Europe – Making a Fresh Start

This paper critically examines a possible new European approach to business failure and insolvency. It sets this approach in the context of the objectives of insolvency law to rescue viable businesses and to liquidate non-viable ones and addresses the broader political dimensions of the subject. It also uses the comparable US procedure - Chapter 11 of the US Bankruptcy Code - as a reference point for detailed analysis. Given the 'Brexit' vote in the UK on 23rd June, this new European approach is not of immediate direct relevance in the UK. Nevertheless, the ideas contained in the approach are likely to influence the future reform agenda in the UK.[1]

Background

The European Commission on 12th March 2014 issued a recommendation on a new approach to business failure and insolvency[2]. The Recommendation is part of the Europe 2020 strategy[3] which is designed to foster economic recovery and sustainable growth. The objective is to create a situation where economic and social systems are adaptable, resilient and fair and where human values are respected.[4] The Recommendation encourages EU

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[1] See the Insolvency Service consultation, *A Review of the Corporate Insolvency Framework: A consultation on options for reform* (May 2016). This consultation seeks views on whether the UK regime 'needs updating in the light of international principles … recent large corporate failures and an increasing European focus on providing businesses with the tools to facilitate company rescue. It seeks to establish whether legislative change would improve the UK corporate insolvency regime and provide a better environment to achieve the successful rescue of a viable business' (see p 4).
[2] C (2014) 1500 final and see also the Commission Communication *A New European Approach to Business Failure and Insolvency* COM (2012) 742. The Recommendation also contains provisions on a fresh start for 'honest' entrepreneurs.

In this paper, the expressions 'insolvency' and 'bankruptcy' are used interchangeably while' liquidation' is used in contrast to restructuring as meaning the closing of a business and the division of its assets among creditors.

[3] See *Europe 2020 – A European Strategy for Smart, Sustainable and Inclusive Growth* (2010).

[4] For analysis see, inter alia, S Madaus, 'The EU recommendation on business rescue - only another statement or a cause for legislative action across Europe?' [2014] Insolvency Intelligence 81; K Van Zwieten, 'Restructuring law – recommendations from the European Commission' available athttp://www.ebrd.com/downloads/research/law/lit114e.pdf; H Eidenmuller and K Van Zweiten, 'Restructuring the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency' *European Corporate Governance Institute (ECGI) - Law Working Paper No. 301/2015 Oxford Legal Studies Research Paper No. 52/2015/*.

Member States to "put in place a framework that enables the efficient restructuring of viable enterprises in financial difficulty" and to provide for "minimum standards on … preventive restructuring frameworks."[5]

The launch of the Commission Action Plan on Building a Capital Markets Union[6] means that the encouragement is likely to become something stronger. The Action Plan stresses the fundamental importance of stronger capital markets in providing new sources of funding for business, helping to increase options for savers and making the economy more resilient. It also highlights the fundamental role of corporate restructuring law in this process.[7] The Action Plan proposes taking forward a legislative initiative on business insolvency that will address the most important barriers to the free flow of capital and build on national regimes that work well. It is argued that differences in the implementation of the Recommendation mean continuing legal uncertainty and additional costs for investors in assessing their risks.

This paper addresses in detail the merits of the Commission Recommendation and the likely contours of any future legislative action. In particular, it sets the Recommendation in the context of the debate surrounding the objectives of corporate insolvency law comparing it in this connection with Chapter 11 of the US Bankruptcy Code. According to two leading US bankruptcy law professors[8], Chapter 11 deserves a prominent place in 'the pantheon of extraordinary laws that have shaped the American economy and society and then echoed throughout the world…'. Chapter 11 has been cited as a great success by many people and

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[5] For background see the accompanying Impact Assessment - SWD(2014) 6; the Insol Europe study done for the European Commission, 'Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practice's TENDER NO. JUST/2012/JCIV/CT/0194/A4 and more generally H Eidenmuller, 'A New Framework for Business Restructuring in Europe: The EU Commission's Proposals for a Reform of the European Insolvency Regulation and Beyond' (2013) 20 *Maastricht Journa*l 133.

[6] COM (2015) 468.

[7] For discussion of the Capital Markets Union see the symposium in (2015) 9 *Law and Financial Markets Review* 187-209 and see also Georg Ringe, 'Capital Markets Union for Europe: A Commitment to the Single Market of 28' (2015) 9 *Law and Financial Markets Review* 5 referring to a 'a motley collection of policies' and suggesting that the 'name is more symbolic than real, as the substance falls short of achieving a fully unified capital market across the EU.'

[8] See E Warren & JL Westbrook, 'The Success of Chapter 11: A Challenge to the Critics' (2009) 107 *Michigan Law Review* 603 at 604.

as something of a model to which European restructuring laws should aspire.[9] In a leading study by inter alia, the Association of Financial Markets in Europe (AFME) and Frontier Economics it has been described as an important comparison point for further insolvency law reform in Europe.[10]

The paper consists of four substantive sections followed by a brief conclusion. The first section considers why the Commission has launched the initiative and whether it is worthwhile.[11] In doing so, it addresses the objectives of corporate insolvency law and highlights the broader political dimensions of the subject. The second section considers the US Chapter 11 as a reference point for the Recommendation. The third section addresses the main features of the Commission Recommendation and makes more explicit comparisons with Chapter 11. The fourth section considers what form any legislative initiative by the Commission is likely to take. This is followed by a brief conclusion.

The paper takes the line that the Recommendation and any legislative action is of particular importance and adds value in those EU Member States that have underdeveloped restructuring frameworks. According to the AFME/Frontier Economics study, EU legislative action will lead to improvements generally but such reforms 'will have their greatest positive impact on the EU economy and markets, to the extent that they are implemented consistently across jurisdictions.'[12] This paper takes a somewhat different approach in suggesting that there must be more attention paid to national sensitivities and local differences. Unless reforms can build on practices that currently work well on the local

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[9] See "A 'Chapter 11' Law for Europe's Entrepreneurs" available at http://www.euractiv.com/section/euro-finance/opinion/a-chapter-11-law-for-europes-entrepreneurs/ and see generally M Brouwer, 'Reorganization in US and European Bankruptcy Law' (2006) *22 European Journal of Law and Economics* 5.

[10] *Potential economic gains from reforming insolvency law in Europe* (February, 2016) at p 11. The report was prepared by AFME, Frontier Economics and Weil, Gotshal and Manges LLP and is hereinafter referred to as the AFME study.

[11] The focus of the article is very much on the Commission Recommendation. It does not consider directly the recast Insolvency Regulation – Regulation 2015/848 - which also forms part of the Europe 2020 strategy and which, through the protection of creditors and the survival of businesses, is also intended to 'contribute to the preservation of employment in these challenging times' - see Press Release, *New Rules to Promote Economic Recovery*, 4th December 2014 – available www.consilium.europa.eu/uedocs/NewsWord/en/jha/146041.doc/.

[12] AFME study at p 20.

national level, then they may wither on the wine and risk disillusionment with what is perceived to be a further set of top down bureaucratic requirements from Brussels.

1. **Reasons behind the initiative**

The reasons behind the Recommendation appear to be simple – growth and jobs.[13] The current European Commission President, Jean-Claude Juncker, said on taking office that his first priority was to put growth and jobs at the centre of the European policy agenda.[14] Recital 12 in the Recommendation states that 'removing the barriers to effective restructuring of viable companies in financial difficulties contributes to saving jobs and also benefits the wider economy.'[15]

Fewer liquidations should mean that workers keep their jobs and businesses can contribute to growth across the EU. Fewer liquidations should also mean creditors and other stakeholders incurring fewer losses and thereby enabling them to assist in the growth process. It should also mean less dislocation in local and national communities throughout the EU. Reducing the divergence of national insolvency frameworks could also contribute to the emergence of pan European equity and debt markets. This would reduce uncertainty for investors who would otherwise have to assess investment risks on a country-by-country basis. [16]

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[13] See also the press release of 22nd February 2016 "EU insolvency law reform could boost growth and jobs across Europe, finds new AFME report" stating that differences in national insolvency laws can have a range of negative effects on financial markets and the real economy, including increasing uncertainty among investors; discouraging cross-border investment; discouraging the timely restructuring of viable companies in financial difficulty and making it harder to address the high levels of non-performing loans (NPLs) in the European banking system.

[14] http://juncker.epp.eu/my-priorities

[15] See Recommendation Impact Assessment SWD(2014) 61 at p 26 on the general policy objectives.

[16] On the broader dimensions of insolvency law see generally F Mucciarelli, 'Not Just Efficiency: Insolvency Law in the EU and its Political Dimension' (2013) 14 EBOR 175; J Armour, 'The Law and Economics Debate about Secured Lending: Lessons for European Lawmaking?' (2008) 5 *European Company and Financial Law Review* 3; 'Should We Redistribute in Insolvency?' in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (Oxford: OUP, 2006).

The Action Plan on Building a Capital Markets Union[17] is designed to strengthen Europe's economy and stimulate investment with a view to creating employment. The Action Plan stresses the fundamental importance of stronger capital markets in providing new sources of funding for business, helping to increase options for savers and making the economy more resilient. The free flow of capital is one of the core foundation stones on which the European Union is built.[18] But, as the Action Plan points out, Europe's capital markets are still relatively underdeveloped and fragmented despite the progress over the past 50 years. While the EU economy is as big as that of the US, the EU's equity markets are less than half the size of those in the US and its debt markets less than a third of the size. Moreover, there are even bigger gaps between individual EU Member States. The Action Plan suggests that more integrated capital markets will lead to efficiency gain inter alia by unlocking more investment from the EU and the rest of the world; better connecting financing to investment projects and increasing competition.[19]

The Action Plan was accompanied by a staff working document[20] that detailed various perceived obstacles in the growth path. It highlighted persistent barriers to the cost effective reorganisation of viable companies in the EU, including cross-border enterprise groups, and inefficient and divergent insolvency proceedings. These prevented speedy debt restructuring since non-performing loans were more difficult to resolve without effective restructuring and insolvency tools. There were also difficulties for investors in assessing credit risk, particularly in respect of cross-border investments given the fact that there are 28 divergent insolvency regimes in the EU. Moreover, there were incentives for ailing companies which do not have effective early restructuring possibilities in their home country to relocate to

[17] COM (2015) 468.

[18] See now Article 26(2) of the Treaty on the Functioning of the European Union (TFEU) referring to the creation of an internal market comprising an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured

[19] See generally Action Plan at pp 3-4.

[20] See SWD (2015) 183 final and SWD(2015) 184 final. See in particular pp 24-25 of the Action Plan and pp 73-78 of the staff working document.

Member States with more effective systems.[21] Minority creditors might be adversely affected by the application of a different insolvency regime even though the new regime could be beneficial to the general body of creditors and the debtor company as a whole. In addition, the high costs of relocation made it very difficult, if not impossible, for smaller enterprises (SMEs) to benefit from better restructuring possibilities in other Member States.[22] On the other hand, the convergence of insolvency and restructuring regimes was seen as facilitating greater legal certainty for cross-border investors. It also encouraged the timely restructuring of viable companies in financial distress.

But why turn the Recommendation into something harder and possibly less flexible? After all, it appears that modern restructuring procedures already exist in most, if not all, Member States.[23] It seems that European insolvency law has gone through a remarkable transformation over the past decade or so with France being a good example of a jurisdiction that has carried out major reforms through the introduction of Sauvegarde, Accelerated Financial Sauvegarde and Accelerated Sauvegarde restructuring procedures.[24]

In short, the justification for Commission action appears to be the incomplete and inconsistent implementation of the Recommendation.[25] A Commission evaluation[26]

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[21] On 'forum shopping' under the Insolvency Regulation – Regulation 1346/2000 see M Szydlo, 'Prevention of Forum Shopping in European Insolvency Law' (2010) 11 EBOR 253; WG Ringe, 'Forum Shopping under the EU Insolvency Regulation' (2008) 9 EBOR 579; G McCormack, 'Jurisdictional competition and forum shopping in insolvency proceedings' (2009) 68 CLJ 169.

[22] Recital 1 in the preamble to the Recommendation states that its objective is to ensure that viable enterprises in financial difficulties, wherever they are located in the Union, have access to national insolvency frameworks which enable them to restructure at an early stage with a view to preventing their insolvency.

[23] For a brief outline of some of these developments see the European Commission evaluation of the implementation of the Recommendation - http://ec.europa.eu/justice/civil/files/evaluation_recommendation_final.pdf and see also B Wessels, 'Themes of the future: rescue businesses and cross-border cooperation' [2014] *Insolvency Intelligence* 4.

[24] For a brief account of the French reforms see A Gallagher and A Rousseau, 'French Insolvency Proceedings: La Revolution a Commence' [2014] *American Bankruptcy Institute Journal* 20 and for French/UK comparisons see A Kastrinou, 'Comparative Analysis of the Informal Pre-Insolvency Procedures of the UK and France' (2016) 25 *International Insolvency Review*.

[25] The Capital Markets Action Plan - COM (2015) 468 – at 25 also relies on the World Bank Doing Business report and rankings – www.doingbusiness.org/: "The 2015 World Bank Doing Business Report ranks countries on the strength of their insolvency frameworks on a scale of 0-16. The EU simple average is 11.6, which is 5% below the OECD average for high income countries (12.2). Some Member States score below 8." But for criticisms of these rankings see G McCormack, 'World Bank Doing Business project: Should Insolvency Lawyers take it seriously' [2015] *Insolvency Intelligence* 119.

concludes that while "the Recommendation has provided useful focus for those Member States undertaking reforms in the area of insolvency, it has not succeeded in having the desired impact in facilitating the rescue of businesses in financial difficulty". It appears that in some countries restructuring procedures are completely absent and in other cases, the procedures may be cumbersome and inefficient and have the effect of transferring wealth to out-of-the money managers, shareholders and creditors.[27] Other inefficiencies include prolonging the life of financially unviable enterprises. This may have detrimental consequences for healthy competitors and the overall soundness of the economy since it impedes accomplishment of the objective of putting assets to their most effective use.[28]

Nevertheless, one may query whether Member States were given a sufficiently long period to give effect to the March 2014 Recommendation. The Commission took less than 18 months to move from Recommendation to evaluation. This seems a remarkably quick period given the fact the policy making and legislative processes move slowly in certain countries with crowded parliamentary timetables. Even within the Commission itself, 18th months is a short period to move from policy proposal to legislative instrument. The recast Insolvency Regulation, for instance, took at least 3 years. [29] The short time span gives rise to the suspicion that the Commission planned a legislative instrument rather than a 'mere' Recommendation at the outset.

Moreover, in attaching such importance to the Recommendation the Commission may be guilty of certain wishful assumptions and over-stressing the importance of business

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[26] http://ec.europa.eu/justice/civil/files/evaluation_recommendation_final.pdf at p 5. The evaluation was published on 30th September 2015 – the same date as the Capital Markets Action Plan.
[27] See the Recommendation Impact Assessment SWD(2014) 61 at p 2.
[28] See more generally S Davydenko and J Franks, 'Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK' (2008) 63 *Journal of Finance* 565 and pp 603-604 for the statement that many European restructuring frameworks are still inflexible, costly and value destructive.
[29] For the original European Commission recommendations for recast of the Regulation, see *Proposal for a new Regulation* COM (2012) 744 and see also *Report from the Commission on the application of Council Regulation (EC) No 1346/2000* COM (2012) 743 and the Hess–Oberhammer–Pfeiffer external evaluation of the Regulation commissioned by the European Commission – see JUST/2011/JCIV/PR/0049/A4. The recast Regulation was formally adopted by the European Parliament on 20th May 2015 and was published in the Official Journal on 5th June 2015. Most of the provisions will come into force on 26th June 2017 – see Articles 84 and 92.

restructuring law in an overall economic context. [30]It is important to note the limitations of business restructuring law. The law can create an environment that facilitates negotiations on financial deleveraging; the adjustment of debts and other ongoing obligations. But it cannot mend a bad business model. If a particular company is exclusively committed to the manufacture or supply of a product for which there is no market then the law cannot fix this. Having a liquidation law that facilitates the move of assets away from inefficient enterprises may contribute more significantly to the overall health of the economy.[31]

An effective insolvency law should be able to liquidate speedily and efficiently unviable firms as well as being able to restructure viable ones.[32]For example, at the international level[33], the United Nations Commission on International Trade Law (UNCITRAL) when stating the objectives of modern and efficient insolvency laws and institutions highlights the efficient closure and transfer of assets of failed businesses as well as promoting the restructuring of viable business; facilitating the provision of finance for business start-up and reorganisation and enabling assessment of credit risk, both domestically and internationally.[34]

Certainly not all 'businesses' that be saved[35] though it must be said that definitions and statistical interpretations on business success or failure vary widely.[36] This issue has

30 But see H Eidenmuller and K Van Zweiten *op cit* at p 26 suggesting that the Recommendation in its focus on restructuring financially distressed firms 'appears to overlook economic reality'.

31 In Italy a study has suggested that a reform of the liquidation procedures that strengthened creditor rights reduces the cost of bank financing and spurs investment - see Giacomo Rodano, Nicolas Serrano-Velarde, Emanuele Tarantino, 'Bankruptcy Law and Bank Financing' available at www.igier.unibocconi.it/files/547.pdf

32 See the Recommendation Impact Assessment SWD(2014) 61 at p 2.

33 On international norms in this area, see generally T Halliday and B Carruthers, *Bankrupt: Global Lawmaking and Systemic Financial Crisis* (Stanford, Stanford University Press, 2009); S Block-Lieb and T Halliday, 'Harmonization and Modernization in UNCITRAL's Legislative Guide on Insolvency Law' (2007) 42 *Texas International Law Journal* 481 and also T Halliday, 'Legitimacy, Technology, and Leverage: The Building Blocks of Insolvency Architecture in the Decade Past and the Decade Ahead' (2006) 32 *Brooklyn Journal of International Law* 1081.

34 See UNCITRAL Legislative Guide on Insolvency Law p 10 available at www.uncitral.org/.

35 On different ideas of corporate rescue see V Finch, 'Corporate Rescue: A game of three halves' (2012) 32 *Legal Studies* 302; 'Corporate rescue in a world of debt' [2008] *Journal of Business Law* 756.

36 For US consideration of this see National Bankruptcy Review Commission, *Bankruptcy: The Next Twenty Years* (E Warren, Reporter, 1997) available at http://govinfo.library.unt.edu/nbrc/

provoked a lively debate particularly in the US where the dockets in all bankruptcy/insolvency cases filed are publicly accessible via the Public Access to Court Electronic Records (PACER) system. This facilitates the production of a range of statistical information on Chapter 11 cases by academic and private providers. One of the best known of these is the UCLA-LoPucki Bankruptcy Research Database which provides information on the outcomes in large cases.[37] The available statistics may be interpreted in different ways and this is acknowledged by the team behind the database in a recent study on 'Bankruptcy survival'[38]. The study suggests that about 70% of large, public companies in the US that seek to remain in business through bankruptcy reorganization succeed whereas the assets of the other 30% are absorbed into other businesses.[39]

The study recognises however that it is difficult to define the concept of bankruptcy survival since companies may undergo tumultuous changes during bankruptcy. "They may shrink in size, be split into multiple businesses, sell their businesses to new owners, discharge their managers, change their names, and fundamentally change the nature of their businesses. One or more businesses may survive after a bankruptcy, but it may nevertheless be difficult to say whether that survivor is the bankrupt company, a company that acquired the bankrupt company, or a company that acquired elements of the bankrupt company."[40]

The LoPucki study tries to navigate around these difficulties by regarding the company as the web of relationships among employees and with outsiders and firm assets. If the

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acknowledging at p 611 that reasonable people differ about how to define 'success' in chapter 11 cases: 'Some argue that a Chapter 11 case in which no plan is confirmed should be considered successful where the case produces an orderly sale of assets or a negotiated solution without a formal plan. Creditors may define success in terms of distribution amounts or in terms of preserving future dealings with the debtor. The debtor, on the other hand, may define success in terms of job preservation, enhancement of going-concern value, or future returns to equity. The public may define success in terms of overall fairness.'

[37] See www.lopucki.law.ucla.edu/.

[38]See LM Lopucki and JW Doherty, 'Bankruptcy Survival' (2015) 62 *University of California Law Review* 970.

[39] For a somewhat different analysis of the data see, for example, K Ayotte and D Skeel, 'Bankruptcy or Bailouts' (2010) 35 *Journal of Corporate Law* 469, 477: '[R]oughly two-thirds of all large bankruptcy outcomes involve a sale of the firm, rather than a traditional negotiated reorganization in which debt is converted to equity through the reorganization plan'.

[40] *Ibid* at 979.

structure of those relationships survives and remains distinguishable from the company's owner, then the company is taken as surviving. The General Motors case is given as an example because after the bankruptcy filing, the valuable part of the company's business including its name, its managers and employees, were transferred to a new company formed to purchase them. The old company remained in bankruptcy but did not carry any business and changed its name to Motors Liquidation Company. General Motors is regarded as surviving bankruptcy because the sale of the web of relationships constituting the company is regarded as the sale of the company.

The political context of insolvency and bankruptcy law should be acknowledged and this issue has been hotly contested in the US. It has been argued that business survival is virtually always economically preferable to liquidation with certain commentators pointing to the large economic and social costs that business failure places on employees, suppliers, customers, and communities.[41] The leading bankruptcy law professor and influential US Senator Elizabeth Warren has said: "Business closings affect employees who will lose jobs, taxing authorities that will lose rateable property, suppliers that will lose customers, nearby property owners who will lose beneficial neighbours, and current customers who must go elsewhere."[42]

On the other hand, if employment preservation is seen as an independent policy of bankruptcy law, then it has the potential of undermining the key role of bankruptcy law in facilitating economic growth.[43] In a free-market or entrepreneurial economy, there has to be consequences associated with unsuccessful risk taking and bankruptcy law should not distort incentives and interfere with market mechanisms for monitoring and disciplining.[44]

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[41]See LM Lopucki and JW Doherty, 'Bankruptcy Survival' (2015) 62 *University of California Law Review* 970.

[42] "Bankruptcy Policymaking in an Imperfect World" (1993) 92 *Michigan Law Review* 336 at 355.

[43] DG Baird, 'Bankruptcy's Uncontested Axioms' (1998) 108 *Yale Law Journal* 573 at 580.

[44] See generally Thomas Jackson and David Skeel, 'Bankruptcy and Economic Recovery' in Martin Neil Baily, Richard J Herring and Yuta Seki eds *Financial Restructuring to Sustain Recovery* (Brookings Institution Press, Washington DC, 2013).

These debates have been played out in the context of the restructurings of the huge auto manufacturers, General Motors and Chrysler[45] where the US government provided new finance to facilitate a sale of the enterprises to restructured entities. Critics argue that US government 'may well have saved jobs, but only in the Orwellian universe where it make sense to punish the more efficient because they produce using fewer jobs than the less efficient…. To say that the government "saved jobs" overall both ignores the repercussions felt by other manufacturers … as well as to take credit for the jobs that are saved by propping up the least efficient producer!.'[46]

Nevertheless, and while the US government may have exited its investments in the restructured General Motors and Chrysler entities at a net financial loss, an overall cost benefit assessment has to take into account the enormous social cost and dislocation associated with the closure of these businesses.[47] This mayd have caused an asymmetric shock in a particular region of the US with devastation of the local tax base and a perceived need to provide unemployment relief, training, assistance and relocation packages as well as other transfer payments.

The global financial crisis has brought about asymmetric shocks in the European Union and these have produced political instability and exacerbated difficulties in particular countries. Promoting on a pan-European level the restructuring of potentially viable enterprises appears to be politically desirable given the objectives of the EU to work for the sustainable development of Europe based on balanced economic growth and to promote economic,

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[45] On the Chrysler and General Motors restructurings see the US Congressional Oversight Panel report on the same (September 2009) 'The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry' available at: http://cop.senate.gov/documents/cop-090909-report.pdf This report contains a perceptive analysis of US bankruptcy law and attached papers that are both supportive and critical of the GM/Chrysler de facto rescues.

[46] Thomas Jackson and David Skeel, 'Bankruptcy and Economic Recovery' in Martin Neil Baily, Richard J Herring and Yuta Seki eds *Financial Restructuring to Sustain Recovery* (Brookings Institution Press, Washington DC, 2013) text accompanying footnote 72 and see also for different perspectives on these cases see D Baird, 'Lessons From The Automobile Reorganizations' (2012) 4 *Journal of Legal Analysis* 271; S Lubben, 'No Big Deal: The GM and Chrysler Cases in Context' (2009) 82 *American Bankruptcy Law Journal* 531; M Roe and D Skeel, 'Assessing the Chrysler Bankruptcy' (2010) 108 *Michigan Law Review* 727.

[47] See CAR (Centre for Automotive Research) Research Memorandum by Sean P McAlinden and Debra Maranger Menk, 'The Effect on the U.S. Economy of the Successful Restructuring of General Motors' (2013) available at http://www.cargroup.org/assets/files/the_effect_final.pdf.

social and territorial cohesion, and solidarity among Member States.[48] This remains the case even if estimations about the number of businesses that can be saved as a result prove to be over-optimistic.

2. Chapter 11 as a comparison point

According to a US court, 'the purpose of [Chapter 11] is to provide a debtor with the legal protection necessary to give it the opportunity to reorganize, and thereby to provide creditors with going-concern value rather than the possibility of a more meagre satisfaction of outstanding debts through liquidation.'[49]

Some of the main features of Chapter 11 are as follows

- The management of the company is not displaced in favour of an outside IP and the management itself can prepare a restructuring plan and submit the plan to the creditors.
- A court-appointed trustee may be appointed to monitor the rehabilitation process, but such trustee's powers are not as far-reaching as those under a management-displacement regime.
- A moratorium exists to protect the company from its creditors.
- There is also a mechanism for the approval of a restructuring plan including "cram-down" provisions under which a class of creditors, including secured creditors, can be forced to accept a restructuring plan against their wishes if the court determines that there is at least one class of creditors who have accepted the plan and it is of the view that the restructuring plan is feasible.
- There is provision for debtor-in-possession financing under which the company can obtain new funds either to continue its operations or to further the restructuring

[48] Article 3 Treaty on European Union.
[49] *Canadian Pacific Forest Products Ltd v JD Irving Ltd* (1995) 66 F 3d 1436 at 1442.

process. The providers of these new funds may enjoy "super-priority" ahead of other creditors if existing creditors are deemed by the court to be adequately protected.

All of these elements are found to a greater or lesser extent in the Recommendation and might be thought to form the basis of possible future legislative initiatives by the European Commission in this area.[50] Nevertheless, it is worth sounding a couple of cautionary notes.

Firstly, insolvency law in the US may undergo significant change in the next few years due to expansion in the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current law.[51] The American Bankruptcy Institute, one of the important actors in insolvency law reform in the US, has established a review group which has reported on the reform of Chapter 11.[52]The review group has proposed reforms with a view to achieving a better balance between the effective restructuring of business debtors, the preservation and expansion of employment, and the maximization of asset values for the benefit of all creditors and stakeholders. This suggests that Chapter 11 in its present form may not necessarily be the best model for European restructuring law to work from, at least in all its aspects.

Secondly, any European Commission initiative must be sensitive to the fact that solutions which may work well in one country may not work so well in other countries where the

[50] For a discussion of the main features underlying Chapter 11 see also Appendix B of the AFME study.

[51] For other criticisms of Chapter 11 see e.g. DA Skeel, 'Rethinking the line between Corporate Law and Corporate Bankruptcy' (1994) 72 *Texas Law Review* 471, 535 'Like an antitakeover device, bankruptcy can impair the market's ability to discipline managers because it may substitute reorganization procedures for market mechanisms that would otherwise lead to the ouster of managers outside of bankruptcy.' But this criticism has largely fallen away with new forms of market governance in US bankruptcy cases – see DG Baird and RK Rasmussen, 'The End of Bankruptcy' (2002) 55 *Stanford Law Review* 751; 'Private Debt and the Missing Lever of Corporate Governance' (2006) 154 *University of Pennsylvania Law Review* 1209; B Adler, V Capkun and L Weiss, 'Value Destruction in the New Era of Chapter 11' (2013) 29 *Journal of Law, Economics, and Organization* 461.

[52] www.commission.abi.org/full-report/

balance of interests are very different. [53] While the Recommendation contains a central underlying philosophy of promoting business rescue, it is also committed to the balancing of the interests of the different economic actors within the insolvency process.[54] The concept of balance is fundamentally important. UNCITRAL for instance, has stressed that a desirable legal framework should "(a) Provide certainty in the market to promote economic stability and growth; (b) Maximize value of assets; (c) Strike a balance between liquidation and reorganization; (d) Ensure equitable treatment of similarly situated creditors …"[55]

For reasons of history, culture and experience and because of pressure group politics, the balance may have to be struck in different ways in different countries. This is especially true of priority systems. One leading commentator has made the point that there are no two priority systems that are identical, and that harmonisation or unification of the law in this area is extremely unlikely to happen. [56]

Priority systems are important in a business restructuring context because parties bargain in the shadow of the framework provided by liquidation law.[57] The parties must consider the alternatives if the negotiations fail. Liquidation and debt enforcement law provides these alternatives and liquidation law is ultimately a distributional exercise – 'why gets paid what'. Liquidation law reflects distributional norms and interest group politics rather than being purely an exercise in abstract economic efficiency[58]. Provisions in national insolvency law

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53 Professors Warren and Westbrook highlight the US centric features of Chapter 11 suggesting that 'Based on the idea that a failing business can be reshaped into a successful operation, Chapter 11 was perhaps a predictable creation from a people whose majority religion embraces the idea of life from death and whose central myth is the pioneer making a fresh start on the boundless prairie' - E Warren & JL Westbrook, 'The Success of Chapter 11: A Challenge to the Critics' (2009) 107 *Michigan Law Review* 603 at 604.

54 See Recommendation 13 in this regard.

55 See UNCITRAL Legislative Guide on Insolvency Recommendation 1.

56See generally JM Garrido, 'No Two Snowflakes are the Same: The Distributional Question in International Bankruptcies' (2011) 46 *Texas International Law Journal* 459, 460–461.

57 See generally S Paterson, 'Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards' (2014) 14 *Journal of Corporate Law Studies* 333; 'Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century' *Law Society and Economy Working Paper Series,* WPS 27-2014 December 2014.

58 See generally A Levitin, 'Bankrupt Politics and the Politics of Bankruptcy*' (*2012) 97 *Cornell Law Review* 1399.

giving priority to certain categories of claim express the political bargains that have been reached in that particular country.

Priority systems and restructuring law also overlap when it comes to legislative authorisation for super-priority new finance in a restructuring situation. In the UK during the parliamentary debates on the Enterprise Act 2003, the government resisted an amendment that would have created a statutory framework for super-priority financing.[59] It was wary of creating a situation that effectively guaranteed a return to lenders advancing funds on a super-priority basis irrespective of how commercially viable the rescue proposals were. In its view, it would also be inappropriate to attempt to replicate the chapter 11 provisions in the UK where the business culture and economic environment were quite different.

In the international restructuring domain, the importance of the local in the global context has also been acknowledged recently by the Insolvency Law Review Committee in Singapore.[60] The Committee recognised that Chapter 11 had proved durable and successful in the US, but nevertheless considered that it would be inappropriate to attempt to reproduce it in Singapore where the local economic and social conditions were very different.

3. Main features of the Commission initiative

The evaluation carried out by the Commission on implementation of the Recommendation singles out six features for particular attention.[61] It suggests that these six elements increase the efficiency of restructuring procedures and should each be present in national law. In other words, these conditions should be met cumulatively. The six elements are

a) The possibility to file early with the objective of avoiding insolvency

b) The position of the debtor i.e. debtor-in-possession

[59] See House of Lords parliamentary debates for 29th July 2002 and the discussion in Stephen Davies ed Insolvency and the Enterprise Act 2002 (Bristol, Jordans, 2003) at pp 20-26.
[60] Report of the Insolvency Law Review Committee, Final Report 2013 at pp 106-107 available at https://www.mlaw.gov.sg/content/dam/minlaw/corp/News/Revised%20Report%20of%20the%20Insolvency%20Law%20Review%20Committee.pdf
[61] http://ec.europa.eu/justice/civil/files/evaluation_recommendation_final.pdf at p 2.

c) The possibility of a stay on individual enforcement actions

d) Adoption of the restructuring plans by creditors

e) The protection for new finance granted in restructuring procedures

f) The involvement of courts when third party rights could be affected

Some of these elements are quite controversial and are certainly not present in the law of all the EU Member States. It is a large claim to suggest that all the elements, both individually and cumulatively, will necessarily enhance the efficiency of restructuring procedures.[62] It is proposed now to examine each of these elements in turn with a view to determining the role they might play in the overall context of a restructuring regime

a] <u>The possibility to file early with the objective of avoiding insolvency</u>

The Recommendation[63]suggests that debtors should have access to a framework that allows them to restructure their business with the objective of preventing insolvency and that this restructuring possibility should become available as soon as it is apparent that there is a likelihood of insolvency. The Recommendation itself does not formulate any test for determining insolvency but two tests are generally in international currency i.e. the 'cash-flow' test and the 'balance sheet' test.[64] The 'cash-flow' test of insolvency depends on it being established that the debtor is generally unable to pay its debts as they fall due for payment and the 'balance-sheet' test on it being established that the debtor's liabilities exceeds the value of its assets.[65]

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[62] For a justification of the position adopted in the Recommendation see the accompanying Impact Assessment SWD(2014) 61 at pp 26-48.

[63] See Recommendations 8–13.

[64] See the Insol Europe study done for the European Commission, 'Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practice's TENDER NO. JUST/2012/JCIV/CT/0194/A4 at p 6.

[65] In <u>BNY Corporate Trustee Services Ltd v Eurosail</u> [2013] UKSC 28 the UK Supreme Court took more a global rather than a literal view of balance sheet insolvency holding that the fact that a company's latest audited balance sheet showed a net deficit did not necessarily mean that the

Whether creditors in particular may be able to establish whether the 'cash flow' test is satisfied, debtors clearly are in the best possible to judge the likelihood of insolvency. Therefore, there is a presumption in the Recommendation that debtors should initiate restructuring proceedings though creditor initiation of such proceedings is not necessarily precluded.[66]

Early stage proceedings are clearly beneficial in that they allow value to be preserved in an ailing business when there is still value that might be preserved. The corporate patient might be cured if the intervention takes place sufficiently promptly. Early stage intervention is possible in the US under Chapter 11. As certain commentators note:[67] "[S]olvent firms have filed for Chapter 11 bankruptcy to take advantage of the considerable powers to remake the corporation, undo its commitments, and reduce its obligations…In many cases, the reorganizing firm was not insolvent, and may in fact have been performing rather well."

This includes cases where a company was faced with large potential tort liabilities and attempts to reach a global settlement with plaintiffs have broken down. Well-publicised examples include the Johns-Manville case involving asbestos-related liabilities where the court stated that a business foreseeing insolvency was not required to wait until actual inability to pay debts before entering Chapter 11.[68] Another example concerns the AH

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company was "balance sheet insolvent". Instead, the court had to be satisfied, on the balance of probabilities, that a company had insufficient assets to be able to meet all of its liabilities, including prospective and contingent liabilities, if and when they eventually fall due for payment; and that eventually there would be a deficiency.

[66] Paras 6a and 8 of the Recommendation refer to debtor initiation of the restructuring process and are silent on creditor initiation. For a discussion of incentives to initiate proceedings see H Eidenmüller, 'Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts, and the Incentives for Shareholders/Managers' (2006) 7 EBOR 239.
[67] B Carruthers and T Halliday, *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Oxford, Clarendon Press, 1998) at p 266.

[68] (1984) 36 Bankruptcy Rep 727.

Robins corporate restructuring precipitated by the liability to women plaintiffs who had suffered injury as a result of using the Dalkon Shield birth control device.[69]

Applications for relief under Chapter 11 must however be made in 'good faith' which means that the application must have been filed with the intention of achieving a corporate restructuring or to bring about a liquidation or sale of the company. If this is not the case, then creditors may apply to have the Chapter 11 petitions dismissed. SGL Carbon Corporation[70] is a case in point where a Chapter 11 petition was dismissed on the basis that the company had failed to manifest a genuine 'reorganizational purpose.' A good faith requirement guards against the danger of a restructuring process becoming a charter for the unscrupulous.

The European Commission recommendation suggests that debtors should be able to enter a restructuring process without the need to formally open court proceedings.[71] Chapter 11 in the US appears also to be the model in this regards since the Chapter 11 procedure begins with the mere filing of certain documents with the court. Normally, the debtor voluntarily files a petition with a bankruptcy court and the petition is accompanied by a list of creditors and also a summary of the debtor's assets and liabilities.

In many respects however, the 'early stage' restructuring procedure envisaged by the Commission seems to be modelled on the UK scheme of arrangement.[72] At one in the accompanying impact assessment it is suggested that a procedure modelled along the lines of the UK scheme would make restructuring 'procedures less cumbersome, less costly and

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[69] For an account of this case see Richard B Sobol, *Bending the Law: The Story of the Dalkon Shield Bankruptcy* (Chicago, University of Chicago Press, 1991) and see his comment at p 326: 'Bankruptcy is the appropriate response when a business is unable, or can foresee that it will be unable, to pay the cost of mass tort liability. Novel and difficult questions are presented when the liabilities of a financially distressed business arise primarily out of personal injury claims, but no other mechanism is available and, with due regard for the exceptional context, these questions must be addressed and resolved within the bankruptcy system.'

[70] ((1999) 200 F 3d 154.

[71] Recommendation 8 and according to Recommendation 7 the 'involvement of the court should be limited to where it is necessary and proportionate with a view to safeguarding the rights of creditors and other interested parties affected by the restructuring plan.'

[72] S Madaus, 'The EU recommendation on business rescue - only another statement or a cause for legislative action across Europe?' [2014] Insolvency Intelligence 81 at 84 suggesting that the 'Commission obviously had this tool in mind when they designed the Recommendation'.

speedier than they are currently in some Member States.'[73] The scheme however, is a procedure based on company law rather than insolvency law.[74] It is activated by the filing of documents with the court and an application to the court to convene meetings of relevant creditors and shareholders to approve the scheme though the process is set in train without any court decision as such. The scheme process can be used for various purposes including as a takeover mechanism in relation to wholly solvent companies. In addition, it may be used within a formal liquidation process to achieve a less costly and more efficient realisation and distribution of assets than the liquidation rules would normally allow.

But it may also be used by companies of more or less doubtful solvency to restructure their debts or rearrange their affairs. The majority of large scale corporate restructurings in the UK are accomplished by means of schemes of arrangement it has proved extremely attractive as a restructuring vehicle of choice for companies incorporated outside the UK since the UK courts have jurisdiction to sanction a scheme if the company is deemed to have 'sufficient connection' with the UK irrespective of where it was incorporated.[75] In practice, a loan facility governed by English law will be enough to pass the sufficient connection test.[76]

It should be noted however, that the scheme of arrangement is a procedure that is outside the Insolvency Regulation – Reg 1346/2000 – and its Recast - Reg 2015/848 since it is not listed in Annex A which sets out exhaustively the list of proceedings covered by the Regulation.[77] There seems something anomalous in the Commission relying, at least

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[73] Recommendation Impact Assessment SWD(2014) 61 at p 38. The impact assessment also references UK company voluntary arrangements (CVAs) at pp 15-16 though the reference does not acknowledge that most CVAs take place during the course of the administration procedure.

[74] Schemes are dealt with in Part 26 of the Companies Act 2014 and see generally G O'Dea, J Long and A Smyth, *Schemes of Arrangement Law and Practice* (Oxford: OUP, 2012); J Payne, *Schemes of Arrangement; Theory, Structure and Operation* (Cambridge: CUP, 2014).

[75] See *Re Seat Pagine Gialle SpA [2012] EWHC 3686; Primacom Holdings GmbH v Credit Agricole* [2011] EWHC 3746; *Re Rodenstock GmbH* [2011] EWHC 1104 and see generally LC Ho, 'Making and enforcing international schemes of arrangement' (2011) 26 JIBLR 434; J Payne, 'Cross-Border Schemes of Arrangement and Forum Shopping' (2013) 14 EBOR 563.

[76] *In Re Magyar Telecom BV* [2013] EWHC 3800 (Ch).

[77] In *Ulf Kazimierz Radziejewski* Case C-461/11 OJ 2013 C9/20 **t**he Court of Justice of the European Union held that the **R**egulation applied only to the proceedings listed in the annex. Recital 9 of the preamble to the recast Regulation states that where a procedure is not listed in Annex A it is not covered by the Regulation.

implicitly, on a procedure as the basis for its new approach to business failure and insolvency that is not covered by the recast Insolvency Regulation and therefore not entitled to the benefit of automatic EU-wide recognition under that Regulation.[78]

b] <u>Debtor in possession</u>

The Commission Recommendation suggests that the debtor should keep control over the day-to-day operation of its business.[79] The fact that the management of the debtor will not be displaced in favour of an outside insolvency practitioner (IP) is designed to encourage timely use of the restructuring option. The US Chapter 11 also takes a debtor-in-possession approach to corporate restructuring. It has been said in a US context that 'current management is generally best suited to orchestrate the process of rehabilitation for the benefit of creditors and other interests of the estate…. The debtor-in-possession is a fiduciary of the creditors and, as a result, has an obligation to refrain from acting in a manner which could damage the estate, or hinder a successful reorganization. The strong presumption also finds its basis in the debtor-in-possession's usual familiarity with the business it had already been managing... often making it the best party to conduct operations during the reorganization.'[80]

The recommendation countenances the possible appointment of mediator or supervisor by the court but stresses that this should not be compulsory, but rather done on a case by case basis where this is considered to be appropriate.[81] The role of the mediator is envisaged as being one of assisting the debtor and creditors in negotiations on a restructuring plan while that of a supervisor as overseeing the activities of the debtor and taking the necessary measures to safeguard the legitimate interests of creditors and other interested parties.

It should be noted however, that the mediator or supervisor envisaged by the Recommendation does not have exact parallels in the US Chapter 11. Under Chapter 11 an

[78] Regulation (EU) 2015/848 Articles 20 and 32 which are essentially the same as Articles 17 and 25 of Regulation 1346/2000.
[79] Recommendation 6(b).
[80] *Re Marvel Entertainment Group* (1998) 140 F 3d 463 at 471.
[81] Recommendation 9.

outside bankruptcy trustee can be appointed to take over management of a company for cause though their appointment in Chapter 11 is exceptional. In Re Marvel Entertainment Group,[82] for instance, it was stressed that the appointment of an outside trustee should be the exception rather than the rule.

Alternatively, a US court may appoint an examiner instead of an outside trustee though, again, it seems that such an appointment is not the norm.[83] The examiner carries out the investigations that have been entrusted to it by the court that are appropriate in the particular circumstances of the case and often examiners they are called upon to consider possible causes of action that a company may have. Unlike however the appointment of a trustee, the appointment of an examiner does not displace the existing management who may continue to conduct the day-to-day operations of the company in tandem with whatever functions the court assigns the examiner.[84]

In the UK under the scheme of arrangement procedure, which is considered by some to be a possible model for the Recommendation,[85] there is no IP either to mediate or supervise the debtor. If negotiations break down or the debtor is perceived to be misbehaving in terms of its obligations, then the creditors would be likely to have recourse to formal insolvency procedures. The threat of creditor action in this regard forms a backdrop to the negotiations and may act as a powerful stimulus on the debtor.

French law appears to come close to the Recommendation in terms of debtor-in-possession and exceptions thereto but it should be noted that in France, unlike under the

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[82] (1998) 140 F 3d 463 at 471.

[83] Section 1104(c)(2) at first glance, appears to require the appointment of an examiner where the company's unsecured, non-trade and non-insider debt exceeds $5m i.e. in every medium to large case. See however, the American Bankruptcy Institute (ABI) Chapter 11 Commission report - www.commission.abi.org/full-report/ - at p 33: 'Whether the appointment of an examiner is truly mandatory in any given case has met with resistance by some courts and created a split in the law.'

[84] It should be noted that in the US the ABI Chapter 11 Commission (Final report at p 32) have recommended that the Bankruptcy Code should be amended to delete any reference to an "examiner" and to incorporate the concept of a more flexible "estate neutral" – see www.commission.abi.org/full-report/

[85] S Madaus, 'The EU recommendation on business rescue - only another statement or a cause for legislative action across Europe?' [2014] Insolvency Intelligence 81 at 84 and see also Recommendation Impact Assessment SWD(2014) 61 at p 38.

Recommendation, the appointment of an IP is mandatory. Under the French mandate ad hoc procedure, the court appoints an official who assists the company in trying to resolve its differences and coming to an agreement with creditors but does not interfere with management. In the Sauvegarde procedures, one or more IPs are appointed who supervise the debtor, safeguard the interests of creditors and assist with the negotiations on the restructuring plan.[86]

The choice between debtor-in-possession and management displacement is not an 'all-or-nothing' one. There are in fact a plurality of possible approaches on this issue[87] but there may be certain risks however associated with what might be termed 'co-determination models' like the French Sauvegarde procedure. The division of authority caused by the dual decision-making structure may create an arena for clashes of opposing interests. As one commentator remarks: 'The flow of information between the various decision-makers is susceptible to errors, miscommunication and hence distortion. Secondly, between management and the trustee, the former enjoys superior access to information concerning the debtor. Because the two decision-makers represent different interest groups, management has an incentive to withhold information from the other representative (the trustee), undermine the latter's effective decision-making and thus tip the scale of power and risk taking in favor of its own constituency, the equity holders.'[88]

In consequence, the approach adopted in the Recommendation is sensible in making discretionary, rather than mandatory, the appointment of a mediator or supervisor.

[86] For a general discussion of French rescue procedures and US/ UK parallels see A Kastrinou, 'Comparative Analysis of the Informal Pre-Insolvency Procedures of the UK and France' (2016) 25 International Insolvency Review; P Omar, 'A Reform in Search of a Purpose: French Insolvency Law Changes (Again!)' (2014) 23 International Insolvency Review 201; RF Weber, 'Can the Sauvegarde reform save French bankruptcy law?: A comparative look at chapter 11 and French bankruptcy law from an agency cost perspective' (2005) 27 Michigan Journal of International Law 257.

[87] These approaches are discussed in the Insol Europe study done for the European Commission, 'Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States' relevant provisions and practice's TENDER NO. JUST/2012/JCIV/CT/0194/A4 at pp 24-26.

[88] D Hahn, 'Concentrated Ownership and Control of Corporate Reorganizations' (2004) 4 *Journal of Corporate Law Studies* 117 at 52 and see generally S Franken, 'Creditor - and Debtor-Oriented Corporate Bankruptcy Regimes Revisited' (2004) 5 EBOR 645.

c] Stays on enforcement actions

The Recommendation suggests that debtors should have the right to request a court to grant a temporary stay of individual enforcement actions instituted by creditors, including secured and preferential creditors.[89] The stay is intended to give the debtor a breathing space in order to negotiate a restructuring plan - to allow recovery procedures by creditors to operate without restraint could frustrate the goal of restructuring and rescue. Going-concern value may be a lot more than breakup value and restructuring proceedings are designed to keep a business alive so that this additional value can be captured. This goal will be compromised, however, if creditors are able to seize assets that are essential to the carrying on of the company's business. Therefore, we have a stay or moratorium on actions by creditors to collect debts or repossess property in the ailing debtor's possession but there are counter-balancing measures in place to protect those who may be affected by the stay.

The stay is also an intrinsic feature of the US Chapter 11 and has been described[90] as one of the 'fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganisation plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.'

The US stay is automatic and imposes a freeze on proceedings or executions against the debtor and its assets and has worldwide effect.[91] The US courts have inferred extraterritorial effect from the language of the Bankruptcy Code provisions[92] and they have also held that the bankruptcy estate comprises property of the debtor wherever situated throughout the

[89] Recommendations 6(c) and 10-14.

[90] HR Rep No 595, 95th Cong, 1st Session 340 (1977).The statement continued: 'The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that.'

[91] For a recent example see *In re Nortel Networks Inc* (2011) 669 F3d 128.

[92] See *Nakash v Zur (In re Nakash)* (1996) 190 BR 763 where the automatic stay was enforced against a foreign receiver in respect of the foreign assets of a foreign debtor.

world.[93] The long arm of the US bankruptcy jurisdiction is illustrated by a recent series of Chapter 11 cases involving foreign shipping companies.[94] These debtors have recognized the benefits and advantages served by Chapter 11 proceedings including the debtor in possession norm and the reach of the automatic stay but, in some cases, the US connections of the debtors have been rather tenuous.[95]

The stay contemplated by the Recommendation is much more modest however. It is discretionary rather than automatic and it is suggested that debtors should generally be granted a stay where '(a) creditors representing a significant amount of the claims likely to be affected by the restructuring plan support the negotiations on the adoption of a restructuring plan; and (b) a restructuring plan has a reasonable prospect of being implemented and preventing the insolvency of the debtor.'[96]

The Recommendation also suggests that the stay, in terms of duration, should strike a fair balance between the interests of debtor and creditors, including in particular secured creditors. It goes on to say that the length of the stay should depend on the complexity of the case, and the anticipated restructuring. In the first instance, it should not exceed 4 months but, depending on progress in the negotiations, it might be extended though the total duration should not exceed 12 months.[97] Linked with duration is the question of lifting the stay and the Recommendation provides that where the stay is no longer necessary for facilitating the adoption of a restructuring plan, it should be lifted. [98]

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[93] See *Hong Kong & Shanghai Banking Corp v Simon (In re Simon)* (1998) 153 F3d 991 at 996: 'Congress intended extraterritorial application of the Bankruptcy Code as it applies to property of the estate.'

[94] For an early example see *In re Global Ocean Carriers Ltd* (2000) 251 BR 31 which concerned a shipping company headquartered in Greece and where it was held that the unearned portions of retainers provided to US counsel constituted property that was sufficient to form the basis for a US bankruptcy filing.

95 See generally I Drake, 'Use of US Chapter 11 Filings by Non-US Corporations; Realistic Option or Non-Starter' [2011] *International Corporate Rescue* 206.

[96] Recommendation 11.

[97] Recommendation 13.

[98] It should be noted that UK schemes of arrangement do not benefit from a statutory stay though recently the court has fashioned a limited stay from the Civil Procedure Rules - *BlueCrest Mercantile BV v Vietnam Shipbuilding Industry Group* [2013] EWHC 1146.

Long drawn out restructuring proceedings and in particular those involving restrictions or a stay on the enforcement of collateral have the effect of transferring wealth to managers and shareholders at the expense of creditors. Creditors are kept out of their money while managers may keep their jobs. Shareholders may also benefit from the restructuring efforts in that if the company is kept afloat, the value of their shareholdings can be preserved.

|In the US Chapter 11, a secured creditor, along with anybody else affected by the statutory stay, can apply to have it lifted and there is a specific requirement of 'adequate protection' for the holders of property rights who are adversely affected by the stay.[99] Examples of 'adequate protection' are provided by the statute although the concept itself is not defined.[100] It should however that it is only the value of the collateral that is entitled to adequate protection.[101] An under-secured creditor may find itself footing the bill for an unsuccessful restructuring attempt. It is prevented from enforcing the collateral by the automatic stay yet it is not entitled to interest during what may be a long drawn out Chapter 11 process. An over-secured creditor however, is entitled to be paid interest out of the security 'cushion' at the plan confirmation stage as a condition of the court approving the plan.

The Recommendation stresses the importance of safeguarding creditor rights during the period of any stay, and, in particular, the rights of secured creditors, but it is light on detail.[102] It would enhance certainty if further details were added if and when the Recommendation is transformed into a legislative instrument and Chapter 11 contains a precedent in this regard. A possible approach would be to provide while the stay lasts, a secured creditor is entitled to protection of the value of the asset in which it has a security interest with appropriate

[99] Section 361 US Bankruptcy Code.

[100]The examples given are cash payments, additional or replacement security interests on other property and, unusually expressed, something that will give the creditor the 'indubitable equivalent' of its security interest.

[101] See *Re Alyucan* (1981) 12 BR 803 where the court rejected the view that the preservation of a certain collateral-to-debt ratio was part of the creditor's property interest that warranted protection. See also *United Savings Association of Texas v Timbers of Inwood Forest Associates Ltd* (1988) 484 US 365 where the Supreme Court held that the adequate protection provision did not entitle an under-secured creditor to compensation for the delay caused by the stay in enforcing the security.

[102] Recommendation 13.

measures of protection including cash payments by the debtor's estate, provision of additional security interests, or such other means as the court determines.[103]

d] Restructuring plans

The Recommendation contains certain provisions on the contents of restructuring plans. It is provided that creditors with different interests should be dealt with in separate classes which reflect those interests and as a minimum, there should be separate classes for secured and unsecured creditors.[104] The recommendation does not prescribe detailed rules on the majorities required before a majority of creditors in a particular class is deemed to have accepted a plan and whether all classes of affected or impaired creditors are required to give their consent. It does however lay down that creditors should enjoy a level playing field irrespective of where they are located and that it should be possible to adopt restructuring plans even though non-affected creditors have not been consulted or given their consent.[105]

Creditor classification and division is very important in a corporate restructuring context. It may facilitate negotiations over the division of the 'going concern surplus' since different creditors may have different views on the value of the restructured enterprise and the risks that may be presented by extending the maturity of debts. There are several practical justifications for classifying creditors differently. For example, creditors with alternative forms of payment such as third party guarantees have different incentives vis-à-vis the debtor and creditors who view the ailing company as a valuable vendor or customer have more of an interest in its survival than do the company's once off tort victims.[106] On the other hand, certain creditors may have extraneous interests that run contrary the goal of corporate

[103] See Recommendation 50 of the UNCITRAL Legislative Guide on Insolvency.
[104] Recommendation 17 Commission Recommendation.
[105] Ibid, Recommendation 19.
[106] See the comment made by the US Bankruptcy Court in *Re Greystone 111 Joint Venture* (1991) 995 F 2d 1274: '[I]f the expectation of trade creditors is frustrated … [they] have little recourse but to refrain from doing business with the enterprise. The resulting negative reputation quickly spreads in the trade community, making it difficult to obtain services in the future on any but the most onerous terms.'

rescue. These creditors, for example, may be debt traders or hedge funds who have bought all or part of the company's debt at a steep discount. They may have a 'loan-to-own' strategy. Alternatively, they may wish to preserve a reputation for toughness and this reputation is seen as more important than their private stake in the particular case. The individual interests of these creditors is at odds with the goal of restructuring the particular debtor.

In many cases, it makes clear commercial sense to group creditors into separate categories and deal with them somewhat differently[107]. For instance, tort creditors could be paid out of a newly established fund while trade creditors are paid off directly in cash but unsecured debt held by financial institutions is paid over a longer period or is exchanged for an equity stake in the business. The ability to put creditors into separate classes is a powerful one and while it may facilitate negotiations on a restructuring plan, it may also in some cases hinder the goal of debtor rehabilitation and rescue. A multiplicity of creditor classes may make it more difficult to achieve creditor consensus especially if the legislative framework in place in a particular country requires that all creditor groups should approve a restructuring plan before it becomes binding. This is the case with the UK scheme of arrangement but it may be that the scheme can be structured in such a way that classes of creditors without an economic interest in the proposed restructuring are not required to give their consent.[108]

UK judicial decisions have smoothed over some of the potential pitfalls in class composition through distinguishing between rights and interests. This distinction can be traced at least as far back as the judgment of Bowen LJ in <u>Sovereign Life Assurance Co v Dodd</u>[109] and operates to prevent small groups being given veto powers over the decision-making process.[110] He said: 'it seems plain that we must give such a meaning to the term "class" as will prevent the …[provisions] being so worked so to result in confiscation and injustice, and

[107] See generally Bruce A Markell, 'Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification' (1994) 11 *Bankruptcy Developments Journal* 1.
[108] *Re Tea Corpf Ltd* [1904] 1 Ch 12 and *Re My Travel Group plc* [2004] EWHC 2741 (Ch).
[109] [1892] 1 QB 573.
[110] [1892] 2 QB 573 at 583.

that it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.'

The test is based on the similarity or dissimilarity of legal rights against the company and not on the similarity or dissimilarity of the interests that may be derived from such legal rights. The fact that creditors may hold divergent views that were based on private interests not derived from their legal rights against the company, was not a ground for saying that there were separate class of creditors.[111]

In the US, Chapter 11 contains reasonably detailed rules on approval of restructuring plans including issues of class composition and creditor consent. A plan should distinguish between what the Bankruptcy Code refers to as 'claims' i.e. indebtedness and 'interests' – equity shares. The notion of 'impairment' is also fundamental because only the holders of 'impaired' claims or interests are entitled to vote on the restructuring plan. Section 1124 provides that a claim or interest is impaired unless the plan leaves unaltered the rights outside bankruptcy that are associated with that claim or interest. Each class of claims or interests should be designated as either impaired or not impaired and in accordance with s 1126(f), the holders of claims or interests that are not impaired are deemed to have voted to accept the plan since their rights against the debtor outside bankruptcy are preserved and protected in full.

The lack of detail in the Recommendation on matters such as class composition, voting majorities and detailed requirements for getting a restructuring plan approved are explored further in section 4 of this paper. This lack of detail suggests continued scope for the operation of divergent national rules.

[111] See Chadwick LJ in Re Hawk Insurance Co Ltd [2001] 2 BCLC 480 at para 33. He also said that the relevant tests should not be applied in such a way that they become an instrument of oppression by a minority and referred to the observations of Lush J in the Australian case Nordic Bank plc v International Harvester Australia Ltd [1982] 2 VR 298: 'To break creditors up into classes, however, will give each class an opportunity to veto the scheme, a process which undermines the basic approach of decision by a large majority, and one which should only be permitted if there are dissimilar interests related to the company and its scheme to be protected. The fact that two views may be expressed at a meeting because one group may for extraneous reasons prefer one course, while another group prefers another is not a reason for calling two separate meetings.'

e] <u>Encouraging new finance</u>

There are certain provisions in the new approach to business failure and insolvency to encourage new financing in respect of ailing businesses. It is provided in Recommendations 27 and 28 that new financing which forms part of a restructuring plan that is confirmed by a court should be exempted from civil and criminal liability and not rendered invalid as an act detrimental to the general body of creditors.

Most insolvency laws contain transactional avoidance provisions that strike at advantage gaining by creditors in the period immediately prior to the commencement of formal insolvency proceedings though the length of this 'suspect' or 'vulnerability' period may vary greatly depending on the type of avoidance action; the nature of the transaction and whether it is in favour of a person connected with the debtor.[112] Transactions in favour of 'connected' parties generally attract longer vulnerability periods. In principle, these transactional avoidance mechanisms are capable of being used to attack the provision of new finance that forms part of a 'pre-insolvency' restructuring process. In the vast majority of cases however, even if there are no formal legal provisions, new finance is likely in practice to be safe from attack under transactional avoidance or claw-back provisions. The conditions for avoidance will not have been made out because the provisions generally catch what might be termed incongruent transactions where the creditor is receiving disproportionate benefits such as security for an existing unsecured debt or repayment of an existing loan facility. In a new finance situation there is no disproportionate benefit but rather a reciprocal flow of benefits and obligations from creditor to debtor and vice versa. The creditor is providing new finance and in return gets the benefit of the debtor's promise to repay and possibly security or a guarantee from a third party reinforcing the debtor's commitment to repay the advance.

[112] See generally R Bork, 'Transactions at an Undervalue—A Comparison of English and German Law' (2014) 14 *Journal of Corporate Law Studies* 453 and for a UK/US comparison see G McCormack, 'Swelling Corporate Assets: Changing What Is on the Menu' (2006) 6 *Journal of Corporate Law Studies* 39.

The general philosophy of the Recommendation is to facilitate new money financing with a view to promoting corporate restructuring and rescue. This is acknowledged in paras 15 and 23 and the Commission evaluation of the implementation of the Recommendation suggests that encouraging new financing is necessary to ensure the success of a restructuring plan. [113] The Recommendation however, only offers the negative protection already alluded to in the form of protection from civil or criminal liability and in the event of avoidance proceedings. The comparable provisions in Chapter 11 are much stronger and more detailed.

In the US, new financing is dealt with in s 364 of the Bankruptcy Code, which lays down that credit extended during the restructuring process has priority over existing unsecured claims.[114] If the extension of credit is in the ordinary course of business, then priority is automatic, whereas if the extension of credit is outside the ordinary course, then the priority must be authorised by the court prior to the granting of credit. Unless the lender agrees to the contrary, a company can get a restructuring plan confirmed only by ensuring that the new lender is paid in full at the confirmation stage and even if the plan fails, 'new' debts have priority over existing unsecured debts in the ensuring liquidation. There may be a lot of cases where a company's assets are secured to such an extent that mere priority over existing unsecured creditors offers new lenders little chance of recovery in any subsequent liquidation. In these circumstances, meaningful priority means priority over existing secured creditors and s 364(d) provides that the court may authorise this in narrowly defined circumstances. The existing secured creditor is safeguarded by the fact that the company must prove that it cannot obtain the loan without granting such a security interest and that the secured creditor is adequately protected against loss. The case law suggests that the

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[113] See the European Commission evaluation of the implementation of the Recommendation - http://ec.europa.eu/justice/civil/files/evaluation_recommendation_final.pdf at p 4.

[114] A lender may be able to exert substantial control over the Chapter 11 process by means of provisions in new finance agreements and commentators have spoken of a new 'Chapter 11' with a greater emphasis on sales of the debtor's business as a going concern rather than on reorganisations in the traditional sense – see K Ayotte and E Morrison, 'Creditor Control and Conflict in Chapter 11' (2009) 1 *Journal of Legal Analysis* 511 who find 'pervasive creditor control'.

statutory requirements are strictly applied and that the 'priming' of prior secured lending is permitted only in infrequent and exceptional instances.[115]

Super-priority new financing is often seen as necessary to resolve 'debt overhang', i.e. existing assets being fully secured, and to cure 'underinvestment' problems, i.e. lack of incentives to finance value-generating projects.[116]Accordingly there have been some calls, most notably in the AFME study[117] on potential economic gains from reforming insolvency law in Europe, for essentially transplanting the US regime to Europe. There is a danger however, in assuming that if certain legal reforms are enacted, then certain consequences will more or less automatically follow. It may be that if reforms are enacted that are not rooted in the soil of a particular legal country, culture or tradition then these reforms may wither on the vine and not come to fruition in practice. The AFME Study also makes the point that a specialised market has evolved in the US for this sort of super-priority rescue funding but such funding is yet to develop in Europe.[118]In the US, it seems that bank lenders are likely to seek to provide this form of finance with the temptation of substantial upfront fees, higher margins and a strong package of covenants. There also appears to be 'increased activity from bespoke lenders such as hedge funds, private equity funds, institutional lenders and CLO funds, drawn by the higher yields available or possible loan to own strategies.'[119]

It may be preferable to have a new funding market for distressed business develop organically in Europe though developments in real world finance and business practice rather than trying to kickstart the process through top down legislative interventions. In the

[115] For consideration of some of the upsides and downsides of new finance during a restructuring period see DA Skeel, 'The Past, Present and Future of Debtor-in-Possession Financing' (2004) 25 *Cardozo Law Review* 1905.

[116] See generally G McCormack, 'Super-priority New Financing and Corporate Rescue' [2007] *Journal of Business Law* 701; G Triantis, 'A Theory of the Regulation of Debtor-in-Possession Financing' (1993) 46 *Vanderbilt Law Review* 901; S Dahiya, K John, M Puri and G Ramirez, 'Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence' (2003) 69 *Journal of Financial Economics* 259.

[117] *Potential economic gains from reforming insolvency law in Europe* (February, 2016) at p 17.

[118] AFME Study at p 17.

[119] Ibid.

UK, for instance, successive governments have resisted proposals for creating a legislative framework that would facilitate super-priority new finance.[120] References were made to differences in business culture and economic environment. It was hesitant about creating a situation that essentially guaranteed a return to lenders advancing funds on the basis of super-priority irrespective of the commercial viability of the rescue proposals. In its view, the issue of whether to lend to a distressed business was a commercial one that was best left to the commercial judgment of the lending market. It was up to potential lenders to take into account the viability of the rescue proposals and the availability of free assets to serve as collateral.

Reform proposals were considered in the context of the Enterprise Act 2003 and again in a 2009 consultation[121] but in light of the responses received from stakeholders, these proposals were not taken forward. A recent Insolvency Service consultation reviewing the Corporate Insolvency Framework suggests that changes in market conditions mean it is now once again appropriate to consider a US style new financing regime. [122]

E] Role of the court

[120] See the parliamentary debates on the Enterprise Bill; in particular House of Lords debates for 29th July 2002 and the discussion in Stephen Davies ed Insolvency and the Enterprise Act 2002 (Bristol, Jordans, 2003) at pp 20-26 where there is this comment at p 20: “Anecdotally, it has been said that, during the preparation of the proposals and the Bill, more time was spent by the Insolvency Service and those whom they consulted considering the vexed question of how administrations would be funded than any other single topic. The assumption is that the topic proved too difficult because neither the White Paper nor the Bill made any provision for funding administrations.”

[121] Encouraging Company Rescue – a consultation’ (2009)

[122] See the Insolvency Service consultation, *A Review of the Corporate Insolvency Framework: A consultation on options for reform* (May 2016).

Recommendation 22 provides: 'The conditions under which a restructuring plan can be confirmed by a court should be clearly specified in the laws of the Member States and should include at least the following: (a) the restructuring plan has been adopted in conditions which ensure the protection of the legitimate interests of creditors; (b) the restructuring plan has been notified to all creditors likely to be affected by it; (c) the restructuring plan does not reduce the rights of dissenting creditors below what they would reasonably be expected to receive in the absence of the restructuring, if the debtor's business was liquidated or sold as a going concern, as the case may be; (d) any new financing foreseen in the restructuring plan is necessary to implement the plan and does not unfairly prejudice the interests of dissenting creditors.'

Cleary the legislative framework in a particular country might adopt a variety of possible approaches in determining whether a restructuring plan should be approved. This is a complex issue but creditors may, in particular be concerned with whether the valuation mechanisms in a particular insolvency regime and the delays associated with the procedure means that in practice a creditor is disadvantaged.

Rec 22(c) suggests however the principle that no creditors are left worst off should be a formal requirement of national restructuring law. This basically reflects the position in the US Chapter 11 which contains a 'liquidation' or 'best interests' test requiring that a creditor should receive at least as much under a restructuring plan as it would in liquidation.[123]

Another possible approach would not have the 'no creditor worst off' principle as a formal requirement of the restructuring law. Instead, if the necessary majorities are obtained then the court would approve a restructuring plan is approved and it does not have formally to consider alternative values of the debtor's assets such as liquidation value. The legislative assumption may be that if the restructuring value is likely to be less than the value obtained on a liquidation, then creditors would not support a restructuring.

[123] Section 1129)(7)(A)(ii).

The UK, for example, takes what might be described as a 'creditor democracy' approach. Schemes of arrangement do have to be approved by the court but, in deciding whether or not to give approval, the court will accord considerable latitude to the scheme proponents. The court must be satisfied that it is a fair scheme - one that 'an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve.'[124] On the other hand, the scheme proposed need not be the only fair scheme or even, in the court's view, the best scheme. There is room for reasonable differences of view on these issues and in commercial matters creditors are considered to be much better judges of their own interests than the courts. The court in Re British Aviation Insurance Co Ltd[125] pointed out that the test is not whether the opposing creditors have reasonable objections to the scheme. A creditor may be equally reasonable in voting for or against the scheme and in these circumstances creditor democracy should prevail. Nevertheless, formally incorporating as backstop the principle that creditors should receive at least as much value in a restructuring as they would in a liquidation may be desirable. While not constituting too great a departure from present practice, it may provide some measure of further reassurance to debt investors and help to structure more the exercise of the court's discretion in approving a scheme.[126]

According to Recommendation 23, Member States should ensure that courts can reject restructuring plans which clearly do not have any prospect of preventing the insolvency of the debtor and ensuring the viability of the business, for example because new financing

[124] See *Anglo-Continental Supply Co Ltd* [1922] 2 Ch 723 at 736.
[125] [2005] EWHC 1621 at para 75.

[126] In the UK, CVAs do not come to the court for approval but the CVA may be challenged on grounds of material irregularity or unfair prejudice and for application of the 'unfair prejudice' test *see IRC v Wimbledon Football Club Ltd* [2004] EWCA Civ 655 where the Court of Appeal said (para 18) '(1) to constitute a good ground of challenge the unfair prejudice .. must be caused by the terms of the arrangement itself; (2) the existence of unequal or differential treatment of creditors of the same class will not of itself constitute unfairness, but may give cause to inquire and require an explanation; (3) in determining whether or not there is unfairness, it is necessary to consider all the circumstances including, as alternatives to the arrangement proposed, not only liquidation but the possibility of a different fairer scheme; (4) depending on the circumstances, differential treatment may be necessary to ensure fairness ... (5) differential treatment may be necessary to secure the continuation of the company's business which underlines the arrangement ..'

needed to continue its activity is not foreseen. This approach is also reflected in the US where 'feasibility' review is a strongly entrenched part of Chapter 11. Section 1129(a)(11) says that for a plan to be confirmed it must be feasible. This involves the court in finding that plan confirmation is not likely to be followed by liquidation or the need for further financial restructuring of the company or any successor to the company under the plan, unless the plan itself proposes liquidation. In trying to establish whether the feasibility standard has been achieved, the courts may look at a number of matters of factors affecting a company including (1) adequacy of the capital structure (2) earning power (3) general economic conditions and the identity and abilities of the firm's management.[127]

The feasibility standard may help to ensure that companies come out of the restructuring process with adequate capital structures. Conducting a financial viability review however, seems more a matter for investment bankers than for judges. One leading US bankruptcy judge has commented:[128]

'A judge is bound by the record that is presented. If you have good lawyers, they will present a record that establishes feasibility. If the judge reviews the disclosure statement and things leap out, I think the judge will ask questions. But if you have good lawyers and they're doing their job right, the likelihood of things jumping out is pretty slim. Lawyers may disclose assumption, but in the absence of discovery or something being flagrant on its face, it's hard for a judge to know what's wild assumption and what's not.'

In general, it does not seem the most appropriate approach for courts to be required to consider the overall economic feasibility of restructuring plans nor the commercial basis of decision by creditors. Financial viability might be considered indirectly however, perhaps as

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[127] See *Consolidated Rock Products Co v Du Bois* (1941) 312 US 510 at 525: 'Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a sine qua non to a determination of the integrity and practicality of the new capital structure.'

[128] See Lynn M LoPucki, *Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts* (Ann Arbor, University of Michigan Press, 2005) at p 105.

part of an overall fairness criterion; in deciding whether a restructuring plan is likely to be carried out or in determining whether the debtor is reasonably likely to fulfil the promises contained in the plan.[129]

4. The form any legislative action by the Commission might take?

In 'firming up' the Commission Recommendation and turning it into legislation there are two broad approaches that might be taken based alternatively on 'minimum' or 'maximum' harmonisation. It is suggested that a minimum harmonisation model is the more appropriate. The jurisprudence of the European court suggests that a mere disparity in national legislation is insufficient to justify European Commission action.[130] Any legislative action should be sensitive to local legal institutions and the history and traditions of Member States by avoiding simplistic solutions and a 'one size fits all' mentality. Different restructuring solutions have worked in different countries and it makes sense to build on these successes by establishing minimum rules rather than opting for a uniformity of approach. Paying respect to the principle of subsidiarity means that there should still be room for national autonomy and divergence on matters such as the majorities required to get a restructuring plan approved.[131] Jurisdictional diversity creates opportunities for competition between national legal orders while jurisdictional uniformity eliminates these opportunities; there is no scope for innovation at the local level and less chance for initially unpromising, but ultimately beneficial ideas, to win through and gain general international acceptance. [132]This would include innovative ideas on how to facilitate new finance for ailing companies undergoing a restructuring process. While history is not destiny and concrete measures to achieve real

[129] See also UNCITRAL Legislative Guide on Insolvency at pp 228-229.

[130] See the 'Tobacco Advertising' case – Case C-380/03 *Germany v European Parliament and Council*, judgment of 12 December 2006 2006 I-11573.

[131] Article 5(3) of the Treaty on European Union provides that 'under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States…'

[132] See S Deakin, 'Two types of regulatory competition: Competitive federalism versus reflexive harmonisation. A law and economics perspective on Centros' (1999) 2 *Cambridge Yearbook of European Legal Studies* 231-260; 'Legal Diversity and Regulatory Competition: Which Model for Europe?' (2006) 12 *European Law Journal* 440.

legal and regulatory improvements are possible, complete European uniformity can be stifling and lead to economic sterility.[133]The impact assessment that accompanies the Commission Recommendation also notes that given the level of intrusiveness on the national legislative domain, a fully harmonised procedure would be unlikely to meet with the approval of Member States.[134]

Allowing individual States the opportunity to experiment with different designs on corporate restructuring instead of seeking out European uniformity means that many experiments may proceed at once.[135] Of course, not all innovations will turn out to be successful and the costs of wasted expenditure or unanticipated harm through inefficient features of the law are reduced if the unsuccessful experiment is confined to a single country or at least not reproduced across the whole of Europe.[136]

The merits of regulatory competition have been considered in many fields, not least for providing the possibility of a more dynamic and innovative law-making process[137]. But there is also the risk of 'social dumping'[138] and a so-called race to the bottom; in this context through wealth transfers to favoured insiders and certain creditors at the expense of other creditors.[139] In short, there is a question about whether harmonisation or regulatory

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133 See generally A Ogus, 'Competition Between National Legal Systems: A Contribution of Economic Analysis to Comparative Law' (1999) 48 ICLQ 405.
134 SWD(2014) 61 at p 41.
135 But for a suggestion that the 'regulatory environment in Europe is not geared towards regulatory competition in the field of restructuring laws" see H Eidenmuller and K Van Zweiten *op cit* at p 23.
136 See C Tiebout, 'A Pure Theory of Local Expenditures' (1956) 64 *Journal of Political Economy* 416 suggesting that a decentralised system of government, with horizontally arrayed municipalities competing to attract residents on the basis of differing tax and benefit structures, generates increased social welfare while not leaving anybody worse off as a result. Tiebout concedes however (at 424) his solution may not be perfect because of 'institutional rigidities' but he argues that it is 'the best that can be obtained given preferences and resource endowments.'
137 D Esty and D Geradin eds, *Regulatory Competition and Economic Integration: Comparative Perspectives* (Oxford, Oxford University Press, 2001), and see generally F von Hayek, 'Competition as a Discovery Procedure' (2002) 5 *Quarterly Journal of Austrian Economics* 9.

138 In the context of employment law the European Court made specific reference to social dumping in Case 341/05 *Laval* [2007] ECR I-5751 at para 103. See also Case C-438/05 *International Transport Workers' Federation, Finnish Seamen's Union v Viking Line ABP* [2008] 1 CMLR 51.

139 See generally A Johnston, 'EC Freedom of Establishment, Employee Participation in Corporate Governance and the Limits of Regulatory Competition' (2006) 6 *Journal of Corporate Law Studies* 71. See also C Barnard, 'Social Dumping and Race to the Bottom: Some Lessons for the EU from

competition produces better rules from an economic efficiency point of view. The debate has covered various branches of law, including company incorporations since a company may incorporate in one EU Member State but then carry on business in another. Advocates of regulatory competition suggest that competition between countries will lead to a race to the top and engender rule efficiency, because experience will teach them that in the long run they benefit from a high-quality and stable legal system.[140]

But critics of regulatory competition refer to 'negative externalities' – the adverse impact of rules adopted in a particular country on other countries. Consequently, there is a strong argument in favour of minimum standards to prevent a race to the bottom between different countries. This is what a Commission directive on a new approach to business failure and insolvency may do – establish minimum standards.

The current Recommendation sets out minimum standards but is silent or does not go into a huge amount of detail on certain matters. Consequently, if the Recommendation is translated into legislation in something resembling its current form, there will still be some scope for regulatory competition among EU Member States. Three particular issues could be singled out in this regard. Firstly, the Recommendation does not go into details about the majorities required before a particular class of creditors or other stakeholders is deemed to have accepted a restructuring plan. This is an area where there are large potential differences; for instance, whether one should distinguish between creditors who are connected to the debtor and creditors not so connected. Part of the complexity and variation is accounted for by the fact that is some cases majorities may be determined by reference only to those creditors actually voting and in others to the total number of creditors, whether voting or not. There are three possible approaches. One is to say that creditors not voting are deemed to have voted in favour of the plan. Another approach is to say that those not

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Delaware?' (2000) 25 *European Law Review* 57; L Enriques and M Gelter, 'Regulatory Competition in European Company Law and Creditor Protection' (2006) 7 EBOR 417.

[140] See generally J Armour, 'Who Should Make Corporate Law? EC Legislation versus Regulatory Competition' (2005) 58 *Current Legal Problems* 369; H Eidenmüller, 'Free Choice in International Company Insolvency Law in Europe' (2005) 6 EBOR 423.

voting are deemed to have voted against the plan where the third approach, a via media, in effect disregards the votes of those not voting.

A second issue that is not addressed in detail but nevertheless is of vital importance is that of creditor 'cramdown' i.e. the extent to which a restructuring plan can be made binding on dissenting creditors. The term 'cramdown' can be understood in two senses. In one sense, it simply means that if the necessary majority within a class approve a plan then the plan becomes binding on the other class members. But it can also be used in the sense of cramming down a dissenting class in its entirety, i.e., forcing a majority of the class to accept a scheme against their wishes. Cross class creditor cramdown is a notable feature of Chapter 11 of the US Bankruptcy Code. A class of creditors, including secured creditors in exceptional circumstances can be crammed down in the US i.e. forced to accept a restructuring plan against its wishes provided that at least one other class of impaired creditors has accepted the plan.

Before an objecting class of creditors can be crammed down however, an onerous list of requirements must be met. To cram down a secured class, the requirements of sections 1129(b)(1) and 1129(b)(2)(A) must be satisfied. Under (b)(1), the plan must not discriminate unfairly and must be fair and equitable. This requires that creditors who are similarly situated should be treated in a comparable fashion. A fortiori, it would for example be unfair discrimination for a junior creditor to receive a higher interest rate than that imposed on a senior creditor on the same property. The fair and equitable standard means that an unreasonable risk of the plan's failure should not be imposed on the secured creditor. It also includes the section 1129(b)(2)(A) requirement such that a secured creditor must receive one of three alternatives:

(a) retention of its secured interest plus sufficient deferred payments to equal the present value of the collateral;

(b) sale of the collateral with the creditor's security interest attaching to the proceeds of sale

(c) the creditor's receipt of the "indubitable equivalent" of its security interest.

Thirdly, while the Recommendation provides that creditors with different interests should be treated in separate classes which reflect those interests it is silent on the so-called 'absolute priority' rule requiring that insolvency priorities should be respected. This rule requires that creditors should be paid in the same order as they would in liquidation with respect for the rank of creditors. This means that creditors should be paid out before shareholders and senior creditors before junior creditors etc. The 'absolute priority' principle is also a fundamental part of the US Chapter 11 [141] requiring payment of senior creditors before junior creditors and the latter before shareholders. Unless creditors are to be paid in full, or unless each class of creditors consents, the company's old shareholders are not entitled to receive or retain any property through the restructuring process on account of their old shares. Section 1129(b)(2)(B)(ii) provides that the 'holder of any claim or interest that is junior to the claims of …[an impaired] class will not receive or retain under the plan on account of such junior claim or interest any property'.

The principle was originally applied to prevent senior creditors and shareholders from colluding to squeeze out junior creditors and, more recently, Law and Economics scholars have argued that deviations from the priority rules that apply outside insolvency are too costly and will result in increases in the cost of borrowing - lenders adjust their rates to reflect the fact that shareholders retain some value that would otherwise have gone to the lenders. Put another way, the failure to enforce the absolute priority rule will affect investment decisions; drive up the cost of capital and distort allocations between equity and

[141] For a suggestion that the 'absolute priority' principle in the US is less absolute than it might superficially appear see Mark J Roe and Frederick Tung, "Breaking bankruptcy priority: How rent-seeking upends the creditors' bargain" (2013) 99 *Virginia Law Review* 1235.

debt. On the argument, it may be that these propositions are based on perfect market theories that are not necessarily sound in practice.[142]

The late 2014 report by the American Bankruptcy Institute on the reform of Chapter 11 has recommended some changes to the ‘absolute priority’ principle principally by giving the ‘out of the money’ stakeholders who are next in line ‘redemption option value’.[143] Basically a class that receives no distribution under a restructuring plan or from asset sale proceeds but is next in line to receive such a distribution would be given a ‘redemption option value’. This is the value of a hypothetical option with a 3 year lifespan to purchase the entire company and with an exercise price equal to the face value of the senior claims. The recommendation is intended to address the fact that bankruptcy proceedings may take place during an economic downturn, resulting in a lower company valuation and lower recoveries for junior creditors. The report explains that ‘the valuation may occur during a trough in the debtor’s business cycle or the economy as a whole, and relying on a valuation at such a time my result in a reallocation of the reorganized firm’s future value in favour of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair and inconsistent with the Bankruptcy Code’s principle of providing a breathing spell from business adversity.’[144] The payment of the redemption option value is designed to reflect the possibility that within 3 years the value of a restructured company might be such that enables the senior creditors to be paid in full and provides incremental value to the immediately junior class of stakeholders. The detailed rules are quite complex however, and there seems little prospect of their immediate implementation.

5. Conclusion

[142] See National Bankruptcy Review Commission Report *Bankruptcy: The Next Twenty Years* (1997) at p 566.
[143] www.commission.abi.org/full-report at pp 207-211.
[144] *Ibid* at p 207.

An efficient business restructuring law should enhance the overall value of an enterprise and thereby maximise the potential for growth and employment. These ideas are at the core of the European Commission Recommendation on a new approach to business failure and insolvency. The Commission has made the case that because some Member States have either not implemented the Recommendation at all, or implemented it in a divergent way, there is a case for legislative action. In short, gaps and inconsistencies in the implementation of the Recommendation are said to suggest the need for a mandatory measure of legislative harmonisation.[145] Imminent legislative action is more than implied in the most recent policy emanations from the Commission.[146] Nevertheless, Member States have in practice been given little time to implement the principles behind the Recommendation and legislative reforms are ongoing in many countries.[147] Moreover, in translating the Recommendation into a legislative action, there are a number of matters that have to be addressed.

Firstly, one has to consider the relationship between any 'mandatory' Europe wide restructuring regime as implemented in national law and existing national law provisions? For instance, if existing national law sits side by side with a new EU wide regime, what incentives should be in place to ensure that the EU regime is not effectively supplanted in practice by the national regime.[148] Secondly, there are detailed issues of legislative design that need to be addressed e.g. whether and to what extent the provisions should go beyond 'minimum standards'. There include the matters considered in the previous section of this paper i.e. majorities required, creditor cramdown including cross-class cramdown and the

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[145] http://ec.europa.eu/justice/civil/files/evaluation_recommendation_final.pdf at p 4. The evaluation was published on 30th September 2015 – the same date as the Capital Markets Action Plan.

[146] See http://ec.europa.eu/justice/newsroom/civil/events/160712_en.htm and the public consultation at http://ec.europa.eu/justice/newsroom/civil/opinion/160321_en.htm.

[147] Ibid.

[148] See also H Eidenmuller and K Van Zweiten *op cit* at p 26.

'absolute priority' rule. Another example is whether legislative authorisation for super-priority new finance should be given and, if so, the detailed conditions under which this is permitted.

Nevertheless, even with minimum standards and a new Directive, there may be unequal allocation of the benefits of having a new European approach to business failure and insolvency. Once the merits of a particular jurisdiction or regulatory regime have been established, that jurisdiction etc. has 'first mover' advantage and the advantages conferred by that status are not easily matched by other jurisdictions. The UK scheme of arrangement has become the restructuring tool of choice for European incorporated companies and it may that even with a new Europe-wide restructuring regime its popularity will not wane substantially.[149]

[149] Such a result is likely to be welcomed by City of London lawyers and UK insolvency practitioners for they have lobbied hard to keep schemes outside of the recast Insolvency Regulation – see e.g. the Insolvency Lawyers Association (ILA), City of London Law Society Insolvency Law Committee and Association of Business Recovery Professionals joint response of 25th February 2013 to the UK Government consultation on the proposed changes to the Insolvency Regulation - https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/279289/insolvency-lawyers-association-evidence.pdf/. Their exclusion means that they are not entitled to the benefits of automatic EU wide recognition but this is outweighed by the fact that the ability of the English courts to sanction schemes is not hampered by the jurisdictional conditions of the Regulation. In particular, there is no need to establish that the centre of main interests (COMI) of the company is in the UK. The courts can sanction a scheme if a foreign company is deemed to have a 'sufficient connection' with the UK, even though its COMI may not be in the UK.