Has Newton had his day? Relativity and realism in European restructuring

Riz Mokal and Ignacio Tirado applaud the imminent introduction of a cross-class cram-down mechanism, support the Council's proposal of a relative priority rule, and suggest a better interpretation of the creditors' best interest test

IGNACIO TIRADO
Professor at the Universidad Autónoma of Madrid, currently serving at UNIDROIT

RIZ MOKAL
Barrister at South Square, London, Visiting Professor at the University of Florence, Honorary Professor at University College London

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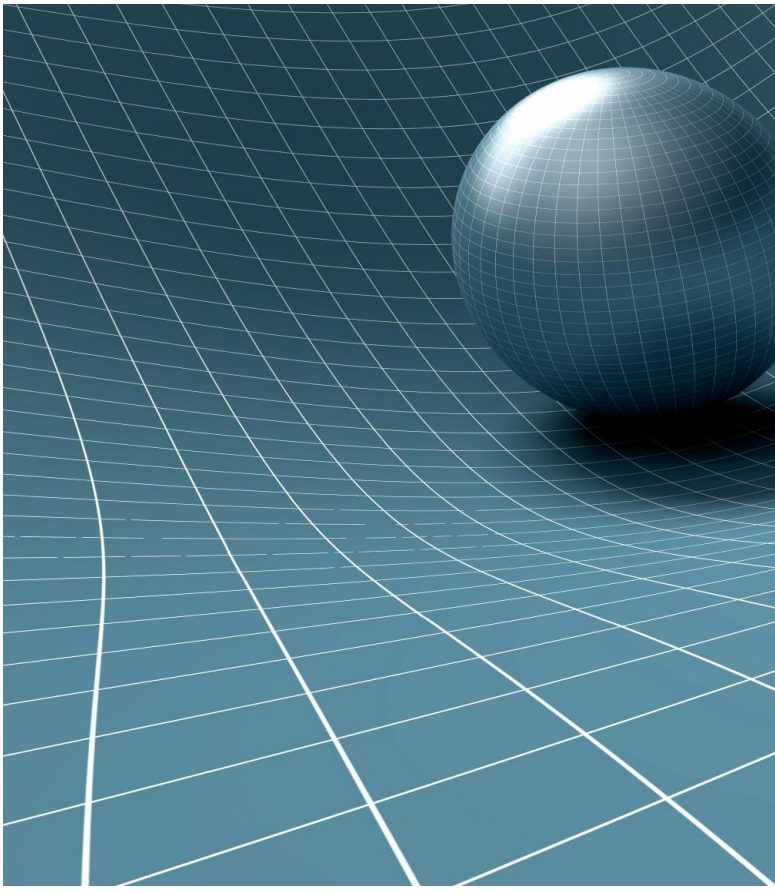
Isaac Newton had good reason for believing space to be absolute, and absolute space to be essential to the operation of the laws of motion. In a famous example, he noted that water in a rapidly spinning bucket is at rest relative to the bucket, yet has a concave surface.

This, he thought, evidences the water's being in motion in relation to absolute space. Similarly, according to his first law, in the absence of an applied force, a body stays at rest or, as the case may be, continues in a straight line, in either case again in relation to absolute space. And so on. The notion of absolute space, then, was indispensable to Newton's monumental contribution to human knowledge. And yet the same concept eventually came to be recognised as a hurdle to scientific progress. The problem — as explained variously by Berkeley, Leibniz, and Mach, the last of whom denounced "*the monstrous conceptions of absolute space and absolute time*" — is that absolute space is inaccessible to the senses, impervious to meaningful analysis, and useless in practice.[1] The displacement of Newtonian absolutism by Einsteinian relativity marks a milestone in the advance of civilisation.

We do not claim quite the same status for the European Council's proposal to substitute or at least supplement the absolute priority rule ('**APR**') in restructuring law with one based on relative priority ('**RPR**'). Yet the comparison is irresistible, not least because it flatters insolvency law and those who practice, study, and teach it.

Cross-class cram-down in the Preventive Restructuring Directive

The Council's proposal concerns the forthcoming Directive on Preventive Restructuring Frameworks, which has just completed. The Directive looks



set to create an extensive toolbox with which Member States may equip entrepreneurs and enterprises seeking to respond to distress, without invoking formal insolvency proceedings. Much has already been written about various aspects of the Directive. We focus here on the primary conditions that must be met before a restructuring plan may be made effective against a claimant class, amongst whose members it has not attracted requisite support, i.e. on the preconditions for a 'cram-down' against a dissenting class.

Drawing on practice under Chapter 11 of the US Bankruptcy Code, the Commission had proposed that a cross-class cram-down be permitted only if (among other things) the APR was respected and the plan was in the best interest of creditors, understood in a particular way. The APR requires that no claimant class ranking below the dissenting one should receive or retain anything under the plan unless each member of the dissenting class has been paid the full face value of his outstanding claim. The best interest of creditors test sets the floor in relation to each dissenting creditor by requiring that no such creditor be left worse off under the plan than they would be in the debtor's liquidation. We will call this the 'returns in liquidation' test ('**RIL**'), and will contrast it with the 'returns in realistic alternative' test ('**REAL**').

The very introduction of a cross-class cram-down mechanism would constitute a huge advance in European restructuring law and practice, for which the Commission is to be commended. The availability of cram-down would potentially facilitate value- and employment-preserving restructurings of distressed but viable debtors which, under the current dispensation, are subject to unnecessary liquidations. And the RIL and APR have historically provided the conceptual foundations for the cram-down mechanism. Experience in the US and elsewhere has taught, however, that neither is quite suited to the task.

Getting 'REAL' about creditors' best interests

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

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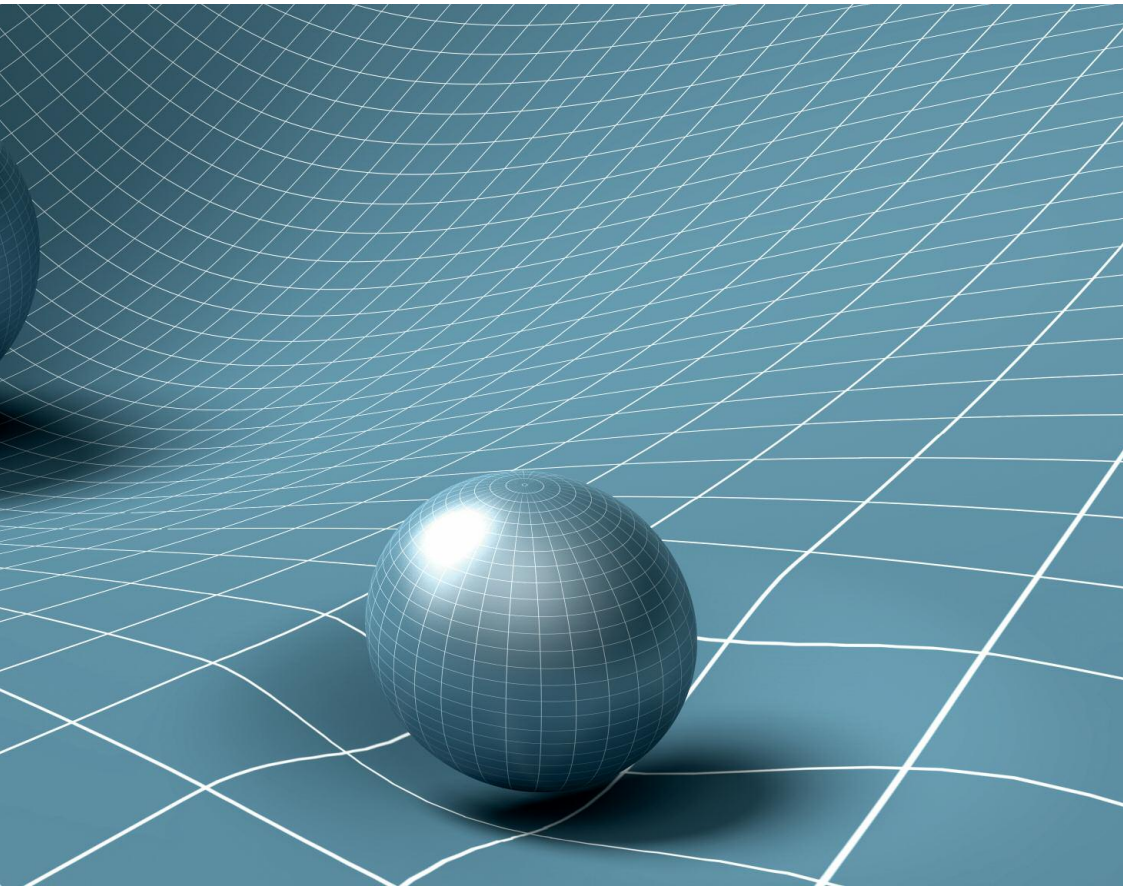

> **A DISSENTING CREDITOR DOES NOT WANT THE PLAN TO BE APPROVED AND SO HE CANNOT COMPLAIN AS LONG AS HE IS PAID AT LEAST AS MUCH AS HE WOULD BE IN THAT SCENARIO**

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

The Council proposes that the best interest test may be met if each dissenting creditor received at least as much as he would either in liquidation or in "*the next best alternative scenario, if the restructuring plan was not confirmed*". The latter terminology is open to misunderstanding in suggesting comparisons with the position of the dissentients in a hypothetical scenario that, by stipulation, is worse than (i.e. is next best to) the plan. This is perverse, as the example above illustrates, since the dissentients would want their plan returns to be compared with a scenario in which they claimed they would be *better* off.

We suggest that REAL provides a more sympathetic reading of the Council's proposal:[3] the dissentients' plan returns ought to be compared — not with a hypothetical worse scenario—but with the scenario realistically likely to materialise if the plan was not approved. This may, but need not, be liquidation on either a going concern or a piecemeal basis. By definition, a dissenting creditor does not want the plan to be approved, and so he cannot complain as long as he is paid at least as much as it would be, precisely in that scenario. REAL has a proud lineage in restructuring practice[4] and enjoys scholarly support.[5]

Relativity displaces absolutism

Where the RIL requires too little, the APR demands too much. There are four overlapping problems with it.

First, it subjects approval of the plan to a requirement that may be utterly unrealistic on the facts. The debtor's estate may, on any credible assessment, lack sufficient value to pay the dissentients anywhere near 100 cents on the euro. In such cases, which are unlikely to be rare, the APR does not serve any defensible purpose.

Second, the rule incentivises dissent on the expectation of a free ride. Members of a class who expect there to be sufficient support elsewhere for the plan have an incentive to vote against it in the hope of receiving full payment, effectively by free-riding on the sacrifice of those who agree to give up part of their claim by voting for the plan.

Third, however, this incentive to hold out risks backfiring. Creditors in multiple classes may have more or less symmetrical incentives to hold out, with the result that some plans that might have been approved in the absence of this strategic behaviour would end up being rejected.

Fourth and finally, the absolute priority rule makes it very difficult to award value, under the plan, to equity. This is particularly problematic in relation to small and medium enterprises in which separation of ownership and control is not feasible because of the size, nature, or location of the debtor's business, and/or because the business is only viable if it were to retain its pre-distress goodwill, which in turn could only be retained if some of the pre-distress management continued to stay in place under the plan.

The Council proposes that Member States may supplement or substitute the APR with an RPR that provides that the dissentient class be treated at least as favourably as any other class of the same rank and more favourably than any junior class.

The RPR, which is likely to address many of the APR's problems, again enjoys scholarly support.[6] The version of the RPR recommended by the Council appears to derive from the recommendations resulting from a Commission-funded project on

restructuring best practices, led by the authors of this article together with Profs. Lorenzo Stanghelini and Christoph Paulus.[7] We understand that this RPR commended itself to members of the Council as a result of workshops to present this project's results, conducted at the Bank of Italy in Rome and at the Centre of European Policy Studies in Brussels.[8]

Let no one mock any more the notion that publicly funded academic hard work may enrich policy discourse and legislative process.

Conclusion

The APR, like absolute space, was once crucial to progress, yet must now be acknowledged as a possible barrier to it. Restructuring law is ready for a dose of relativity. Time is also ripe to reinterpret the best interests test by breaking its hitherto invariant focus on the debtor's liquidation, and by aligning it with the creditors' returns, in the realistic alternative scenario to the plan.

The Council's proposals may yet herald restructuring law's Einsteinian revolution. ■

We are grateful to Judge (retd) Charles Case, Lorenzo Stanghellini, and Wolfgang Zenker for lengthy, brilliant, instructive, inspiring conversations on the topic. Unless explicitly attributed to another, the views expressed here are ours alone.

Footnotes:

1 Arden Zylbersztajn, 'Newton's absolute space, Mach's principle and the possible reality of fictitious forces' (1994) 15 *European Journal of Physics* 1 provides an interesting and accessible account.

2 This point is explicated by Michael Crystal QC and Riz Mokal in 'The valuation of distressed companies: A conceptual framework' (2005) 3 *International Corporate Rescue* 63-68 and 123-131.

3 In any event, the statement of the best interest test as proposed by the Council could benefit from a reformulation along the lines suggested in the text here.

4 See e.g. the judgment of the Court of Appeal of England and Wales in *In re English, Scottish, and Australian Chartered Bank* [1893] 3 Ch 385, 406 and 413-414 (Lindley LJ) and 415 (Lopes LJ). On a related point, see *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621 (Ch), [88]; one of the present authors, then a pupil barrister, assisted counsel for the opposing creditors.

5 Lorenzo Stanghellini, Riz Mokal, Christoph Paulus, and Ignacio Tirado (eds), Best Practices in European Restructuring (Walters Kluwer, 2018) (European Commission Grant JUST/2014/JCOO/AG/CIVI/7627), 37-38 and Policy Recommendation 2.6.

6 See e.g. Baird and Rasmussen, 'Chapter 11 at Twilight' (2003-4) 56 *Stanford Law Review* 673, 691-693; Douglas G. Baird, 'Priority Matters: Absolute Priority, Relative Priority and the Costs of Bankruptcy', 165 (2016) *University of Pennsylvania Law Review* 785, 791; Wessels, Madaus, and Boon, *Rescue of Business in Insolvency Law* (Instrument of the European Law Institute, 2017), pp. 335-6, paragraph 686; and Madaus, 'Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law' (2018) 19 *European Business Organisation Law Review* 615, particularly Section 5.2.

7 See Stanghellini *et al*, *supra*, at pp. 45-47, including Policy Recommendation 2.16. For full access to the results of the project, see www.codire.eu.

8 A complete recording of the latter proceedings is accessible at the Centre's YouTube channel here: https://youtu.be/z5ArsT3-Y1w.

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