INSOL EUROPE

INSOL Europe Guidance Note

on the Implementation of Preventive Restructuring Frameworks under EU Directive 2019/1023

Claims, Classes, Voting, Confirmation and the Cross-Class Cram-Down

Tomáš Richter & Adrian Thery

April 2020

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Foreword to INSOL Europe Guidance Note

It is with great pleasure that INSOL Europe presents the first in a series of Guidance Notes on the Implementation of Preventive Restructuring Frameworks under EU Directive 2019/1023 on Restructuring and Insolvency.

In March 2019, during Alastair Beveridge's presidency, the Council of INSOL Europe launched a "Directive Project" with the specific objective of preparing a helpful guide for legislators in the Members States who are in the process of turning the EU Directive into updated or brand new national legislation.

As you will be aware, the objectives of INSOL Europe are to take and maintain a leading role in European business recovery, turnaround and insolvency issues, to facilitate the exchange of information and ideas amongst its members and to discuss business recovery, turnaround and insolvency issues with official European and other international bodies who are affected by those procedures.

As the leading pan-European association of practitioners, academics and judiciary within the field of insolvency and restructuring, and whose members have between them thousands of years of experience, INSOL Europe is well-positioned to take a close look at and provide a pan-European perspective on those tools which would be beneficial in delivering successful restructurings and those tools which may be counter-productive.

We would like to extend our immense gratitude to the following INSOL Europe members who bravely undertook the huge and highly important task of drafting a series of Guidance Notes on the Directive:

Adrian Thery (Chair), Garrigues, Madrid, Spain
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The first Guidance Note in the series deals with **Claims, Classes, Voting, Confirmation and the Cross-Class Cram-Down**. The main authors of this first Note are **Adrian Thery** and **Tomas Richter**.

It is our hope that this Guidance Note, as well as the subsequent Notes that will be published over the coming months, will be considered to be a significant and useful contribution to enhancing the harmonization of the pre-insolvency restructuring regimes across the Member States. It is our sense that, in the wake of the unfolding Covid-19 pandemic, the restructuring frameworks envisaged by the Directive might need to be in place rather sooner than originally envisaged by the EU legislator. We hope that our Guidance Notes will assist in that.

March, 2020

On behalf of INSOL Europe

Alastair Beveridge
Immediate Past President

Piya Mukherjee
President

Introduction by authors

This Guidance Note has been written in order to provide assistance to legislative drafters in the 27 Member States of the European Union tasked with implementing into their national laws the restructuring frameworks envisaged in Title II of EU Directive 2019/1023 on restructuring and insolvency.

That task is as difficult as it is important.

Implemented well, the Directive might bring a lot of good to the Member States' credit markets and economies in general, facilitating early restructurings of financially distressed businesses and averting the social costs which are often incurred when financial distress is allowed to develop into full-blown insolvency that must be dealt inside formal court procedures. If implemented poorly, the Directive might stifle the market process of reallocation of resources used by failing businesses to more productive uses or even make credit less available (or more costly) to certain types of business debtors.

What means of implementation will be correct or wrong will to an overwhelming degree depend on the pre-existing institutions available in the individual Member States. This includes both the pre-existing legal rules applicable to the resolution of corporate financial distress and insolvency, and the actual practices through which those rules are being applied by the respective public authorities and market players. A specific implementing solution that might work perfectly well in one Member State might bring about disappointing outcomes in another.

However, certain threshold questions will be very similar across jurisdictions when it comes to particular topics relevant to corporate restructurings.

In the context of agreeing and adopting a restructuring plan, some of the key questions arise in relation to classification of investors' claims and interests, grouping these claims and interests into classes, voting in the classes, and obtaining an official approval of the restructuring plan after investors have expressed their opinions on it *via* the voting mechanism.

It is the purpose of this Guidance Note to flag some of the key issues that national legislators will want to consider in this particular context when implementing the restructuring frameworks prescribed by Title II of the Directive, and, at least at times, also to respectfully suggest which approaches, in the authors' humble opinions, might perhaps be explored more productively than others.

In Prague and Madrid, March 2020

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He authored sections VI to X of this Guidance Note.

Defined Terms

“Consensual Plan” means a Restructuring Plan that is supported by each and every voting class.

"**Directive**" means DIRECTIVE (EU) 2019/1023 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

"**EU Restructuring Framework**" means one or more of the preventive restructuring frameworks to be implemented into Member States' laws pursuant to Title II of the Directive.

"**Member State**" means member states of the European Union.

“Non-Consensual Plan” means a Restructuring Plan that is not supported by all the voting classes.

"**Restructuring Plan**" or **“Plan”** means a restructuring plan pursuant to Article 8 and the following of the Directive.

When this Note refers to "**Articles**" and "**Recitals**" it is referring to Articles and Recitals of the Directive, unless indicated otherwise.

I. BASIC TYPES OF CLAIMS

1. Rules on formation of classes of creditors (or creditors and shareholders) will be one of the keys to any functioning implementation of the Directive. After all, the Restructuring Plan can be viewed as "a contract entered into among the classes." Accordingly, the parts of the Restructuring Plan dealing with the creation of classes are equally important to certainty, and thus enforceability, of the plan as are the parts identifying the parties to all other types of contracts.

2. In order to implement the rules on the formation of classes meaningfully, one must first grasp the key terms and categories that the Directive uses in order to describe the persons which may, and which may not, have their rights impacted by the Restructuring Plan. Accordingly, this Note will start with the basic taxonomy of the parties on whose rights the Restructuring Plan may have an impact. It will then move to the rules under which such parties may be grouped into classes and vote on the Restructuring Plan.

(A) Affected creditors or parties

3. The basic dichotomy by which the Directive categorizes creditors or other parties with respect to the Restructuring Plan is into "affected" and "unaffected" parties.

4. An "affected" party is, under the definition given in Article 2(1)(2), a creditor or an equity holder "whose claims or interests, respectively, are directly affected by a Restructuring Plan".

5. By contrast, an "unaffected" party is simply a person on whose rights the Restructuring Plan has no effect, or at least no *direct* effect (see Recitals 39 and 43 where the term is used in exactly that context. Recital 51 uses the term "non-affected" to the same end, and Articles 8(1)(e) and 9(2) refer parties who are "not affected"; these are all slightly different ways by which the Directive refers to the same concept).

6. There will always be a certain amount of uncertainty as to what effects (impacts) of the Restructuring Plan are "direct enough" to make a party "affected" and what effects (or impacts) are sufficiently distant to warrant that a party is treated as unaffected. See section I(E) below.

(B) Impaired creditors

7. An "impaired" party is a special sort of "affected" party. Recital 54 *in fine* explains that "the impairment of creditors should be understood to mean that there is a reduction in the value of their claims". In addition to Recital 54, the term is only used in Article 11(1)(b)(ii) and in the final sentence of Article 11(1) in relation to the [cross-class] cram-down.

8. The concept of "reduction of value of a claim" allows for ambiguity. In a certain broader sense, the value of claims against debtors who need to avail themselves of the EU Restructuring Framework will always be "impaired" when compared to a claim against a non-distressed debtor, simply because they may face discounts in secondary trading, etc. But because the Directive treats classes of "impaired" creditors as an

alternative to classes of "affected" creditors in the operative provisions of Article 11(1) where the former term is actually used, one should assume that the term should be construed narrowly. In order to arrive at a meaningful distinction between "affected" and "impaired" creditors, the latter term will need to be construed as referring to creditors whose claims are reduced in their amount (whether as to the principal or interest) as the result of the application of the EU Restructuring Framework as such, as opposed to other circumstances on the part of the debtor which may have an impact on the "value" of their claims in the broader sense.

9. By way of an example, a creditor whose claim's repayment date will be extended under the Restructuring Plan as against the original term but who, when the Restructuring Plan is fully performed, will have received the same amount in principal, and also interest covering both the interest pertaining to the creditor under the original terms of his loan (or other entitlement) and such additional interest as will be needed to compensate the creditor for the delay imposed by the Restructuring Plan (and the preceding stay, if any) will be merely an "affected" creditor. By contrast, a creditor who will not have received the full principal amount of its claim and such additional payments as are sufficient to compensate for the interest originally agreed plus the time value of any postponements imposed by virtue of the EU Restructuring Framework, will not only be "affected", but "impaired" as well.

10. On this interpretation, it will be quite rare in actual restructuring practice for affected parties not to be impaired as well.

(C) Involved creditors

11. Unlike full-fledged insolvency proceedings, the EU Restructuring Framework does not aim to deal with all of the debtor's obligations. The Restructuring Plan will only affect claims which are identified as such in it. For these purposes, the Directive uses the concept of "involved" parties in Recital 64 and Article 15(2). Recital 64 explains that "the binding effects of a Restructuring Plan should be limited to the affected parties that were involved in the adoption of the plan" but immediately thereafter affords considerable leeway to Member States as regards the definition of which creditors are to be considered as having been "involved", including the treatment of "creditors that have been notified correctly but that did not participate in the procedures". Article 15(2) provides that "Member States shall ensure that creditors that are not involved in the adoption of a restructuring plan under national law are not affected by the plan."

12. The concept of "involved" parties means no more than that the ambit of the EU Restructuring Framework is not universal, and that the Restructuring Plan will only affect claims specifically identified in it (see Article 8(1)(c) and 8(1)(e)). When using their discretion under Recital 64 (and by extension Article 15(2)), Member States should be cautious not to do more than that purpose calls for. In particular, they should be careful not to encourage tactical opt-out behaviour. It is obvious that any rule allowing a creditor whose rights the Restructuring Plan proposes to affect to easily "opt-out" of the restructuring by simply not participating in the process would defeat the entire purpose of the Directive, which is exactly to bind non-cooperating creditors "into the deal".

(D) Pre-commencement and post-commencement creditors

13. Recital 25 provides that "Member States should be able to determine whether claims that fall due or that come into existence after an application to open a preventive restructuring procedure has been submitted or after the procedure has been opened are included in the preventive restructuring measures or the stay of individual enforcement actions."

14. This provision clearly reminds one of the classical distinction between the treatment of pre-commencement and post-commencement claims in formal insolvency proceedings. The rationale for that distinction is as universal as it is non-controversial: any party expected (or, even more poignantly, compelled) to extend new credit to a debtor who is already insolvent, and thereby not expected to pay its debts in full, must be provided with ranking superior to that of pre-existing creditors, and in any case pre-existing general creditors.

15. By and large, this rationale applies to debtors distressed enough to need to avail themselves of the EU Restructuring Framework. Here too, there is a significant risk that creditors, and at any rate ordinary creditors, will not be paid in full. Accordingly, parties expected to extend new credit to the debtor need to be incentivized by ranking more favourably than pre-existing debt.

16. Procedurally, the situation in the EU Restructuring Framework will most likely be different from that in formal insolvency proceedings in several important aspects, however.

17. First, there might well not be any single moment which could meaningfully be described as the "commencement". For example, a limited stay issued privately by an official order under Article 6(3) of the Directive might not carry with it many features similar to those of a commencement of insolvency proceedings. Yet, in order to keep the debtor's business running, certain fundamental impacts on the debtor's counterparties' freedom to terminate their dealings with the debtor might need to kick in already at this point in time (see Article 7 of the Directive). Such counterparties, stripped of their contractual termination rights by the fiat imposed through the EU Restructuring Framework, will need to be provided with ranking corresponding to the changed credit risk that they are forced to keep facing under previously agreed contracts.

18. Second, the EU Restructuring Framework will usually have no process similar to the registration, verification and admission of (pre-commencement) claims known from formal insolvency proceedings, and neither will it have the various procedures by which post-commencement (often referred to as administrative) claims are submitted and settled in the course of the proceedings.

19. In light of the above, Member States would be well advised to carefully consider the point(s) in time after which claims are to be treated as if they were post-commencement, or "administrative" claims, as well as the applicable rule of priority afforded to these claims.

20. The solution must address the position of the new creditors inside the restructuring framework proper (i.e. in case that the restructuring attempt succeeds) but also in any subsequent proceedings (i.e. in case that the restructuring attempt actually fails), the

latter being the more important consideration from the point of view of a party expected to extend new credit to the restructuring debtor.

21. In procedural terms, granting these claims preferential ranking will most naturally be achieved by providing that such claims may not be affected nor impaired by the Restructuring Plan, and legislating for an appropriate priority in any subsequent, formal proceedings.

22. Whether such claims shall be immune from the effects of the stay as well is, on the other hand, a less clear matter. Affording a substantive priority ranking to a claim is not the same thing as allowing such ranking to be collected and/or enforced immediately against the debtor\s assets under circumstances when the debtor is attempting to put together a restructuring transaction. Careful consideration should be paid to these aspects as well.

23. As regards the point in time after which credit extended to the debtor (whether financial or trade credit) is to be treated as "new money", it is suggested that the relevant point in time is the moment where most creditors can be assumed to get wind of the restructuring and potentially "opt out", either by refusing to deal at all, or by demanding pre-payment etc. Different Member States will want to define such point differently, in particular by reference to their rules on the publicity of the EU Restructuring Framework.

(E) Direct and indirect impacts of a Restructuring Plan on claims

24. The typical direct impacts a Restructuring Plan may have on affected parties include alterations of the payment terms of the affected claims (e.g. reinstatements or extensions of maturity of the claims), reductions in the amount of the principal or interest owed (referred to as "haircuts" in restructuring jargon), or conversions of one type of claim into another (e.g. debt into equity). Secured claims may have their collateral released or replaced with security over different assets. Existing equity holders may have their shares cancelled without replacement.

25. Indirect impacts may be of various types as well, ranging from the creation of new claims senior to those in question (effectively resulting in subordination although the nominal rank of the affected claim in question has not changed) to fundamental changes on the left-hand side of the debtor's balance sheet (e.g. transfer or substitution of material assets) which may lead to claims being affected and/or impaired even though, nominally, the right-hand side of the balance sheet has not been altered. A merger of the debtor company with another entity may profoundly alter both the assets which the creditor may have recourse to, and the other liabilities with which the creditor competes for those assets, again without nominally changing anything about the creditor's claim in the narrow sense of the word. Yet the claim would no doubt be affected as a result of such a transaction.

26. Member States would be well advised to pay attention to the definition of "directly affected parties" – this Note does not believe that the term "affected party" should be constructed as an autonomous concept of EU law. (In other words, the Note does not take Article 2(2) to mean that concepts not listed therein are *à contràrio* exempted from the definitional legislative powers of Member States). It is of course possible to take the view that the task of defining the boundary between direct and indirect effects

of a Restructuring Plan will be left to court adjudication. However, that process may lead to undesirable results and, in any case, only operates *ex post*, often with considerable delays after the enactment. It might therefore be desirable to clarify the distinction upon implementation of the Directive, even if the clarification would not be done via exclusive lists of one or the other type of effect. Leaving the distinction unregulated might create too much open ground and incentive for tactical litigation.

27. By the same token, Member States may want to consider what other legal rules to review and potentially amend in relation to indirect effects of Restructuring Plans – company law rules on mergers, transfers of assets, and the like, seem like an obvious candidate which might bring about unintended consequences even in instances where share capital is not affected by the Restructuring Plan.

(F) Ranking of claims

28. The Directive is utterly silent on the issue of priorities and ranking of claims. This is clearly for national law to decide.

29. However, within that discretion, Member States need to bear in mind that introducing different priority rules in alternative procedures dealing with similar types of issues (here, the imminent threat of the general default by a business debtor) is bound to skew parties incentives and will by definition trigger regulatory arbitrage of all sorts.

30. This Note would therefore suggest that keeping consistent priority rules across all procedures that a Member State offers to the market for dealing with the insolvency or threatening insolvency of business debtors is generally the sounder regulatory approach than the opposite.

31. In any case, Member States must remember that, whether or not consistent with those legislated for inside the EU Restructuring Framework, rankings in their national liquidation process will serve as an important benchmark under the EU Restructuring Framework.

32. Under Article 2(1)(6), the "best-interest-of-creditors test" looks at the "normal ranking of liquidation priorities under national law" for the purposes of the individual remedy available to affected parties under Article 10(2)(d). Similarly, for the purposes of the minimum acceptance of the Restructuring Plan by classes as a gate to the [cross-class] cram-down, Article 11(1)(b)(ii) looks to the "normal ranking of liquidation priorities […] under national law".

33. The Directive is of course an impulse to review national insolvency laws in a whole host of respects and contexts. The issue of ranking and priorities features high on the review checklist. Member States which choose a different priorities scheme for the EU Restructuring Framework than for their other processes, and in particular for those of the liquidation type, should be mindful that the application of the best-interest-of-creditors test and the [cross-class] cram-down, which will be challenging enough for many a public authority entrusted with the confirmation of Restructuring Plans, will be made yet more complex. This is because, in addition to the valuation exercise which will be involved in the adjudication of those issues, the relevant public authority will need to switch between different sets of priority rules.

34. Irrespective of the statutory scheme of priorities, sophisticated financial creditors and the debtors will often contract about the priorities of their claims using subordination and other ranking agreements. This Note suggests that national laws should respect and enforce such agreements within the EU Restructuring Frameworks, certainly to the extent that they do not have a negative impact on non-contracting creditors.

II. SPECIAL CONSIDERATIONS RELATING TO CERTAIN TYPES OF CLAIMS

35. At its core, the Restructuring Plan is a multiparty agreement entered into between the debtor and its investors by way of majority voting. The ground rule therefore is that all affected parties should be entitled "to contract" – i.e. to vote on the adoption of the Restructuring Plan (see Recital 43, Article 9(2)). And conversely, parties not affected by the Restructuring Plan should not be entitled to vote (Article 9(2), second sentence).

36. However, with respect to certain investors, deviations from the ground rule might be in order so as to protect the integrity of the contracting process.

(A) Debt owing to equity holders and other related parties

37. The most natural candidates for exclusion from voting on the adoption of the Restructuring Plan are debt claims held by equity holders (Article 9(3)(a)) and by parties related to the debtor (Article 9(3)(c)), where the conflicts of interest are obvious. A less absolute rule might allow these parties to vote but put their debt claims into a separate class, thus preventing them from "contaminating" the vote by unrelated creditors, and allowing the court to "cram the plan down" on such class if need be.

(B) Subordinated creditors

38. Although it will not always be obvious where in the debtor's capital structure "the value breaks" and thus, which investor classes are "out-of-the-money", creditors of claims subordinated to claims of general (ordinary unsecured) creditors are obvious candidates. In order to simplify matters (and valuation disputes), Member States may want to adopt a bright-line rule always preventing subordinated creditors from voting (Article 9(3)(b)). A less absolute rule, which this Note would respectfully recommend, might allow these parties to vote but, once again, put them into a separate class (see Recital 46), thus preventing them from "contaminating" the vote by general creditors, and allowing the court to cram the plan down on such class if need be.

(C) Contested and contingent claims – in general

39. The position of contingent and contested claims is never easily dealt with, even in formal insolvency proceedings which have the requisite procedural apparatus to deal with them, as well as much more time than is available in a restructuring transaction. Rather than offering a solution, Recital 46 simply reminds Member States of this difficulty, providing that "Member States should [….] ensure that [….] their national

law contains rules that deal with contingent claims and contested claims. Member States should be allowed to regulate how contested claims are to be handled for the purposes of allocating voting rights."

40. One approach to this problem might be based on the proposition that a business whose liabilities are subject to a significant amount of controversy or uncertainty is not a likely candidate for a successful restructuring in the first place. After all, a restructuring under the EU Restructuring Framework is first and foremost a deal between the debtor and its capital providers, and among the capital providers themselves, albeit one negotiated against the backdrop of the majoritarian and other anti-obstruction decision-making solutions provided by the Directive. Situations where there is material controversy as to who those capital providers (or other claimants on the debtor's assets) even are (or might be in the future) bode ill for a contractual solution to the debtor's financial distress. Such situations would normally call for the procedurally much more robust tools of translating the debtor's liabilities from the bilateral world of individual debt collection *via* litigation to the collective world of resolution of general default *via* formal insolvency proceedings.

41. Member States which take this view of the problem will most likely want to simply provide that the Restructuring Plan may not affect creditors of contested or contingent claims. Such a rule would be similar to an election expressly provided for in Article 1(5)(c) whereby Member States are free to exclude from the impacts of the EU Restructuring Framework "claims that arise from tortious liability of the debtor". Here too, the uncertainties about the amount and even the existence of the claims might be so grave that a contractual restructuring framework could not realistically cope with them. A distressed business that has a material exposure to tortious claims may simply need to use the more robust formal insolvency procedural framework.

(D) Contested claims – in particular

42. A less absolute rule with respect to contested claims might be formulated along the lines of only excluding such amounts (and such ranking issues) as are actually subject to the controversy, allowing the Restructuring Plan to include non-controversial elements of the contested claims, if any. But while this may sound reasonable, one must keep in mind that no part of the contested claim will have been subject to the sort of scrutiny which normally ensues during the claims submission, verification and admission process in formal insolvency proceedings, not least because there will not be a claims submission process or an insolvency practitioner who could conduct such scrutiny in the first place. Therefore, the risk of collusion between the debtor and the holder of the dubious claim should be obvious – whether that collusion might aim at bringing in an inflated claim in order to outvote other, legitimate creditors, or whether it might pretend that there is a dispute where there is none, in order to shield the complicit counterparty from the impacts of the Restructuring Plan which other creditors will have to suffer. Parts of this risk might be neutralized by rules on voting by related parties (see section II(A) above) - or by conferring the role of investigator on a neutral practitioner appointed by the public authority - but other parts might not. (It is, after all, fairly unlikely that parties colluding with the debtor in order to skew the outcome of the restructuring will be transparent about it).

43. Indeed, when legislating for the issue of contested claims, Member States should pay close attention to the definition of a "contested claim" in the first place - a focus that

will swiftly lead to the problem of who gets to bring about the assertions that make a claim "contested", and by what procedural means this should occur. Reaching once again to the insolvency proceedings analogy, a proof of claim filed into the proceedings may usually be contested by the debtor, the insolvency practitioner, and often also by other creditors. There will therefore be at least two players entitled to assert issues that make a claim contested, one of whom – the insolvency practitioner - should be both independent of the parties involved in the debtor's financial crisis, and particularly qualified to take a view of the sort of circumstances that give rise to creditors' claims. Insolvency laws that grant creditors the standing to contest proofs of claim filed into the proceedings by other parties create a potentially vast number of further players entitled to raise questions about the legitimacy of claims submitted into the proceedings. (This solution clearly creates ample issues on its own, however, discussing these would go beyond the scope of this Note). The Directive provides nothing at all on these issues and Member States will have to come up with their own solutions, fitting their own judicial and other institutions.

44. But the problems do not stop with working out what claims are potentially bogus.

45. Viewed from the point of view of the debtor's counterparty, the existence of a dispute (and a *bona fide* dispute in particular) as to how much the counterparty is owed, triggers constitutional-level questions of the right to fair trial under Article 6 of the European Convention on Human Rights and its various incarnations in Member States' constitutional laws. Giving these rights a short shrift in the name of "supporting a restructuring culture" sounds like a bad idea to start with, not to mention the likely judicial reviews of the implementing legislation on constitutional grounds which such an approach would surely trigger in the first cases where the stakes are high enough to support the litigation.

46. The fact that the Directive is pretty much oblivious to this entire area of insolvency-related law does not mean that the issues are not relevant to restructurings. What it means is that informal restructurings, which the Directive aims to support, only ever succeed with respect to debtors who are by and large free of doubt as regards the existence, the amounts and the rankings of the claims involved. Moreover, where doubts exist about the debtor's exposure to claims other than those owed to the contracting investors, the restructuring will only ever have a chance of succeeding if the dubious additional exposure is so limited in its significance as to not, in the contracting investors' view of the situation, endanger the future viability of the restructured business.

(E) Contingent claims – in particular

47. Whereas including contested claims would require the provisional "adjudication" of some kind of legal dispute in the present, to which the EU Restructuring Framework is ill equipped, contingent claims imply an uncertainty about the future, whether the uncertainty is of legal or factual nature. Whether the EU Restructuring Framework could be designed so as to glean through the contingencies involved (whatever their nature might be) in the time frame and institutional set-up of a restructuring transaction is open to question and much depends on what the particular Member State thinks of the actors and institutions involved. If scepticism is in order, leaving contingent claims unaffected by the Restructuring Plan might once again be a possibility Member States should entertain.

(F) Information and disclosure

48. In any case, whenever contested or contingent claims are left out of the Restructuring Plan's impacts, Member States would be well advised to make sure that under the relevant information and disclosure rules, their existence is duly disclosed and explained to the affected parties voting on the Restructuring Plan. In order to make an intelligent decision on adopting the Restructuring Plan, the affected parties will need to understand the risks which these unaffected claims pose for the debtor's financial position going forward. After all, these claims will not go away – the restructured debtor will still need to litigate or settle them (in case of contested claims) or be able to perform them (in case of contingent claims if the contingency in question materializes).

(G) Verifying claims in the EU Restructuring Framework

49. The last point leads to a larger issue related to the entire business of figuring out who the debtor's creditors are in a situation which (at least potentially) relies on state coercion replacing a consensual agreement, while largely lacking procedurally sound means of verifying the debtor's assertions as to the make-up of its debts. Granted, the EU Restructuring Framework does not aspire to the sort of universal, once-and-for-all settlement of all of the debtor's obligations that is the purpose of full-fledged insolvency proceedings. The Restructuring Plan will only affect the claims of parties identified as affected in it (Article 15(2), Recital 64). Yet clarity as to the debtor's overall indebtedness is needed both in order to assess the viability of the proposed restructuring measures (see Article 8(1)(b) which requires the Restructuring Plan to list all of the debtor's liabilities at the time of the submission of the Restructuring Plan) and in order to assess whether leaving certain claims unaffected is legitimate (see Article 8(1)(e) which requires that the plan explains the reasons why it proposes not to affect certain claims; see also Recital 46 which provides that the power of the relevant Member State's authority to examine class formation includes the power to examine the selection of affected creditors).

50. The Directive provides no guidance whatsoever on how such clarity might be obtained. But the Directive also does not prevent Member States from devising "gate-keeping" mechanisms aimed at assuring that the information on the debtor's indebtedness provided to investors and the relevant judicial or administrative authority is accurate. One such mechanism may be the involvement of an auditor confirming the accuracy of the list of liabilities provided pursuant to Article 8(1)(b). In any case, debtors who already have their accounts audited should have no problem procuring such a confirmation, and the additional cost involved in this should not be disproportionate to the benefits which this gate-keeping measure would bring towards the integrity of the entire restructuring process. Another option might be involving a neutral practitioner appointed by a public authority to conduct a "quick-and-dirty" claims verification exercise where the issue of existence or ranking of claims is contested among the parties, and report to the public authority tasked with the power to confirm or reject the Restructuring Plan.

III. FORMATION OF CLASSES

(A) Secured and unsecured claims

51. Recital 44 explains that in order "[t]o ensure that rights which are substantially similar are treated equitably and that restructuring plans can be adopted without unfairly prejudicing the rights of affected parties, affected parties should be treated in separate classes which correspond to the class formation criteria under national law. 'Class formation' means the grouping of affected parties for the purposes of adopting a plan in such a way as to reflect their rights and the seniority of their claims and interests. As a minimum, secured and unsecured creditors should always be treated in separate classes."

52. In a similar vein, Article 9(4) provides in its first paragraph that "Member States shall ensure that affected parties are treated in separate classes which reflect sufficient commonality of interest based on verifiable criteria, in accordance with national law. As a minimum, creditors of secured and unsecured claims shall be treated in separate classes for the purposes of adopting a restructuring plan."

53. The point that the rankings, and thus the incentives, of secured and unsecured creditors are different is trivial enough. However, while general (unsecured, ordinary, unsubordinated) creditors are homogeneous as regards their ranking, no such thing can be confidently assumed where a debtor has more than one secured creditor. Where multiple security interests exist over the debtor's assets, each of the secured creditor's position may be radically different from that of the other ones. Some may be comfortably over-secured on collateral of durable value, others might be secured on collateral prone to value erosion, yet others might be under-secured to start with (perhaps because their security has second or even lower rank among more security interests created over one and the same asset). Member States should therefore carefully consider whether they should not follow the U.S. law example whereby each secured creditor is put into a separate class. Granted, a rule such as this will result in the more frequent need to invoke the [cross-class] cram-down feature. But on the other hand, it will result in the contracting process following more closely the true ranking of secured creditors' investments. And where a [cross-class] cram-down will need to be used against a secured class, it will be a relatively straight-forward exercise, turning on the valuation of clearly specified collateral securing clearly ranking secured debt, rather than the sort of judicial nightmare that would arise upon an attempt to cram a Restructuring Plan down on a single class encompassing multiple creditors holding diverse security interests over numerous different assets in order to secure claims of possibly differing seniorities.

54. An important election that Member States also need to consider upon implementation of the Directive is whether secured claims should be "notionally split up" (or bifurcated, as U.S. bankruptcy law terminology would call it) based on the value of the relevant collateral (see Recital 44, the penultimate sentence). The election will have important implications for the voting on the plan as well as potential cram-down of the secured classes. Importantly, as literally and correctly follows from Recital 44, a rule mandating the bifurcation of secured claims will by necessity trigger the need to value the collateral, an exercise which will not only involve costs (including those which arise as the result of the time needed to produce and approve the valuation), but may also lead to disputes, including those brought for tactical reasons. Member States

should thus carefully weigh the benefits of a bifurcation rule against its costs, bearing in mind the workings of the actual institutional framework in which the rule would be applied in practice.

55. As already noted above, sophisticated financial structures might contain more refined ranking of debt than would normally follow under the statutory scheme of priorities. This Note respectfully suggests that national laws should generally respect and enforce these ranking agreements inside the EU Restructuring Frameworks. In the current context, this would manifest itself in the relevant public authority seeing to it that classes are formed in a manner which reflects the agreed order of priorities.

(B) Workers' claims

56. Recital 43, Article 1(5) and several other provisions of the Directive make it quite clear that impacting employee claims is not the EU legislator's preferred option. Neither would it normally be the preferred option of the debtor or its financial investors; once the debtor is in arrears on salaries, it is very likely to be deeply in the zone of insolvency, and thus beyond the point where restructuring of the sort envisaged by the Directive is commercially feasible. To the extent that restructuring contributions from employees are needed, these are much more likely to be related to compromises about future salaries or benefits dealt with at the collective bargaining level going forward, rather than to unpaid arrears already owed to employees individually.

57. Where a Member State makes the election under Article 1(5)(a) to allow the Restructuring Plan to affect employee claims, a further election may be made under Article 9(4) to place such claims into a separate class. Whether such a rule would make good sense or not will depend on several other factors, including whether the Member State adopts a numerosity test under the election available pursuant to Article 9(6) or not. However, given the flexibility that permeates the entire Directive, Member States would probably be well advised to provide for the creation of a separate employee claims class as an option at most, rather than as a mandatory feature of all plans.

(C) Suppliers

58. Recital 44 *in fine* provides that "it should also be possible for Member States to lay down specific rules supporting class formation where non-diversified or otherwise especially vulnerable creditors, such as workers or small suppliers, would benefit from such class formation."

59. In informal restructurings of financial indebtedness, it will often be the case that trade creditors, and small trade creditors at any rate, will simply be paid in full while the necessary compromise is agreed among the financial investors. This is not only because the financial investors are diversified whereas the trade creditors, and small trade creditors at any rate, are unlikely to be. It is also because the business' going concern value may to a large extent hinge on the debtor's trading relationships remaining untainted by the financial distress as much as is possible under the given circumstances. Often, the smaller trade creditors will only have found out about the financial restructuring *ex post*.

60. Recital 44 and Article 9(4) should therefore be understood as a tool towards a similar goal. Under these provisions, Member States are free to legislate for the creation of one or more classes of non-diversified creditors, such as employees or trade creditors, whose continued support for the business is of key importance to the success of the restructuring, with a view to allowing these claims to be treated more favourably under the Restructuring Plan than other general (unsecured, unsubordinated) claims. At the limit, these claims might be left fully unaffected by the Restructuring Plan, as they would often be in an information restructuring of financial indebtedness.

(D) Public creditors: tax authorities, social security authorities, etc.

61. Recital 44 provides that "Member States should also be able to treat types of creditors that lack a sufficient commonality of interest, such as tax or social security authorities, in separate classes".

62. Whereas placing non-diversified, vulnerable creditors in a separate class would most likely follow the goal of paying their claims at a higher rate than other creditors of the same legal rank but of radically different commercial standing, one can doubt that claims owed to tax or social security authorities would be natural candidates for similar sympathies. Much like with secured creditors or shareholders, the placement of these claimants into a separate class will probably be driven by the fact that such classification might allow the use of the cross-class cram-down feature, should the taxman oppose the restructuring in spite of the support of commercial claimants.

63. Having said this, what was mentioned with respect to employee claims holds true here as well: a business which is in arrears on tax and social security levies is probably deeply cash-flow insolvent (if it wasn't, it wouldn't have risked triggering all the enforcement powers that these agencies routinely wield). Rather than being a useful criterion of class formation, tax and similar arrears appearing among the debtor's liabilities might indicate that the restructuring attempt is coming hopelessly late.

(E) Separate class(es) for equity holders

64. One of the obvious purposes of the Directive was to allow the Restructuring Plan to affect not only the claims of the debtor's creditors but also the interests of the debtor's equity holders (see in particular Article 2(1)(2) and (3) and numerous other provisions of the Directive). Indeed, the inability to tie in equity holders into a restructuring has been a major plague of restructuring (and even non-liquidation insolvency) processes in many Member States and in those Member States in particular, the Directive should represent a major opportunity to reform national law.

65. In principle, the Directive allows for two approaches to equity holders upon a restructuring. First, they may be left out of the Restructuring Plan, in which case, however, the Member State must take appropriate legislative measures in order to prevent equity holders from frustrating the restructuring efforts by abusing their rights, including the rights otherwise following from the Second Company Law Directive (recast under number 2017/1132)(see Recital 96). The second approach is to bring equity holders into the Restructuring Plan but adopt rules which would prevent them from blocking the adoption of the plan to the extent that the equity is out of money (see Recitals 57 and 58).

66. This Note would respectfully suggest that the latter approach will in most instances be the more feasible one, not least because it has been extensively tested in US reorganization law under Chapter 11 of the US Bankruptcy Code, and in several of its transplants into Member States' insolvency laws. Bringing equity holders into the process of formulating and approving the Restructuring Plan assures that they have a legitimate platform to express and defend their views on the necessary restructuring measures and, importantly, on the underlying valuation assumptions. But, even more importantly, it also assures that those views can legitimately be overcome in the plan confirmation process to the extent that they are not in accord with the majority view of the other, more senior investors, and with valuation assumptions as verified during the plan confirmation process (for details, see section VII.A below).

67. Most capital structures will only have one class of equity (the common shares or their equivalents). However, where the debtor's capital structure is more complex, with different classes of shares and possibly also hybrid instruments (such as preferred shares or debt instruments convertible into shares), it will be important for Member States to legislate for the creation of more equity classes in line with Recital 58, in particular in the event that different classes of equity have different cash-flow rights, not merely different control rights.

(F) Exemption from class-formation with regard to SMEs

68. Recital 45 provides that "Member States should be able to provide that debtors that are SMEs, can, on account of their relatively simple capital structure, be exempted from the obligation to treat affected parties in separate classes. In cases where SMEs have opted to create only one voting class and that class votes against the plan, it should be possible for debtors to submit another plan, in line with the general principles of this Directive".

69. As with all of the Directive's provisions relating to SMEs, much of the import of the language in Recital 45 will depend on each national rule defining what an SME is (Article 2(2)(c) expressly reserved this definition for the Member States, not the EU). Even at the micro level, where security *in rem* is a key tool for managing credit risk (since all the alternatives such as covenants and their kin are simply disproportionately expensive in relation to the size of the credit exposure), capital structures are bound to include at least secured debt, unsecured debt, and equity. The idea that Member States should promote restructurings that attempt to lump all capital providers into a single class, irrespective of the ranking on their investment, seems as questionable as the next idea, i.e. that the market will tolerate and sustain repeated attempts at restructurings if the first time around, the debtor fails to push a plan through based on the sort of "gerrymandering" envisaged in Recital 45. Member States should proceed with great caution in this respect, not least because at the upper bound of what one might reasonably expect to be the likely size range defining SMEs, a rule based on Recital 45 may encompass large parts of the national economy, and thus endanger the availability of credit to them.

(G) Official review of class formation and voting rights

70. Under Article 9(5), the relevant authority (administrative or judicial) in charge of the process in the Member State must have the power to "examine […] voting rights and the formation of classes […] when a request for confirmation of the restructuring plan

is submitted". However, under the next paragraph of the same Article 9(5), "Member States may require a judicial or administrative authority to examine and confirm the voting rights and formation of classes at an earlier stage."

71. The formation of classes and the right to vote on the adoption of the Restructuring Plan (or the disqualification from that right) are of paramount importance to the entire restructuring process.

72. The Directive leaves Member States much room on the issue of class formation. National laws that implement the Directive with a similar amount of leeway will create room for legitimate creativity, as well as for abusive gerrymandering of investors. The line between the two will often be a fine one. Article 9(5) requires Member States to give their relevant public authorities the power to review how classes were formed in all cases where official confirmation of the plan is required. However, Member States would be well advised to make use of the option in the second paragraph of Article 9(5) and vest in their public authorities the power to review class formation at an earlier stage on a pre-emptory basis, where a party in interest requests such a review. Even if a pre-emptory review of this sort is not binding on appeal (which it probably should not be, lest legal development in this important area be stalled), it might still give parties to the process important indications as to the likely legitimacy (or otherwise) of the way the classes were defined in the proposed Restructuring Plan. This, in turn, may lead to negotiated solutions, rather than to litigation and appeals.

73. The exact same considerations apply to official decisions on voting rights and valuations as well.

IV. VOTING ON THE RESTRUCTURING PLAN

(A) *Ex post* and *ex ante* adoption of the Restructuring Plan

74. Although much of the Directive is drafted with the assumption that the process of putting together and approving the Restructuring Plan will unwind prospectively, whereby a debtor applies for the stay, obtains a time period to come up with a proposal of a plan which will be disclosed and then voted upon by investors, Recital 43 and Article 9(7) make it very clear that this is not the only option. The restructuring process may also unwind retrospectively, as it were. In such scenario, the debtor would negotiate the restructuring transaction privately with a substantial proportion of its investors, document the agreement reached in the form of a Restructuring Plan, and file such plan as a "done deal", either on the basis that sufficient majorities of votes have already been reached in all classes or, if this is not possible, then on the basis that certain key classes have already adopted the plan. The clear benefit of the latter approach rests in the fact that in it, what the debtor presents to the public and to the markets is a solution (or a near solution) enjoying the support of a significant part of its investors. By contrast, in the former, prospective approach, what the debtor presents publicly is the admission that it has got a very serious financial problem and that it will now work to propose a solution to it whose success can, however, not be guaranteed.

75. The latter approach could also be labelled as the "preventive pre-pack" and it should be quite clear which of the two approaches is more likely to bring about successful restructurings. Member States would be well advised to implement the Directive such that the latter, retrospective approach, is facilitated as much as possible, rather than complicated or even obstructed.

(B) Majorities required for the adoption of a Restructuring Plan within a class

76. It has been said above that at its core, the Restructuring Plan is a contract, albeit one that is entered into on the basis of majority decision-making rather than on the basis of unanimity.

77. In this analogy, it is also clear that the restructuring "contract" is actually entered into among the investor classes, not the individual investors. The individual investors in turn co-form the will of the class into which their claims or interests were put. They do so by way of voting with their claims or interests for, or against, the adoption of the Restructuring Plan.

78. As in corporate law and all other collective decision-making processes, the policies behind majoritarian voting rules are clear. While unanimity prevents value redistribution (assuming full rationality of agents), it allows for tactical refusal to agree with the aim to extract private rents, often referred to as "hold-out" in restructuring jargon.

79. The art of choosing the right majority rule lies all in the balancing of the two countervailing risks – the risk of tactical abuse of the majority, against the risk of tactical abuse of the veto power of the minority (see Recital 47).

80. Article 9(6) gives Member States a lot of freedom in defining the majority rules within classes. Its first paragraph provides that "a restructuring plan shall be adopted by affected parties, provided that a majority in the amount of their claims or interests is obtained in each class. Member States may, in addition, require that a majority in the number of affected parties is obtained in each class." The second paragraph adds that "th[e] majorities [prescribed by the Member States] shall not be higher than 75 % of the amount of claims or interests in each class or, where applicable, of the number of affected parties in each class."

81. It is thus clear that the Directive only prescribes two firm voting parameters. First, Member States must base the voting on the capital stakes of the affected investors. And second, the required majority for the adoption of a Restructuring Plan in a class may not be higher than 75% of the amount of the capital put into that class. Everything else is in the discretion of the Member States.

82. In order to help use that discretion, this Note would respectfully submit the following:

    (i) Adopting a numerosity test (i.e. a requirement that within a class, the plan is adopted not only by the prescribed majority in terms of capital but also it terms of the number of investors) is questionable at best, and may even be downright harmful to restructurings. Experience shows that, in particular in classes including larger numbers of smaller claims, the requirement to reach majorities in numbers might inadvertently trigger the need to use the cram-down feature even where the outcome of the vote based capital would not do so. When trying to protect the interests of small or otherwise vulnerable claimants (an argument traditionally used in support of the numerosity test), Member States would be better advised to make use of the tool of formation of separate classes pursuant to Recital 44 and Article 9(4)(see Section III(C) above).

(ii) When construing majority rules, one must always start with defining the denominator – i.e. decide whether the majority will be counted based on all of those entitled to vote, or only of those present. If one decides for the latter, one will also need to consider whether a minimum attendance, i.e. a quorum, should be required (Recital 47 *in fine* refers to this as the "participation threshold" and expressly allows Member States to introduce the rule). One must also remember that where national law provides for the "preventive pre-pack route", there might be no creditors meeting at all and reference to those "present" might be confusing; the majority rule might thus need to be appropriately tailored towards the "preventive pre-pack".

(iii) The prescription of a quorum is unlikely to be helpful in the restructuring context. Unlike in corporate law where a quorum is often required for a general meeting and may only be dropped if the first time round, the general meeting is not quorate and another one must be called, there may simply not be any second chance in a restructuring context.

(iv) Of course, not having a quorum means that provisions on notice and service will be quite important (see Recital 51 and Article 10(2)(c)).

(v) A majority of 75%, even if counted from the capital stakes of those present or otherwise casting a valid vote, is quite high and may result in restructurings failing or in the cram-down feature being triggered where this might not otherwise be warranted. Member States could usefully explore lower majorities.

V. MANDATORY OFFICIAL CONFIRMATION OF THE RESTRUCTURING PLAN: CONCEPT AND PURPOSE

83. Recital 48 and Article 10(1)(a) assure that confirmation of the Restructuring Plan by the relevant public authority will be the rule, not the exception. In practice, it will be quite rare for a plan to find 100 per cent. acceptance in all classes. The term "dissenting affected party" clearly refers to an investor who actively votes against the adoption of the plan (as opposed to not participating in the process or abstaining from the vote). Such votes will routinely be cast (otherwise, the debtor would not have needed to use the EU Restructuring Framework in the first place), which will land the Restructuring Plan in front of the relevant public authority under Article 10(1)(a). (At times, the concept of "dissenting affected parties" may need to be interpreted more broadly, for example so as to include parties who did not vote against the plan because they could not. This might be the case of investors or other claimants who have been labelled as "unaffected" and thus been excluded from the vote, but who

assert that their claims or interests are actually being affected by the plan and accordingly, should have been allowed to vote (see section I(E) above).

84. In order to succeed, individual dissent which does not command enough votes to sway an entire class into voting against the Restructuring Plan will need to challenge the plan on some grounds other than the individual dissent as such (otherwise, majority decision-making within classes would be meaningless).

85. The Directive lists five possible grounds of such challenge by way of listing, in Article 10(2), the conditions for confirmation of the Restructuring Plan by the relevant public authority. Article 10(2) makes it clear that these five conditions – adoption of the plan by the requisite majorities in investor classes, equal treatment of similarly positioned creditors, notification of the plan to affected parties, satisfaction of the best-interest-of-creditors test, and new financing, if any, being compliant with the prescribed protective criteria – are not exclusive. Indeed, Recital 50 confirms that Member States may legislate for other conditions required for the confirmation of the Restructuring Plan, and thus for other grounds of challenge against it.

86. Recital 50 and Article 10(3) list one such possible ground, being the commercial non-feasibility of the proposed restructuring measures. This Note respectfully suggests that involving public authorities in the business of second-guessing commercial decisions made by investors deciding about their own capital investments is a questionable use of public resources, and is unlikely to provide much meaningful protection to dissenting affected parties nor to improve a Member State's overall macro record in restructurings.

87. On the contrary, public authorities would be much better placed to examine the overall legality of the proposed Restructuring Plan (beyond the features expressly listed in Article 10(2)) and Member States could usefully consider legislating for such an overall legality test.

88. Perhaps even more importantly, public authorities would by definition be the only player who can be tasked with policing the honesty of the entire restructuring transaction, *via* administering a good faith test or a similarly labelled anti-fraud provision. The tight time frame, the pervasive information asymmetries, and the valuation uncertainties involved in situations marked by financial distress provide fertile ground for abuse and Member States would be well advised to put in back-stops against restructurings transactions which "go through the motions" but are fraudulent or otherwise abusive under the surface. Of course, Member States should be mindful of the limitations of their own institutions – entrusting an openly-worded principle to an authority who cannot be trusted to administer it competently and in good faith might make the cure worse than the disease.

89. One specific context in which the outcome of a non-consensual restructuring will turn on the decision-making powers vested in the relevant public authority's is the power to confirm a Restructuring Plan even though it has not been adopted by all classes of affected creditors, a concept to which the Directive refers as the cross-class cram-down.

VI. CRAM-DOWN: GENERAL CONSIDERATIONS

90. Cross-class cram-down allows a Restructuring Plan to be confirmed even if such plan has not been approved by each and every voting class (Article 11(1)). This Guidance Note will refer to a Restructuring Plan supported by each and every class as a "Consensual Plan", whilst a plan that is not supported by all the voting classes will be referred to as a "Non-Consensual Plan".

91. Cross-class cram-down in the Directive is inspired in the US Chapter 11 model. The inclusion of cross-class cram-down in the Directive has been labeled as one of its main breakthroughs. Cross-class cram-down aims to sort out collective action problems: it enables restructuring plans to be adopted in situations where otherwise a plan could have failed due to it been vetoed by a dissenting class (usually, in practice, a junior, out-of-the-money class – typically equity-holders). A system that allows the veto of a dissenting class is creating the ability for this kind of classes to hold-out and to condition their support on some sort of private benefits being offered to them. In this context, cross-class cram-down eliminates the risk of class hold-out, just as the majority rule (or democratic decision-making) applied within a class (intra-class cram-down) limits the risk of individual hold-out. Therefore, the hold-out problem, as the main factor that jeopardizes viable restructuring plans, is only correctly tackled if both the risk of individual and class hold-outs receive an adequate legislative solution through, respectively, the majority rule (intra-class cram-down) and cram-down (cross-class cram-down).

92. Cross-class cram-down (to which we will also directly refer to as "cram-down") is a powerful restructuring resource in the tool-kit, although for its proper functioning it must also be accompanied by a careful regulation of "class formation" (see section III above) and "enterprise valuation" (see section X of this Guidance Note). "Class formation" and "enterprise valuation" are the instruments that allow the determination of which classes are in-the-money or out-of-the-money.

93. The main additional requisite that a Non-Consensual Plan shall meet (on top of ordinary requisites that apply to a Consensual Plan) in order to be confirmed is the fairness test. The fairness test is composed of three sub-tests:

    (i) The "priority rule", which may be the "absolute priority rule" ("APR", Article 11.2: "claims of affected creditors in a dissenting voting class [shall be] satisfied in full by the same or equivalent means where a more junior class is to receive any payment or keep any interest under the restructuring plan ") or its alternative in the Directive, the "relative priority rule" ("RPR", Article 11(1)(c) in fine: "dissenting voting classes of affected creditors [shall be] treated (…) more favourably than any junior class");

    (ii) The "corollary" to the priority rule (Article 11(1)(d): "no class of affected parties can, under the restructuring plan, receive or keep more than the full amount of its claims or interests"); and

    (iii) The "no unfair discrimination principle" (Article 11(1)(c): "dissenting voting classes of affected creditors [shall be] treated at least as favourably as any other class of the same rank").

We will refer as "the fairness test" to the combination of the priority rule (be it APR or RPR), the corollary of the priority rule and the prohibition of unfair discrimination.

94. Classes that are out-of-the-money are eligible to be crammed-down. Also, out-of-the-money classes cannot seek that a Plan is crammed-up on dissenting in-the-money classes (see Article 11(1)(b)(ii)). Therefore, only in-the-money classes have the right to seek that more junior in-the-money or out-of-the-money classes are "crammed-down", but also that more senior in-the-money classes are "crammed-up". Due to the eloquence of the term, we will refer as "cram-up" to the cramming-down of more senior (in-the-money) classes than the class proposing the Non-Consensual Plan (by definition, also an in-the-money class).

95. Cram-down means the fact of imposing on dissenting classes, by virtue of the plan confirmation, the specific contents that the Plan sets forth for the specific dissenting class. The Directive allows very ample latitude as to the contents of the Plan, and thus also as to the contents of the cram-down (see Article 1(1): "restructuring means measures aimed at restructuring the debtor's business that include changing the composition, conditions or structure of a debtor's assets and liabilities or any other part of the capital structure").

96. The contents of the Plan that may be crammed-down on dissenting classes of creditors can therefore be debt-to-debt conversions, debt-to-assets conversions, debt-to-equity conversions or a combination of these conversions. The Plan may of course also set forth the full write-off of certain classes of claims or interests, when these are out-of-the-money.

97. The contents of the Plan may also be imposed on equity-holders. The Directive leaves to Member States the decision as to the ability of the Plan to affect equity-holders (Article 12).

98. Should equity-holders be eligible to be affected by the Plan, then determining whether the shareholders are in or out-of-the-money is made by setting out the value of the business in a vertical line alongside the classes in the capital structure listed in descending order, to find the class where the value breaks. This Guidance Note will refer as "fulcrum class" to the class where the value breaks, and it may or may not be the class of the pre-existing shareholders.

99. The company's shares may end up in the hands of different holders according to whether the company's plan is consensual or non-consensual. In the event of a Consensual Plan, supported by a majority of the value within each of the relevant classes, the shares must be allocated as set out in the plan, and the fairness test does not have to be fulfilled. This means that the post-restructuring shares may end up in the hands of the existing shareholders, be distributed among all the classes, or be allocated in whatever way the classes agreed among themselves. In the event of a Non-Consensual Plan, only then must the fairness test be fulfilled, and as a result the shares must be allocated (should the APR be applicable – no ex ante visibility with RPR) to the fulcrum class, which will be the class of the pre-existing shareholders if they are in-the-money, or in whichever other class in which the value breaks if the shareholders are out-of-the-money.

100. The valuation of the enterprise is necessary to determine the write-off or unsustainable portion of the debt, which in turn will determine the content over time of the Plan's measures restructuring the debtor's liabilities. But the write-off also constitutes the amount of the premium that the class of shareholders must pay for exercising their cram-up right and their pre-emptive right in any capital increase contained in the Plan (see section VII.E). However, the premium that the existing shareholders must pay for exercising those pre-emptive and cram-up rights does not contain the whole amount of the write-off that they intend to impose on all the classes of creditors – instead only the debt write-off for the dissenting classes. In fact, if the accepting classes voluntarily consent to a debt write-off, it is not included in the premium that the class of the proposing shareholders must pay. The comments made in this paragraph in relation to the class of shareholders apply by substitution in relation to the fulcrum class, where the shareholder class is out-of-the-money.

101. In case the condition of a certain class as in-the-money or out-of-the-money is disputed, such dispute shall be channeled by means of a valuation challenge against Plan confirmation (Article 14(3)). Member States shall regulate the challenges against the Plan, and whether challenges shall be part of a possible appeal or be substantiated otherwise (Article 14(3) in fine).

102. Member States shall provide for cross-class cram-down when implementing the Directive. However, as mentioned, the Directive leaves to the Member States the decision on whether the class/es of equity-holders shall be eligible for cram-down, or whether only creditor classes shall be eligible (Article 12, see section VII.A below). Besides, the Directive allows the Member States to decide on certain important details regarding the cram-down conditions.

103. For a Non-Consensual Plan to be crammed down on dissenting classes, it shall fulfil, apart from the regular conditions of a Consensual Plan (Article 11(1)(a)), also the following requisites:

   (i) An alternative requisite that replaces the need for all-class support as in a Consensual Plan (Article 11(1)(b)): this Guidance Note will refer to this alternative requisite as "the minimum support test". The Directive allows Member States to incorporate the minimum support test by requiring either the support of a "majority of classes", either the support of "at least one in-the-money class" (see section VII.C below).

   (ii) An additional requisite as compared with a Consensual Plan (Article 11(1)(c) and 11.(1)(d)): this Guidance Note will refer to this additional requisite as "the fairness test". The Directive permits Member States to incorporate the fairness test through the "absolute priority rule" (which Members States may implement by way of an opt-out) or by means of the so-called "relative priority rule" (the default option in the Directive's scheme) (see section VII.D below).

104. The cram-down options granted by the Directive to the Member States are analyzed more in-depth below.

VII. CRAM-DOWN: THE OPTIONS IN THE DIRECTIVE

(A) Equity-holders being affected by the Plan as opposed to a duty being imposed on them to not obstruct the Plan

105. Equity-holders may pose two kinds of hold-out problems in a restructuring. The first hold-out problem consists of equity-holders not approving in the general shareholders meeting a debt-for-equity swap that is embedded in the restructuring plan adopted by creditors. The second hold-out problem consists of equity-holders instructing the debtor's directors to not submit or approve a restructuring plan proposed by creditors. This section is dedicated to the first hold-out problem. The second hold-out problem will be analyzed in section (B) below.

106. The Directive grants two alternatives for the Members State to tackle the hold-out problem of equity-holders. The first alternative is to allow restructuring plans to affect equity-holders (i.e. even in case the general shareholders meeting is against a certain content of the restructuring plan, for instance, a debt-for-equity swap). That alternative entails to apply the cram-down (Article 11) to classes of equity-holders – just as to any other class of affected parties. Member States will then still have to decide whether the position of classes of equity-holders vis-à-vis a restructuring plan is expressed in accordance with the formalities set forth in general corporate law; or whether equity-holders are to be simply granted the rights –information, meeting, voting, challenge– that any other affected party will have under insolvency and restructuring law.

107. This Guidance Note respectfully suggests that the latter option is the more workable one. Not only will it obviate the need to legislate for the interface between the EU Restructuring Framework and corporate law, a task which the Guidance Note considers non-trivial. But it will also bind equity into the entire restructuring process, making sure that there is a level playing field among all the investor classes and thus, in constitutional terms, that equity has little grounds for alleging violations of the right to own property or the right to fair trial in case that the Plan needs to be crammed down on it.

108. The second alternative offered to Member States by the Directive is to impose on equity-holders a duty to not "unreasonably prevent or create obstacles to the implementation of a restructuring plan" (Article 12). The enforceability of such duty is less clear than the enforceability of the cross-class cram-down regime. As with the two options mentioned immediately above, it is not clear to this Guidance Note how the interface between corporate law and the EU Restructuring Framework would operate in order to be effective in the tight time frame required for restructurings to succeed. The difficulties and potential traps seem manifold, starting with potentially diverging court or administrative jurisdiction over each side of the process, and ending the formulating the relevant substantive rules in the corporate law code.

109. The Guidance Note respectfully suggests that legal regimes whose Plans are able to affect equity-holders are likely to be more effective than regimes whose plans are unable to affect equity-holders. In jurisdictions where existing plans are incapable of being crammed-down on shareholders, the situation has been criticized by reputed academics. The Directive orders all Member States to reach the same goal of equity not being able to strategically obstruct a restructuring if the equity is out-of-the-

money. The Guidance Note would respectfully suggest that achieving that goal via including equity into the EU Restructuring Framework by treating it as a class for the purposes of voting on, confirming, and performing the Plan, is likely the more feasible option that trying to legislate for equity not being able to obstruct the restructuring transaction while leaving it outside the EU Restructuring Framework.

110. The Directive grants permission to depart as appropriate from the Second Company Directive (Article 32) to Member States that opt to allow Restructuring Plans to affect equity-holders. This now permits Member States to no longer require, in the framework of a Restructuring Plan, the general shareholders' meeting consent for capital increases or reductions, as well as to exclude shareholders' preemption rights in the case capital increases. Capital increases are the legal instrument necessary to articulate debt-for-equity swaps, either on a stand-alone basis (in which case the preexisting shareholders are merely diluted – to a lower or greater extent depending if preemptive rights are recognized in a rights issue or if preemption is excluded), either in combination with a previous capital reduction and simultaneous exclusion of the preemptive rights (in which case the preexisting shareholder may be, not only diluted, but also completely wiped-out). By derogation of the Second Company Directive, this latter result may now be achieved without the need to count with the general shareholders' meeting approval of the corporate decision in question (capital increase or reduction, or exclusion of preemptive rights).

(B) The debtor's initiative or approval in relation with the cram-down application

111. The second hold-out problem (directors not submitting or not approving a plan supported by creditors) is also tackled in the Directive (Article 9(1) in fine and Article 11(1), penultimate paragraph). The Directive permits Member States to only require the debtor's consent (i.e. expressed through its directors, who may be inclined to favor shareholders, even when these are conflicted with creditors and only the latter are in-the-money) as a requirement for plan confirmation, in the case of SMEs.

112. This option is consistent for Member States that opt for equity-holders cram-down (see section (A) above). Cram-down will most often be used in practice against junior classes – and thus against equity-holders, as the most junior class of the capital structure. Should debtor consent be required for a plan to be confirmed, equity-holders cram-down would likely be useless: the debtor (represented by its directors, who in turn may have been instructed by equity-holders themselves, or may indeed be the shareholders, as will be the case in many closely-held companies) would most probably not consent to a plan entailing shareholders cram-down. Such a plan would therefore meet the equity-holder cram-down requirements in order to be confirmed, but would not have met the requirements to be adopted in the first place if it lacks debtors' (i.e. directors) consent.

113. The need of debtor's consent is closely linked with a number of related matters.

114. First, if a given Member State opts for requiring debtor consent only for SMEs for the purpose of Article 11(1), then such Member State shall take a consistent decision for the purpose of Article 9(1): i.e. the initiative to propose or submit a Plan. Ex-ante consent to submit a Plan (i.e. initiative to propose a Plan) is the flipside of the ex-post consent to agree with a Plan. Of course, in case a Member State opts to grant the initiative to propose a Plan to creditors or to practitioners (Article 9(1)), then this must

reasonably follow that no debtor's consent shall be required for the confirmation of such a Plan.

115. Second, the option for requesting debtor consent only to SMEs restructuring is also related with the option under Article 4(8). However, in this latter case the option for Member States to allow that all the restructuring frameworks (and not only the Plan) are readily available not only to the non-SME debtor, but also to its creditors, is not necessarily a matter of consistency. It may be sound to consider that if a Member State allows for creditor-led Plans in non-SMEs, then the proposer of the Plan (be it the debtor or the creditors) shall have resort to the same panoply of restructuring frameworks or flanking measures (stay, appointment of a practitioner, etc.). But it does not necessarily have to be that way. It all depends on to whom the Member States wants to give the initiative to trigger restructuring negotiations – whose mere existence may affect the debtor's activity, the shareholders' investment and the directors' strategies. Permitting creditors to propose, for non-SME debtors, not only a Restructuring Plan, but also all the rest of restructuring frameworks, is therefore a function of how broad or narrow is the entry test: the broader the entry test to resort to the restructuring frameworks, the narrower the legal standing to initiate them should be.

116. Third, the initiative to propose a Restructuring Plan may be staggered in time in favor of the different stakeholders. For instance, the debtor may have exclusivity to propose the Plan for a certain period of time (exclusivity period). Once such period has elapsed, creditors gain the right to propose their own Plan. The Directive does not refer to such possibility, but does not prevent it either. All in all, bearing in mind that a restructuring should be run as an auction (with certain priority rights in favor of equity-holders in certain cases: see section VII.E below), the more parties have standing to propose competing plans during the very same time period, the more equilibrium and chances exist for stakeholder classes to reach a Consensual Restructuring Plan.

117. Fourth, granting the initiative to propose the Restructuring Plan to creditors and/or practitioners is also related to the matter of directors' liability. Should creditors not be allowed to propose their own Plan directly or indirectly (through a practitioner), then the directors of the debtor shall be more aware and sensible regarding the creditors initiatives. Indeed, in case the Plan proposed by the debtor's directors (i.e. the only Plan in case no right of initiative is acknowledged to creditors) fails due to the directors taking into account the shareholders position rather than the creditors', then the directors' liability may be at stake should the Plan failure entail the loss of the going-concern surplus.

118. Finally, Member States that opt to circumscribe the need for debtor's consent to SMEs shall clearly define the concept of "SME".

(C) The minimum number of classes requirement

119. Article 11(1)(b) of the Directive sets forth the minimum support test and provides a number of options to the Member States as to the number of classes and requisites that they shall meet for Plan confirmation.

120. The first option consists of setting the minimum support at “a majority of the voting classes of affected parties, provided that at least one of those classes is a secured creditors class or is senior to the ordinary creditors class” (Article 11(1)(b)(i)). This option is based on German law and requires a high threshold support, whilst not necessarily granting a higher degree of protection to dissenting classes from a fairness perspective. Indeed, on the one hand, the majority of classes may be obtained by gerrymandering (i.e. the proposer of the Plan artificially breaking down the capital structure into many small classes so as to assure that friendly creditors are present in a majority of such classes, whose support is not necessarily representative of the fairness of the Plan). On the other hand, the fairness of a Plan is measured, by applying the relevant priority rule and its corollary to value distribution amongst the classes, and the best-interest-of-creditors test. As long as the APR is respected, the fairness test is assured, no matter if many or few classes support the Plan. One sole class support would be sufficient (“somebody has to like it”) and is the minimum required according to US standards.

121. Actually, the second option that the Directive offers is to only require the support of at least a single class. However, as opposed to the US, where a single class support is sufficient for the plan confirmation (as long as it also complies with the fairness test), the Directive requires, with a complex drafting (Article 11(1)(b)(ii)), that that single class is also in-the-money. Truth is that the requirement that the single class supporting the Plan is an in-the-money class is futile: if final valuation is not determined until a challenge is ultimately resolved, the proposing class, even if out-of-the-money, will claim that it is in-the-money until the competent body determines on the contrary. Therefore, it is trifling to set forth a legal standing requisite (being an in-the-money class) whose occurrence, if contested, will not be determined until the end of the process. Besides, the fairness test (Article 11(1)(c) and (d)) is a different requisite for Plan confirmation than the minimum support test (Article 11(1)(b)). Requesting that the single supporting class is in-the-money implies mixing both tests altogether and incorporating the fairness test into the minimum support test. All in all, Article 11(1)(b) still allows Member States to follow the US standards by laying down that only a single class approval is required for Plan confirmation, even if that single class shall be an in-the-money class.

(D) The priority rule option: Absolute Priority Rule (APR) VS. Relative Priority Rule (RPR)

122. The basic premise for any restructuring is that, in economic terms, it involves a sale of the business. It is not conceptually different therefore from liquidation, which is also a sale of the business. The only difference lies in who buys the business – a new investor (in an actual sale transaction) or the current investors (who notionally "acquire" the business by exchanging their current claims on the debtor's assets for new claims issued under the Plan). This difference obviously carries a number of legal consequences that set liquidation and restructuring apart. But these legal consequences should not cloud the fact that liquidation and restructuring are essentially alternative means of achieving a very similar end. The key difference being that in a restructuring, the restructuring value differential (generated by the fact that an actual distressed sale conducted at a depressed price is avoided) is kept by the current investors, whereas in a liquidation, where the business is actually sold amidst distress, it is lost with the winding-up of the old debtor entity.

123. Therefore, in liquidation, the company is wound-up and its enterprise is sold to a third party, who pays a price for it, and that price is then distributed in cash among the creditors. In a restructuring, the enterprise is not actually sold to a third party, but instead it is "notionally sold" to the creditors themselves[1].

124. The reason why creditors may decide to take over ownership of the company themselves instead of selling it to a third party lies in the existence of a going-concern surplus. The going-concern surplus is the greater value that is obtained by restructuring the company (going-concern value) compared with the value that is obtained by transferring the enterprise in a unitary transaction (in other words, unitary liquidation value –keeping the business as a going concern–, as opposed to the fragmented or piecemeal liquidation of the company's assets). In the absence of going-concern surplus, a restructuring is not justified: the creditors would be better served by carrying out a unitary liquidation of the company, which will give them the same or greater recovery of their claims immediately and in cash. Restructuring a company without a going-concern surplus by definition does not satisfy the best-interests-of-creditors test.

125. Where creditors take ownership of the company through a restructuring, paying them is not as straightforward as in liquidation. With a few exceptions, creditors cannot be paid in cash, because there is no sale to a third party and no price to be distributed either. As a result, creditors are paid in kind, in new claims issued to them pursuant to the Plan in exchange of their old claims: the way to conceptualise the "notional acquisition" of the company by the existing creditors is to think about the debt and equity instruments (whether incorporated into securities or not) that the restructured company should now able to honour based on the value of the restructured enterprise. The enterprise value, in turn, is a function of the net present value of its future revenues. The debt and equity instruments combined capture by definition the aggregate enterprise value and, as elements of the new capital structure of the debtor company, they will also represent its ownership structure. The old creditors will thus have notionally taken ownership of the company instead of selling it to a third party.

126. Since, under this analytical approach, restructuring amounts to a sale of the company to its creditors, the main difference between liquidation and restructuring is how the value realised is distributed in each scenario. Whereas liquidation consists of distributing the liquidation value in cash among the classes of creditors according to their priority rankings, restructuring consists of distributing the restructuring value (Recital 49) among the classes of creditors in kind, according to the same priority ranking. So the absolute priority rule simply amounts to applying the priority rankings -determined for liquidation- to distribution among the classes of the restructuring value.

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[1] TOLLENAAR, N. "Pre-insolvency proceedings: A normative foundation and framework", Oxford University Press 2019 (p. 42 et ss.): *"In some circumstances the business can only be sold (as a going concern) for cash at a price that is far below the perceived value of the business. In these circumstances it might be a more attractive option for the creditors to acquire (and thus refinance) the business themselves rather than selling it to a third party for cash. If the creditors do acquire the business, its value is distributed amongst them in the form of various financial instruments. In that case, there is no liquidation (sale to a third party for cash) and subsequent payment in cash. The value of the business is distributed directly to creditors in non-cash form. The financial restructuring of an insolvent business is nothing more than a collective enforcement against the value of the business whereby the value is distributed in non-cash form, i.e. in kind, rather than in cash."*

127. Two important consequences ensue from this fairness test as application of the order of priority in liquidation to the restructuring value.

128. The first is that, for the system to be consistent, the priority rankings must be the same in liquidation and restructuring: we may refer to this as the “principle of retrospective application of the insolvency law rankings” in the event of restructuring. Otherwise, if the system allows a preferred creditor in restructuring to be subordinated in liquidation, the best-interest-of-creditors test would not allow a uniform comparison. Therefore, because the Restructuring Directive sets out in its definition that creditor’s “rights and seniority” shall be observed in class formation (Recital 44), then the liquidation rules in the Member States should also recognise inter creditor agreements, which are the covenants typically entered into by the different members of the capital structure.

129. The second consequence is that the relative priority rule (“RPR”) that the Restructuring Directive legislates for as the default solution (Art. 11(1)(c) and Art. 11(2)) should be approached with caution by Member States.

130. The relative priority rule seems to have been introduced in the Restructuring Directive at the last moment of the legislative process as a result of the so-called “Codire Report” released in July 2018, entitled “Contractualized distress in the shadow of the law”. Its consequences on the provision of credit were not considered in the impact assessment of the Directive.

131. The relative priority rule was introduced as an alternative option to the absolute priority rule (“APR”).

132. Certain academics have already raised a number of concerns in relation with the relative priority rule, which may be summarised as follows: (1) RPR may allow for transfers or redistributions of value, and therefore its adoption should be expressly justified by the specific reasoning behind that redistribution and an economic study of its impact should first be made (the relative priority rule may allow that, for instance, a secured creditor shall not be paid in full before a junior debtor, but instead receive only one euro more); (2) Liquidation is after all a sale of the business, as is restructuring, and it is doubtful whether the fact of the sale being to a third party or to the creditors themselves is sufficient justification for giving asymmetrical effects (in liquidation or restructuring) to the priority rankings; (3) RPR distorts the rankings agreed among creditors, and affects ex-ante credit concession; (4) RPR creates legal uncertainty for both investors and judges over the exact amount of incremental value that constitutes “better treatment” of the senior class over the junior class; (5) RPR casts a perverse shadow under which to negotiate, because it gives an incentive to more junior shareholders not to reach consensual plans, but to run the risk to see how the judge will interpret “better treatment”; (6) RPR affects corporate governance by further complicating the determination of which will be the fulcrum class that would entitled to the post-restructuring equity in the absence of consensus among the classes of affected parties; (7) RPR associated uncertainty has an adverse effect on securing the highest price for the sale of non-performing loans; (8) RPR disregards the target of restructuring (pre-existing claims and interests), and therefore ignores that if it is sought to allow equity holders to be rewarded for remaining involved (Recital 56), it is possible to do so on the basis that the possible value that they are to receive under the plan is not a consideration for their pre-existing claims (which the RPR aims to

maintain alive), but a consideration for the future value they are to contribute post-restructuring (which is known as the "new value doctrine" in the U.S.).

133. Therefore, Member States should carefully consider whether it would not be wiser to adopt the tested and well-understood absolute priority rule (Art. 11(2)), perhaps with such modifications as the MS finds fitting for its markets, rather than adopting an untested model based on relative priority rule (Art. 11(1)(c)), in spite of the Directive formulating the latter as the default solution.

134. The operation of cross-class cram-down based on APR has been described many times in legal and economic literature. The practical functioning of a cram-down based on the RPR has not been described to date.

(E) Cram-up as a variation and counterpoint of cram-down: rights of junior classes when they are in-the-money

135. In the field of restructuring, the U.S. Chapter 11 USC system creates a neutral and level playing field which, in abstract, does not appear to especially benefit either shareholders or creditors. Under this system, neither one group nor the other is able to have, simultaneously, absolute legal rights or veto rights that may lead to a bilateral monopoly impasse. Shareholders do not have an absolute right to veto a debt-for-equity swap, and creditors do not have an absolute right to be repaid in cash either.

136. By contrast, under that system, if the shareholders are out-of-the-money (because the company's enterprise value is below the value of its debt), the shareholders may be wiped-out of the capital structure by the creditors in a cram-down. But if shareholders are in-the-money (because the company's enterprise value is higher than the value of its debt), then it is the shareholders who are able to cram-up the creditors, by imposing on them a plan which, while repaying them in full, does not do so in cash but in kind.

137. It must be noted that, for the system to be balanced, the creditor's ability to wipe out a shareholder who is out-of-the-money in a cram-down must have as its counterweight the ability of the shareholder in-the-money to cram-up, and impose payment in kind on, the creditors.

138. This is how the U.S. legal system by which the Restructuring Directive has been inspired manages to disentangle the bilateral monopoly typically occurring in restructurings.

139. In short, the system induces a scenario in which, unlike what is generally happening now in the European Union, it is not the party that has less to lose that is better able to negotiate, but the party more certain of its enterprise valuation and where value breaks.

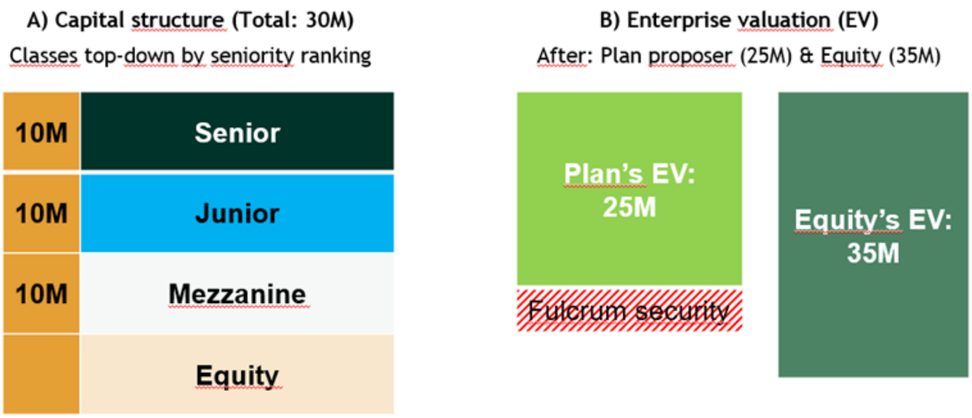
140. A condition for the pre-emptive rights of shareholders is that they must be in-the-money. Shareholders are presumed to be in-the-money where the entry test for collective action legal mechanisms based on technical insolvency (be it insolvency, pre-insolvency or likelihood of insolvency) does not exist. If the entry test is met, where the shareholders are out-of-the-money, they will not have any pre-emptive right whatsoever, because the value of the enterprise will not give backbone to their legal

position which is merely formal. Whereas if the shareholders are in-the-money, their priority must play out on two complementary levels: they should have a pre-emptive right in relation to any necessary capital increases; and they should also have a cram-up right in relation to creditors through payment to them in paper. If technical insolvency exists and the shareholders are out-of-the-money, the pre-emptive rights and cram-up rights should not be for the shareholders but for the creditor class in which the value breaks – the fulcrum class in other words.

141. The allocation of pre-emptive and cram-down rights to the fulcrum class (either the shareholders or another class) entails the right to propose a restructuring plan that will articulate those rights. When implementing the Directive, Member States should thus carefully lay down the rules regarding initiative to propose a Plan and the possible substantiation of competing Plans.

VIII. AN EXAMPLE OF CRAM-DOWN APPLYING THE ABSOLUTE PRIORITY RULE (APR)

142. The best way to illustrate how the APR works is to use an example. Imagine a cross-class cram-down mechanism designed to restructure the following capital structure:



143. The left-hand side lists, by order of priority, the different classes of creditor (with the nominal value of their claims) as well as the shareholders' class ("Equity"). The right-hand side contrasts the two restructuring values of the undertaking: the value of the proponent of the Plan (the class we will refer to as "Mezzanine" or "Mezz") and the value of the dissenting class that seeks to challenge the Plan (the "Equity" class). The other classes ("Senior" and "Junior") have not attained the relevant majority in favour of the Plan. Consequently, the Mezz class (proponent of the Plan) has to ask for the Plan to be imposed on the dissenting classes by means of a cram-down, evidencing fulfilment of the relevant requirements. Of the dissenting classes, only the Equity class seeks to challenge the Plan.

144. Imagine that the Plan proposed by the Mezz class has the following terms: the Senior class receives 100% in cash immediately on the date when the Plan comes into force. Consequently, that class is not affected by the Plan and therefore has no voting right (it is presumed that, since the Senior class will be paid in full and immediately in cash, it will vote in favour of the Plan). The Junior class is indeed affected and is therefore entitled to vote: the Plan provides that the creditors in the Junior class will

recover 100% of their claims subject to a 2-year deferral and with market interest such as to ensure that the net present value of those debt instruments is equivalent to the nominal value of their claims (even though their claims are exchanged for a debt instrument of equivalent and not inferior value, the creditors must nevertheless be regarded as affected by the Plan because the payment they will receive is not immediate but deferred). The Mezz class (proponent of the Plan) is also affected by the Plan and is the only class to attain the relevant majority: the Plan provides for payments subject to a 30% write-off and a deferral of 5 years and, importantly, provides for the receipt of instruments representing 100% of the post-restructuring equity of the debtor company. Lastly, the Equity class is also affected. The members of that class receive nothing under the Plan, no debt instruments, and do not retain any stake or interest in equity (having been replaced by the Mezz class). They do not vote in favour of the Plan and challenge it. The enterprise value according to the Mezz class's Plan is €25 million. By contrast, according to the Equity class challenging the Plan, the enterprise value is €35 million.

145. We will now see whether the Plan abides, not with the general requirements (on viability, etc.), but with the specific additional requirements which would allow it to be confirmed (absolute priority rule) and therefore to cram-down the dissenting classes:

(i) We have seen that since the Senior class is not affected by the Plan, it is presumed to vote in favour of it. If the Senior class does not receive payment of its claims in cash, in full and as soon as the Plan comes into force, it may bring an action for breach.

(ii) The Junior class is the most senior class to be affected. It must be examined whether the Plan complies with the absolute priority rule with respect to that class. The conclusion is that it does: the members of the Junior class receive a debt instrument with a net present value equal to the nominal amount of their claims. The members of that class are not immediately repaid in cash like the Senior class. But they are paid in full, albeit on paper rather than in cash; their original claims have been paid without any write-off. The requirement of the APR is therefore met so that the next class, the Mezz class and proponent of the Plan, may therefore receive the distributions provided for in the Plan.

(iii) The Mezz class is the proponent class and receives debt instruments until the difference between the sum of the instruments of the higher classes and the enterprise value is used up. Additionally, the Mezz class receives the entire post-restructuring equity as a consequence of being the fulcrum class or class in which the "value breaks": the shortfall in recovery of the nominal values of their claims (highlighted in red in the diagram) is the reason for that class receiving 100% of the equity instruments in return.

(iv) The Equity class is apparently the class most adversely affected (to the point that it is not only affected but also "impaired" according to the Directive's terminology) by the Plan as its members receive no consideration under the Plan and lose any interests (such as equity investments or pre-emptive rights) they had until that point in the debtor company. Compliance with the fairness test must be examined. The Equity class may plead that, specifically, the corollary of the APR has not been met. Its argument would be the Mezz class is receiving an amount in excess of its claims. To support it, the Equity class relies on an enterprise value (€35 million) that is higher than the valuation put forward by the Mezz proponent class (€25 million). According to the latter valuation, the shares have zero value (since the debt, €30 million in total, results in a net figure of -€5 million). By contrast, according to the Equity valuation, the net figure would be +€5 million. In the course of the procedure to challenge the Plan, the appropriate expert evidence is heard and the court ultimately determines the enterprise value: if the judicial value is closer to the value claimed by the Mezz proponent class, the cross-class cram-down should be confirmed as it complies with the corollary of the APR. Conversely, if valuation is closer to the Equity's position, then the Plan cannot be confirmed as it fails to comply with the corollary of the APR (instead of simply objecting, the most junior class in which the value breaks could also propose its own competing Plan, in which case that is the Plan that would be confirmed if the court determines that such class is the fulcrum class).

146. As mentioned above, the fairness test has three constituent elements: the APR operates as a safeguard for the Junior class in its relationship with the class immediately below it, the Mezz class (hence this type of cram is usually referred to as a "cram-up" or "upstream cram", in other words, towards a more senior class than the proponent's class – it may be advisable to put in place additional safeguards in cram-ups, such as exit rights[2] for secured creditors). The corollary of the APR operates as a safeguard for the Equity class in its relationship with the class immediately above it, the Mezz class (a pure and simple cram-down or "downstream cram", that is, towards a more junior class). The third constituent element of the fairness text (the principle of "no unfair discrimination") did not come into play because there was only one class per ranking in priority. If we imagine, however, that there had been, for example, two Junior classes with equal priority: this third element would have been fulfilled if the two classes with equal priority had received the same treatment under the Plan (or if any difference in treatment was justified on reasonable grounds and not unfair).

147. This example demonstrates how the enterprise value and APR are the backbones of the non-consensual Plan. If the classes are arranged vertically from top to bottom in order of priority (looking at the normal ranking of liquidation priorities under national law), it is the enterprise value – juxtaposed with the classes – that is distributed among the classes in its full amount via the debt and equity instruments issued under the Plan. By definition, the sum of the net present value of those instruments is equivalent to the enterprise value (see section X below).

148. Many of the rules governing a game (meaning a defined incentive structure) such as a restructuring are effective when the "shadow" which is cast over the participants in the absence of a consensus (in this case, the cross-class cram-down is the shadow under which the classes will first attempt to negotiate a Consensual Plan) will assist with the achievement of such a consensus in the first place. Hence, the discussed cross-class cram-down rules are efficient in that they give the different classes

[2] TOLLENAAR, N. "Pre-insolvency proceedings: A normative foundation and framework", Oxford University Press 2019 (p. 236 et ss.): *"For the cramdown of a dissenting class, the plan must offer the members of that class a choice between (i) payment in cash equal to the distribution in cash they could expect to receive in liquidation; and (ii) a distribution which may be in a form other than cash with a value equal to their share of the reorganization value in accordance with their ranking"*.

(especially the junior classes) an incentive to agree to an arrangement for their interests by consensus rather than by coercion via a cram-down. This is borne out by experience in the U.S., where most of the Plans confirmed under Chapter 11 are not cram-downs but Consensual Plans, precisely on account of the shadow of the cross-class cram-down hanging over them, which the classes are well aware of during negotiations[3].

IX. CONFIRMATION: REQUISITES AND EFFECTS

(A) Requisites for Plan confirmation

149. Although confirmation requisites are not the subject matter of this Guidance Note, for the sake of completion we recap below the minimum requisites for Plan confirmation:

(i) Notification to affected and impaired parties (Art 10.2.(c)).

(ii) Requisite majorities met within the applicable classes (Art 9).

(iii) Fairness test: (1) Equal treatment of creditors (Art. 10(2)(b)); (2) No unfair prejudice of terms of new financing (Art. 10(2)(e)); and (3) APR or RPR, only for Non-Consensual Plans.

(iv) Best-interest-of-creditors (BIC) test (Art. 10(2)(d)).[4]

(v) Viability test: (1) Unfair prejudice of terms of new financing (Art. 10(2)(e)); and (2) The officially-administered viability test (Art. 10(3)).

(B) Effects of Plan confirmation

1. On affected or impaired parties and classes:

150. By virtue of confirmation, the Plan will be binding for dissenting parties (Art. 10(1)(a)) and, if coupled with cramdown, also for dissenting classes (Art. 11(1)).

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3 Thus, the classes that know they are "out-of-the-money" (and whose dissent to the Plan would therefore be frivolous or tactical) are more likely to agree to a Consensual Plan which offers them any reasonable recovery, since those classes are aware that, unless an agreement is reached, they will be totally wiped out of the capital structure by the cross-class cram-down. The classes that are "in-the-money", which could nevertheless completely wipe out other classes if a court confirms the enterprise value on which their Plan is based, will prefer an out-of-court settlement to allow some value to be received by the more junior classes if only to avoid the uncertainty and possible litigation associated with a court decision on that valuation. See BAIRD, D. G. and BERNSTEIN, D. S., "Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain" Yale Law Journal, Vol. 115, 2006; U Chicago Law & Economics, Olin Working Paper No. 259.

4 Although best-interest-of-creditors test (BIC) is not the subject matter of this Guidance Note, it is respectfully submitted that the counter-factual that is used to compare the Plan's restructuring value for BIC purposes is the liquidation counterfactual (i.e. either fragmented liquidation value or the value of the business as a going-concern – whichever is higher) rather than the "next-best-alternative-scenario" alluded to in Article 2.6. As with the RPR, the problem of this "next-best-alternative-scenario" is that its contours are blur, it has not been tested before and it risks entailing a confusion of the best-interest-of-creditors test with the fairness test, which are totally different tests with different purposes.

151. Besides, upon implementation of the Directive, Member States would be well advised to lay down what is the nature of the effects on claims by the Restructuring Plan in case of debt-to-debt conversions. In principle, the Plan may affect the claims by way of “novation” or by way of “pactum de non petendo”. The consequences of each alternative are relevant, especially in case of subsequent breach of the Plan and/or insolvency proceedings. Novation allows for the Plan to definitely affect the claims as set forth therein already upon confirmation, whilst “pactum de non petendo” only links the definitive effects of confirmation on the claims with the Plan having been fully performed by the debtor.

152. Should the Restructuring Plan be a “pactum de non petendo”, then the claims will return to their original features (amount, maturity, security, etc.) if the Plan is not complied with. On the contrary, should the claims be novated, then they will remain the same (and never recover their original tenure) even if in the future the Plan is breached, followed by insolvency proceedings or again re-restructured.

153. A possible option for Member States is to allow that the Plan novates the claims of consenting creditors or classes, but only has the effect of a “pactum de non petendo” with respect to dissenting ones. That option would permit that the Plan contains contractual collective action clauses (for instance, with respect to the future amendment of the plan contents or its acceleration in case of default), whilst at the same time not risking to cause an unfair prejudice on dissenting creditors, who would not suffer the imposition of having to waive beforehand the recovery as per the amount of their original claims in case of breach of a Plan in which they never believed. Besides, the referred option also makes the choice more purposefull, when the Plan contains, as is usual, a menu approach for creditors and allows them to chose between a certain debt-for-equity-swap or an alternative write-off: the choice for the latter option from a creditor that is skeptical about the viability of the debtor would allow that creditor to concur to a possible subsequent bankruptcy distribution with his original claim (as opposed to those creditors who did bet for the equity upside).

154. The choice between the two possible natures of the effects of the Plan would only relate to debt-to-debt conversions (i.e. not to debt-to-equity or debt-to-asset conversions, which may depend on civil law or corporate law of each Member State, but in general should be by themselves definitive and irrevocable when embedded in a Plan).

155. In any case, it would be advisable for Member States to legislate on the restrictions, requisites and effects of possible amendments of Plans.

2. On avoidance protection:

156. Arts. 17 and 18 grant protection against potential subsequent avoidance actions to new financing granted through the Plan and to restructuring related transactions. Challenges against the Restructuring Plan (pre or post-confirmation) may rely on the violation of the fairness test, the best interest test and/or the viability test (in addition to the infringement of the good faith test or the legality test).

157. As regards the viability test, when feasibility is concerned, most usually the challenge will be linked with the best-interest-of-creditors test: the dissenting creditor will plead that, should the non-viable debtor be liquidated, the challenger’s recovery in

liquidation would have been higher than the recovery under the Restructuring Plan. If such a challenge is upheld, then Member States should decide whether the dissenter will benefit: either from the Plan being set aside and the company liquidated; either from monetary compensation (i.e. immediate cash payment, by the debtor and/or by the supporting creditors, of the challenger's share in liquidation value, as if it were an exit right in favor of the succesful challenger as a consideration for the Plan being kept in place despite the challenger's success).

158. However, Member States shall reflect on the legal standing and the effects of certain challenges not only with regard to creditors affected by cram-down, but also to parties not formally affected by cram-down but affected by avoidance protection. For instance, a certain creditor may see that his or her claims are not prima facie affected by the Plan (so that he is not bound by its haircuts and deferrals), but still that creditor may be affected if new financing is taking security interests over the main assets of the debtor (which are benefiting from avoidance protection through Plan confirmation) and that creditor deems that the Plan is unviable and he will be worse-off in a probable subsequent liquidation where all the value will be captured by the new and protected secured creditors.

159. Therefore, if a challenge is based only on the breach of the viability test, but not on the breach of the best-interest-of-creditors test, then Member States may also consider to set forth that, should such challenge be succesful, the avoidance protection associated with the Plan confirmation shall not be opposable to the challenger in case of breach of the Plan.

X. VALUATION

160. Valuation is paramount in restructuring[5] and is often identified with the concept of "enterprise value" ("EV"). The enterprise value[6] is intented to capture the value of the expected future cash flows. The enterprise value may also be expressed as the sum of the value of the enterprise's debt, plus the value of its equity (cash is generally discounted in M&A transactions although not in insolvency scenarios). Those cash flows, and therefore, the enterprise value calculated by reference to them, make it possible to determine the level of debt that a company's business could reasonably

[5] TOLLENAAR, N. "Pre-insolvency proceedings: A normative foundation and framework", Oxford University Press 2019 (p. 43 et ss.): *"Liquidation necessarily involves a market transaction to convert the available value into cash to enable distribution in cash. The market mechanism determines the value available for distribution and thus where the value breaks. A valuation exercise is, therefore, not required. In a restructuring, distribution takes place in a non-cash form. The value of the business is directly distributed to those entitled to the value in the form of various instruments. No transaction on the open market takes place. In a restructuring, determination of the value available for distribution, and thus where the value breaks, necessarily has to take place through a paper valuation exercise. For this reason, restructuring is inextricably linked with valuation."*

[6] There are a range of methods for calculating the value of an enterprise (market approach, asset-based approach or income approach). The most common are the discounted cash flow ("DCF") method and the method involving the multiple of income-statement aggregates such as EBITDA. For further details on enterprise value, see COPELAND / KOLLER / MURRIN, *"Valuation: measuring and managing the value of companies"*, McKinsey, 2000; and, in particular, as regards enterprise value in restructuring scenarios, see SHAKED / REILLY, *"A practical guide to bankruptcy valuation"*, American Bankruptcy Institute 2013.

withstand. Accordingly, in a restructuring scenario, the enterprise value is an ideal measure of the extent to which a company's debt may be covered.

161. The restructuring value is used as opposed to the liquidation value. Whereas the liquidation value represents the price of a compulsory sale of the debtor company's enterprise (as is typically the case in liquidation scenarios), restructuring value represents the fair market value of that enterprise (insofar as the restructuring allows the debtor to retain the enterprise assets within its orbit and be entitled to a market price given that the debtor is not forced to sell it). Liquidation value does not necessarily entail a fragmented sale of assets: actually liquidation value shall be the higher between the value in a fragmented asset sale and the value in the sale of the business as a going-concern.

162. Valuation is relevant for many purposes but, as has been seen in this Guidance Note, most importantly in relation with class formation, the best-interest-of-creditors test and, in particular, the fairness test. It is paramount to note that the relevant valuations in the best-interest-of-creditors test and in the fairness test are different: while the first test looks at the liquidation value and thus at the liquidation quota of each creditor as a recovery floor to which every creditor is entitled; the second tests looks at the restructuring value and thus at the fair share of going-concern surplus to which each class is entitled to according to its ranking and applicable priority rule in case there is no consensus amongst the classes as to how allocate such surplus.

(A) Valuation for the purpose of the best-interest-of-creditors test

163. By definition, restructuring presupposes that the restructuring value is higher than the liquidation value. If it is not, the restructuring in question simply does not meet the best-interest-of-creditors test. In all other respects, with certain exceptions, the enterprise value will generally be lower in a restructuring than in a liquidation where the company has incurred operating losses resulting in the value of the fragmented parts being higher and the cessation of business in itself having a value. This is a further illustration of the importance of the enterprise's economic viability as a premise for its restructuring.

164. There are two types of liquidation value: that related to the sale of the business as a going concern and that related to the fragmented or piecemeal sale of the company's assets. The liquidation value to be taken as the base value is the higher of these two figures, especially for the purpose of the best-interest-of-creditors test[7]. The restructuring of the debtor company may only occur if the value of the business as a going concern within that company[8] exceeds the value of the business in liquidation. If, for instance, the value of the business as a going concern is higher (or the same) in liquidation than if the debtor company were to continue under the Plan, that business

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7 See Recital 52: *"Satisfying the 'best-interest-of-creditors' test should be considered to mean that no dissenting creditor is worse off under a restructuring plan than it would be either in the case of liquidation, whether piecemeal liquidation or sale of the business as a going concern, or in the event of the next-best-alternative scenario if the restructuring plan were not to be confirmed. Member States should be able to choose one of those thresholds when implementing the best-interest-of-creditors test in national law."* Also see article 2(1)(6).

8 There may be reasons why the business as a going concern is worth more within the company than its sale, for example tax reasons or administrative reasons (loss of a concession).

as a going concern should be sold via liquidation (or dissenting creditors be afforded an exit right at their liquidation pro-rata share). This is the result of the best-interest-of-creditors test. The priority is the recovery of the creditors' claims; it is not possible to impose on them a deferral of, for example, 5 years in order to recover 100 under the Plan when they could collect the net present value of those 100 immediately and in cash by liquidating the business through the sale of it as a going concern.

(B) Valuation for the purpose of the fairness test

165. The difference (or delta) between restructuring value and liquidation value is what is available for the distribution agreed to by the classes in a consensual Plan – or what will be distributed between the classes obligatorily in accordance with the relevant priority rule in the case of a Non-Consensual Plan.

166. This delta is sometimes described as the "going-concern surplus" (GCS, which may also be referred to as "restructuring premium"). The distribution of the liquidation value is an unwaivable minimum to which creditors are individually entitled and, unlike the GCS distribution, may not be the subject-matter of inter-class agreements.

167. The whole purpose of the fairness test (and the applicable priority rule) is to assure that the referred going-concern surplus is, in lack of an agreement between the classes through a Consensual Plan, distributed fairly amongst such classes. Whilst the best interest of creditors test sets a floor for creditors recovery at their liquidation value share, the fairness test sets, rather than a cap, a right for creditors to recover their restructuring value share (unless they voluntarily decide to reach a different compromise). The reason why creditors are entitled to a specific share of the restructuring value and not only of the liquidation value is simple: at the end of the day, if the Plan is confirmed, the debtor is restructured and not liquidated.

(C) Challenges and appeals against the valuations underlying the fairness test and the best-interest-of-creditors test

168. Any Plan will have an implied enterprise valuation, both of restructuring and liquidation value (Article 8(1), paragraphs (b), (c) and (d)).

169. Such valuations, and their adequacy to the relevant test, will be subject to control through the possible challenges and/or appeals to be brought against the Plan by dissenting parties (in case of alleged breach of the best-interest-of-creditors test) or by dissenting classes (in case of alleged breach of the fairness test).

170. The Directive rules on judicial valuation (Article 14) and on appeals (Article 16) are complex and fall beyond the scope of this Guidance Note. However, it is important to note the importance of the relevant moment to which the valuation shall be referred to. Indeed, the effects of the reference date will be, for instance for shareholders, very different if the relevant date is the initial moment of the opening of the restructuring or if it is the hindmost moment of the Plan confirmation or valuation judicial determination. An early date being taken as the "day of reckoning" will bring certainty to the process, although may entail that upsides subsequent to that moment are no longer eligible to benefit pre-existing junior stakeholders.

(D) Restructuring estimated valuations and real prices resulting from liquidation auctions

171. Finally, one of the advantages of the liquidation and sale of the business as a going concern is that it averts uncertainty over its value; there is an authentic market-based verification (through the appropriate auction or competitive bidding process) and the proceeds are distributed without further speculation or complications. With the gradual improvement of legal liquidation tools, preventing the assets and contracts of the business from being broken up and favouring the transfer of the business as a going concern, many countries have witnessed how liquidation has become one of the most widely-used mechanisms because it is the preferred, rather than the only, option. Indeed, economic commentators have argued in favour of the liquidation of businesses as a going concern, claiming that nowadays, barring exceptional circumstances, restructuring does not entail any real added value[9].

172. Another disadvantage of restructuring is that, although it may be chosen democratically and even legitimately by a majority of creditors, it involves a certain amount of uncertainty as to the enterprise value because there is no real market verification. The creditors do not divide the cash proceeds among themselves but instead have to resort to estimates of enterprise value which are unlikely to be as convincing. Based on those estimates, they will have to reinvest their liquidation distribution in exchange for which they will receive a paper under the Plan representing their pro-rata share of the restructuring value. And not all creditors will always be equally convinced by such reinvestment.

173. In view of the two paragraphs above, Member States may be well advised to stream-line not only their restructuring regimes, but also their liquidation regimes: it is as important for a system to be equiped with liquidation rules that allow for efficient going-concern sales of businesses free and clear of debts, than to supply sophisticated restructuring rules. Especially because the latter will be of little use to SME's: entrepreneur's are likely to be better served with swift liquidations in which they are not forbidden (as in many Member States) to bid for their own businesses, even if that entails an enhanced scrutiny of the process so as to assure that the auction is transparent and competitive.

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9 See BAIRD, D.G. "The uneasy case for corporate reorganizations", Journal of Legal Studies, Vol. 15, 1986. More recently, see RASMUSSEN, R.K. "The End of Bankruptcy", 55 Stanford Law Review 751, 2002.