UNIVERSITY OF AMSTERDAM

Faculty of Law
Department of Private Law

Nieuwe Achtergracht 166
1018 WV Amsterdam

European Parliament Committee Juri (legal affairs), Rapporteurs, Shadow Rapporteurs and Members of Committees responsible for opinions
Dr. A. Niebler c.s.

Date
20 March 2019

Telephone
+31 20 5253795

Contact person
prof. dr. R.J. de Weijs

Email
r.j.deweijs@uva.nl

Subject
Preventive Restructuring Framework and the last moment introduction of Relative Priority

Dear dr. Niebler, members of the Committee Juri (legal affairs), Rapporteurs and Shadow Rapporteurs and members of committees responsible for opinions,

We would like to bring to your attention our concerns regarding the last moment alteration of the proposal for the *Directive on Preventive Restructuring Frameworks and Second Chance*.[1] Although the proposal for this Directive has been circulated for more than two years from 2016 until the end of 2018, the entire proposal was radically altered by means of allowing for EU Relative Priority Rule ("**EU RPR**") as an alternative to Absolute Priority in the latest 2018 draft.

Because EU RPR is a new, underdeveloped and untested concept, we have conducted our own analysis in a recent report for the Centre for the Study of European Contract Law (CSECL).[2] Based on this analysis, we conclude that the introduction of EU RPR is a mistake with far-reaching negative consequences. One stone can change the current of a river. Likewise, one small, seemingly technical rule, in this case EU RPR, can alter the entire legal system and with it the basic fabric of our European society. This change is probably unintended and will not be for the better.

Since the introduction of EU RPR would amount to a Teutonic shift within private law, company law and insolvency law, while at the same time it has not been debated and not even explained, we send you this letter detailing our concerns. We also attach the aforementioned CSECL report and a letter by the eminent US bankruptcy scholar professor Douglas Baird. The idea for EU RPR seemingly has its roots in his work and most references in the underlying European documents are made to his work on Relative Priority. As professor Baird however explains in the letter attached, he has been misunderstood in as far as EU RPR would actually build on his work as the references suggest.

---

[1] Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive, 15556/18, 2016/0359 (COD), 'Confirmation of the final compromise text with a view to agreement'.

[2] R.J. de Weijs, A.L. Jonkers and M. Malakotipour, 'The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)', available on: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3350375.

We hope you will share these concerns with the other members of the European Parliament so that all members can have the fullest understanding of what they will be voting on. We understand the vote is already at the end of this month. We would like to suggest to the European Parliament that this radical and last-minute change at the very least deserves more thought, debate and explanation. In our analysis, EU RPR should not be included in the Directive.

1. EU Relative Priority: scope unclear and at odds with US Relative Priority

It all comes down to the question who is allowed to get something out of a failing or financially distressed company. There is one basic rule underlying insolvency law which also protects society and the integrity of the insolvency system itself. That rule is that if creditors are not being paid, shareholders cannot hold on to any value unless the creditors explicitly consent thereto.

This outcome of shareholders bearing first losses is the most basic starting point for all insolvency procedures resulting in a dismantling of the company and sale of the assets, also referred to as liquidation procedures. Insolvency or financial distress in itself should, however, not necessarily lead to liquidation. Instead, the law could offer a framework for reorganization, the outcome of which is ideally that the company as a legal entity survives. The main justification of such a procedure is that an operating company will be worth more than a liquidated company and therefore also creditors will benefit if the company is reorganized.

The EU is now betting on this strategy by trying to be more creative in dealing with insolvent and financially distressed companies. The EU aims to implement far-reaching reorganization procedures by means of the so called Directive on Preventive Restructuring Frameworks.[3] This should allow companies to reorganize at an early stage to prevent liquidation. This in itself is worth pursuing. One should, however, not be lured into thinking that such Preventive Restructuring Frameworks are not insolvency procedures. There is no magic here and for the non-initiated, the term might be confusing or even misleading. Although there will be no liquidation of the company and not even a formal court supervised insolvency procedure, there will be parties, most frequently creditors, whose legal rights will be curtailed against their wishes and without their consent. This is mainly achieved by so called cram-down and cross-class cram-down procedures, in which majorities can bind minorities and hold out creditors can be overruled by courts. Or, in the words of Tollenaar: "*On the other hand, in terms of its consequences, the procedure is nothing but an insolvency procedure ("if it's not called a duck, but looks like a duck, swims like a duck and quacks like a duck, it probably is a duck").*"[4]

Because these preventive reorganization procedures will lead to a reduction in debt for the company, the initial question as to whether parties can abuse or opportunistically use insolvency laws resurfaces. The initial draft from 2016 for the Preventive Restructuring Framework contained a rule providing the basic protection that shareholders could not hold on to any value *unless* the creditors by majority vote consented thereto. Such a rule is in

[3] Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive, 15556/18, 2016/0359 (COD), 'Confirmation of the final compromise text with a view to agreement', article 11.

[4] N.W.A. Tollenaar, 'The European Commission's Proposal for a Directive on Preventive Restructuring Proceedings', *Insolvency Intelligence*, 2017, p.5.

force in US and German law as part of reorganization procedures and is referred to as an **Absolute Priority Rule ("APR")**. Since not all Member States yet have a fully functioning reorganization procedure, not all Member States have had to provide for such basic protection. The US has been an important inspiration for implementing a far-reaching reorganization procedure. The APR is generally considered to be one of the most important rules of US bankruptcy law, see recently the US Supreme Court in *Jevic*, calling the APR "*quite appropriately, bankruptcy's most important and famous rule*" and "*the cornerstone of reorganization practice and theory.*"[5]

For two years, from 2016 until the end of 2018, the draft of the Preventive Restructuring Framework was circulated and discussed. Although there was and still is unease as to whether the Directive is actually needed and for which kind of problems it would provide a solution,[6] there was always the basic underlying protection that shareholders could not retain value if the company did not pay its creditors in full, unless the creditors would agree thereto.

The new 2018 draft suddenly and surprisingly provides that Member States can also opt for EU Relative Priority instead of Absolute Priority. Although Absolute Priority would still be allowed, it seems that the preferred rule is now Relative Priority. The new art. 11 Directive stipulates that:

> *1 (c) [] dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class* [EU RPR]*; (...)*
> 2 (a) *By derogation of point (c) of the first paragraph, Member States may provide that a dissenting voting class of affected creditors is satisfied in full by the same or equivalent means if a more junior class is to receive any payment or keep any interest under the restructuring plan* [APR].

This is the stone that alters the course of the river entirely. Under EU RPR, it is no longer required that creditors are paid in full before shareholders are allowed to retain shares. This could possibly be interpreted to mean that if creditors get a payment of € 20 million on their total claim of € 300 million, they are treated better than the shareholders that keep the full equity after reorganisation with a value of € 12 million.

Rather confusingly, EU RPR is something completely different from what US scholars before have also coined Relative Priority (**"US RPR"**). Unfortunately, in the underlying European Reports it is not made clear that where EU RPR and US RPR use the same names, they are entirely different concepts. Since the European Reports do refer to the US Relative Priority, there is also the risk of confusion. The Report for the European Law Institute for example refers explicitly to the work of US professor Baird in arguing in favor of EU RPR:

> *"A more flexible (relative) priority rule would better reflect pre-insolvency entitlements as it allows to create a new capital structure that also keeps everyone in the picture. As Douglas G Baird puts it: "Such a new capital structure can be*

[5] See US Supreme Court, *Czyzewski v. Jevic Holding Corp* (580 U.S. , 137 S. Ct. 973, 979 (2017); See also J.C. Lipson, The Secret Life of Priority: Corporate Reorganization after JEVIC, *Washington Law Review* 2018, Vol. 93, p. 645-646
[6] The assumptions on which this far-reaching shift are based have been questioned, but that is not the focus of our concerns here. See on that point: T. Verdoes & A. Verweij, 'The (Implicit) Dogmas of Business Rescue Culture', *International Insolvency Review*, Winter 2018, p. 398-421

> *consistent with the firm's current financial condition (doing away with such things as the obligation to pay dividends and interest as well as stripping junior investors of voting or other control rights), yet still recognize the junior investors' right to any excess that remains when, at some time in the future, all the accounts are ultimately squared. This is the essence of relative priority.*"[7]

Although the names are the same, the outcome of EU RPR and US RPR will be exactly the opposite. US professor Baird explains the working of the RPR he has in mind as follows:

> "*Implementing relative priority is simple. The senior investor is given all the equity in the reorganized firm, and the junior investor is given a call option on this equity with a strike price equal to the amount owed the senior investor.*"[8]

Where the outcome of Relative Priority under the European Preventive Restructuring Directive in most cases will be that the shareholders remains fully or partly in place, the Relative Priority Rule professor Baird has in mind, removes the old equity all together and leaves them with an option to regain the shares in exchange for full payment of the creditors at a later date.

Since there is very little underlying research into EU Relative Priority and there is no explanation how EU Relative Priority would actually work in practice and the non-initiated readers could mistakenly belief that the European Union would adopt Relative Priority as advocated by highly esteemed US Scholars, we also attach a letter from professor Douglas Baird with his view on how the European Proposals with references to his work actually relate to his research. Professor Baird concludes:

> "*In short, the proposed European directive, to the extent it relies on the experience in the United States, seems to have profoundly misunderstood it.*"

2. Removing basic protection against opportunistic use and abuse of insolvency law

Our main concern is that introducing EU Relative Priority would remove the basic protection against abuse and opportunistic use of insolvency procedures. Although it is unclear how EU Relative Priority should operate in practice, it is clear that shareholders can retain most or possibly even all of the equity. Shareholders will be able to opportunistically orchestrate the *need* for reorganization and retain value at the cost of creditors. An equally disturbing outcome will be that shareholders will no longer be dissuaded from taking excessive risks since they will no longer risk to be wiped out first.

Especially problematic is that some advocates of EU Relative Priority frame the rule as improving the position of SME companies.[9] We expect exactly the opposite will happen. Although the suggestion is made in the Directive that trade creditors should be paid in full,

---

[7] Madaus in B. Wessels and S. Madaus, *Instrument of the European Law Institute, Rescue of Business in Insolvency Law*, 2017, available on ssrn. (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3032309&download=yes), p. 334.

[8] D.G. Baird, Priority Matters: 'Absolute Priority, Relative Priority and the Cost of Bankruptcy', University of Pennsylvania Law Review, March 2017.

[9] R. Mokal and I. Tirado, 'Has Newton had his day? Relativity and realism in European Restructuring' *Eurofenix* 2018/19, p. 22.

there is not a single provision actually protecting their interests. They would have been protected by the Absolute Priority Rule against the shareholder retaining value without their consent, which rule can now be replaced by a Relative Priority Rule European Style. Since it is a standard Private Equity strategy to finance a business with as much debt as possible, preferably trade creditors, this becomes all the more problematic. SME trade creditors are often forced into the position of provider of cheap and non-interest-bearing credit as part of an overleveraged structure. Under Relative Priority EU style, insolvency would actually turn against such creditors and add insult to injury by not protecting against shareholders retaining part or all equity in the company against the consent of creditors.

One of the reasons why we feel compelled to speak out in a more public way and not limit ourselves to purely academic writing, is that we cannot exclude the possibility that politicians involved do not sufficiently realize that the Directive as currently proposed would indeed amount to the most fundamental change in insolvency law. In the limited academic writing that has been dedicated to the subject, the change from Absolute Priority Rule to Relative Priority Rule has been compared to the shift in physics from Newtonian absolutism to Einsteinian relativity.[10] Although we fully agree as to the Teutonic shift the introduction of EU Relative Priority would amount to, we also believe that the politicians responsible for this shift are not fully aware of this imminent most fundamental change. In the press release detailing the last minute changes to the draft Directive, the topic of introducing EU Relative Priority was not even mentioned as such.[11]

3. EU Relative Priority at odds with other EU endeavors of bringing about a sustainable Capital Markets Union and against overleverage

The Preventive Restructuring Framework is presented as part of a larger endeavour to bring about a European Capital Markets Union. The EU relative priority rule allows for the reshuffling and curtailing of pre-existing rights in a manner that is not predictable upfront. This is incompatible with the desire to create legal certainty for investors. Not only has the EU RPR itself not been elaborated upon, we could not find any studies how a bond market can and will operate if bargained for priority rights are reduced to mere points of view in a multi-party negotiation.[12]

The EU Relative Priority Rule will also work counterproductively in relation to other recently adopted measures. The EU RPR will in essence amount to a subsidy to shareholders at the cost of creditors. This subsidizes overleveraging of companies, whereas the EU has recently been trying to reduce such subsidies that stimulate too much debt in the economy, for example with the Anti-Tax Avoidance Directive and the Directive on Combatting Late Payment in Commercial Transactions. The EU has recently also been very active in the field of addressing problems connected to Non-Performing Loans (NPL's) on the balance sheets

[10] R. Mokal and I. Tirado, 'Has Newton had his day? Relativity and realism in European Restructuring' *Eurofenix* 2018/19, p. 22.

[11] See Press Release: "Directive on business insolvency: Council agrees its position", There is a very subdued mentioning of the following alteration: *"the cross-class cram-down: while the rules defined in the proposal are kept, member states have decided on more flexibility at national level to set the conditions needed to carry out a prior valuation of a business, as well as the rules determining when a creditor class can be crammed down."* See https://www.consilium.europa.eu/en/press/press-releases/2018/10/11/directive-on-business-insolvency-council-agrees-its-position/.

[12] See also A. Mennens, '*Puzzling priorities: harmonisation of European Preventive Restructuring Frameworks*', forthcoming.

of banks. Allowing shareholders to siphon value away from creditors increases the problems with NPL's.

4. EU Parliament will kick start new wave of undesirable comi-migration

The European Parliament has for a long time been very outspoken against forum shopping and in the context of European Insolvency Law, against comi-migration.[13] Since Relative Priority is 'only' introduced as the preferred alternative to protection by means of Absolute Priority Rule, one could argue that there is ample room for the Member States themselves to make up their mind.

First of all, one should not underestimate the pressure Member States will be under to provide the most flexibility and the least protection caused by regulatory competition. Secondly, the introduction of two different systems at a European level will most likely kick start a new round of comi-migration. In the words of A. Mennens:

> *"Senior creditors will push for a jurisdiction in which their absolute priority rights will be respected, whereas shareholders of financially distressed companies will press for a jurisdiction in which the chances of keeping their interests in the company are higher: jurisdictions that opted for the relative priority rule. This is contrary to the policy of the European Parliament to avoid incentives for parties to move their COMI from one Member State to another, seeking to obtain a more favourable legal position."*[14]

5. Conclusion

As the EU Relative Priority Rule is untested, underexplored and the change brought about will be a most fundamental and adverse change to private, company and insolvency law, we would like to ask you to reconsider its introduction to the European Union.

Yours sincerely,

Prof. dr. R.J. de Weijs (LL.M. Harvard '01)

also on behalf of
A.L. Jonkers
M. Malakotipour

---

[13] In 2011, the European Parliament gave its view on comi-migration when it adopted its proposal for the harmonisation of European Insolvency Law. The European Parliament apparently held comi-migration is such a dubious practice that it warrants harmonisation of substantive insolvency law throughout Europe. See European Parliament, Resolution of 15 November 2011 with Recommendations to the Commission on Insolvency Proceedings in the context of EU Company Law (2011/2006(INI)).

[14] See A. Mennens, '*Puzzling priorities: harmonisation of European Preventive Restructuring Frameworks*', forthcoming.

THE UNIVERSITY OF
CHICAGO
THE LAW SCHOOL

1111 East 60th Street | Chicago, Illinois 60637
PHONE 773-702-9571 | FAX 773-702-0730
E-MAIL douglas_baird@law.uchicago.edu
www.law.uchicago.edu

Douglas G. Baird
Harry A. Bigelow Distinguished Service Professor of Law

March 7, 2019

Prof. dr. R.J. de Weijs
University of Amsterdam
Department of Private Law
PO Box 15842
1001 NH Amsterdam

Dear Professor de Weijs:

I am reaching out to you as someone who is actively participating in the debate about the reform of European insolvency law. I am troubled by the thought that the work I and others have done on relative priority and Chapter 11 of the U.S. Bankruptcy Code seems to have been misinterpreted.

Reorganization law in the United States has features that turn on many accidents of history, and it is not at all obvious how much others can learn from it. But it would be a serious mistake to equate "relative priority" as I and others conceive it with the idea that is being put forward in the latest European directive. Relative priority, properly understood, is altogether different from a regime in which senior stakeholders are entitled only to be treated more favorably than those junior to them.

"Relative priority" is not a vague idea that allows any plan as long as senior stakeholders fare better than junior ones. Relative priority fully respects the right of senior creditors to be paid before junior creditors. It differs from absolute priority only in the way it identifies the time at which the rights of the players are assessed. Under existing Chapter 7 in the United States, the rights of stakeholders are assessed the moment that the bankruptcy petition is filed. Under existing Chapter 11, the rights are assessed only at the time that the plan is confirmed. A regime of relative priority postpones the moment of valuation further still. Relative priority takes into account the possibility that the firm might increase in value enough to pay the senior investors in full. Instead of taking a snapshot as of the moment of reorganization, it reflects (with precision) the extent to which the value of the firm might rise after confirmation.

Under a regime of relative priority, junior stakeholders can receive options that have value only if the firm in fact does unexpectedly well. Alternatively, one can implement relative priority by giving junior stakeholders the value of these options as determined by the Black-Scholes option-pricing model. The ABI's Commission recommended implementing relative priority in this fashion. See American Bankruptcy Institute,

Commission to Study the Reform of Chapter 11 214-224 (2014). Their illustrations show that the principal beneficiaries of relative priority if implemented in the United States, however, would typically be junior creditors (*not shareholders*). It will almost always be the case in a Chapter 11 that the option value of old equity will be vanishingly close to zero. Id. at 222.

To be sure, relative priority gives senior people less and junior people more than a regime of strict absolute priority, but the extent of the difference is modest. Relative priority or, to say the same thing, respecting the option value of junior interests shares in common with absolute priority the basic idea that the senior creditor is entitled to the value of its interest. The extent of the departure is determined not by vague intuitions about what is fair, but rather by a rigorous focus on option values, using the Black-Scholes option-pricing model or some other comparable methodology.

Different rationales have been put forward for introducing relative priority. The ABI instantiation of relative priority focuses on the unfairness of collapsing all future possibilities and potentially freezing out junior investors merely because of fluctuations in the business cycle. Anthony Casey argues that relative priority ensures that the choice between sale or reorganization is made sensibly. See Anthony J. Casey, The Creditor's Bargain and Option Preservation Priority in Chapter 11, 78 U. Chi. L. Rev. 759 (2011). For my part, I have focused on the way a relative priority regime can save the costs of a valuation of the firm as a whole. (The exercise price of the options given junior stakeholders is geared to the amount owed the senior investors, which is easy to determine. The absolute priority rule, by contrast, requires knowing the value of the firm as a whole. This is much harder. See Douglas G. Baird, Priority Matters, 165 U. Penn. L. Rev. 785 (2017).)

All these arguments in favor of relative priority, however, share one feature in common. They all focus on the way that they will make negotiation easier. Negotiations that take place in the shadow of a valuation fight are costly precisely because the stakes are uncertain. Even in Chapter 11, a regime of absolute priority, options are often given to junior parties as a way of bridging valuation differences. See Douglas G. Baird & Donald Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 Yale L.J. 1930 (2006).

Relative priority is grounded in the idea of option value, rigorously defined. This provides the most salient difference between relative priority and the proposed European directive. Giving option value to junior stakeholders (using either call options or Black-Scholes option pricing) defines entitlements of the players with precision. A loose standard that merely requires more favorable treatment for senior creditors is does nothing to facilitate bargaining. Indeed, it does exactly the opposite. Rather than limiting

the range of possible bargains, it expands them. It provides no benchmarks and does not create a sensible bargaining environment. It is like playing tennis without a net.

It should also be said that relative priority has had a mixed history in the United States. Although some, like me, have used relative priority to illustrate the infirmities of the absolute priority rule, relative priority brings with it its own set of problems. Indeed, the experience with relative priority during the nineteenth century equity receiverships gave rise to widespread perception that it systematically disadvantaged small creditors and brought untoward benefits to insiders. I have argued that a modern regime of relative priority that rigorously applied the lessons of Black-Scholes option pricing should not have this problem, but a regime in which junior stakeholders in control merely had to treat trade creditors only a little better than old equity would recreate exactly this risk.

In short, the proposed European directive, to the extent it relies on the experience in the United States, seems to have profoundly misunderstood it.

You have my permission to share these observations with others who are interested in this debate.

Sincerely,

Dougl G. B