Crossroads in EU harmonization on restructuring and insolvency : Towards a marked-based model or one where "the senior takes it all" ?

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I. Why harmonize ?

The Recast European Insolvency Regulation of 2015 (Recast EIR) has introduced new progress in relation to restructuring and insolvency. However, the Recast EIR has reached the limit of what it could regulate for two reasons. First, because its provisions are limited to international jurisdiction, applicable law, recognition and coordination of insolvency proceedings. Second, because it seeks to accommodate systems that have fundamentally different conceptions of insolvency.

Indeed, the Recast EIR is faced with two models that are difficult to reconcile, since they are based on practically opposing approaches.

On the one hand, lies the English model, in which restructuring is predominantly and almost only possible in the context of pre-insolvency negotiations (the Scheme of Arrangement and the Company Voluntary Arrangement), and where formal insolvency proceedings do not allow the debtor to remain in possession and tend towards liquidation[2].

On the other hand, lies the German model, where pre-insolvency protective shields exist, and where formal insolvency proceedings can lead either to liquidation, either to financial and operational restructuring. This model is closer to the US model and, as opposed to the English model, it also provides expressly for a cram-down in the strict sense (*i.e.* cross-class cram-down).

In between the two models, a wide variety of national systems exist in the different EU member states.

In order to accommodate this duality of models the drafters of the Recast EIR have chosen to retain their lowest common denominator. This is visible in several points of the Recast EIR that may look antithetical yet may prove valuable in practice, for example :

– the relaxation of secondary proceedings as liquidation proceedings ; or

– the possibility that a sole insolvency practitioner be appointed for insolvencies of several entities of the same group (who may have conflicting interests) ; or

– the institution of a coordinator of the insolvency proceedings of several entities of the same group, which must not have a conflict of interests (although there might be differing opinions at different levels of the group regarding whether to reorganize or to liquidate) ; or

– the possibility that the coordinator of the insolvency proceedings of a group companies requests the stay of any of them (likely when it tends towards a piecemeal liquidation of the group which may be detrimental to a viable reorganization of the whole or to a package sale).

These new features may be partly due to the fact that, sometimes, formal insolvency proceedings such as those led under English law, which are eminently creditor-friendly, tend towards direct liquidation, without pausing to take into account other interests at play, this, solely for the benefit of the most senior secured creditors.

Be that as it may, it seems that the current European regulation will not evolve much now other than through an effective harmonization of the substantive legislation of the member states.

II. The will to harmonize

The EU seems to be now aware of the need for a greater degree of harmonization, which will probably not be achieved by way of regulatory competition derived from the Recast EIR, but rather through a substantive harmonization of domestic legislation.

It was the European Parliament which, back in 2012[3], after having received the baton from INSOL Europe in 2010[4], asked the European Commission to analyze the possible harmonization of certain aspects of the domestic regulations applicable to restructuring and insolvency. Following an initial study published in 2012[5] in which the Commission saw the merits of harmonization, the Commission issued non-binding legislation focused on pre-insolvency[6] (the 2014 Recommendation).

The 2014 Recommendation introduced some progress. While some States introduced reforms inspired by it, many others did not. The regulatory competition derived from the EIR has

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2 According to the 2008 Report of the UK Insolvency Service ('Enterprise Act 2002 – Corporate Insolvency Provisions : Evaluation Report'), only 2,4% of Administration procedures achieved a corporate rescue during the period 2001-2005.

3 European Parliament Committee on Legal Affairs, Report with recommendations to the Commission on insolvency proceedings in the context of EU company law (A7-0355/2011, 17 October 2011), and related resolution of the European Parliament of 15 November 2011 (2011/2006(INI)).

4 INSOL Europe (2010), Harmonization of insolvency law at EU level, European Parliament, Directorate General for Internal Policies, Policy Department C : Citizens' Rights and Constitutional Affairs, Legal Affairs, PE 419.633.

5 European Commission, Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee : A new European approach to business failure and insolvency (COM(2012) 724, 12 December 2012).

6 European Commission, Recommendation of 12 March 2014 on a new approach to business failure and insolvency, C(2014) 1500 final.

already borne some fruit, but given the discrepancies between domestic legislation that still exist (and will continue to exist), it is an obstacle to genuinely satisfactory solutions.

The 2014 Recommendation already contemplated an evaluation of the degree of observance of its content by the Member States, set for September 2015, to determine "*whether additional measures to consolidate and strengthen the approach reflected in this Recommendation should be proposed*".

Since then, the Commission seems to be aware of the need to prioritize a broader harmonization in relation to restructuring and insolvency. This can be credited to the publication in 2015 of the Green Paper "Building a Capital Markets Union" (CMU) and the Feedback Statement containing the result of a public consultation. The latter shows that stakeholders with such varied interests such as banks, pension funds, business associations, labor unions or research institutes supported substantive harmonization on restructuring and insolvency law, rather than a regulation limited to cross-border provisions.

In the summer of 2015, the Commission began to select members of the Group of Experts to assist it in the preparation of a potential legislative proposal providing for minimum standards in harmonized restructuring and insolvency laws across the EU.

III. Which areas may be harmonized ?

In its 2010 Report, INSOL Europe pointed to a limited number of substantive points where harmonization was both desirable and feasible.

These included :

– a common test of insolvency as a requirement for the opening of a formal insolvency process ;

– the formal aspects of lodging and dealing with claims in a formal insolvency process ;

– the content of the reorganization plans and the manner in which they are adopted ;

– the rules regarding so-called detrimental acts and the interrelationship between contractual rights of termination and insolvency ; and

– directors' liability.

The 2014 Recommendation of the Commission was limited to pre-insolvency, which seems inextricably linked to formal insolvency proceedings[7].

Hopefully, an effective harmonization shall reach beyond the areas listed above. The Commission seems to be aware of this. When convening the above-mentioned Group of Experts, the Commission named such subjects merely by way of example. A number of other points might therefore be appropriate to also consider for harmonization, such as :

– the degree of divestment of the debtor ;

– the possible stay and its duration ;

– the treatment of executory contracts and *ipso facto* clauses ;

– the features of the reorganization plan ; and, above all,

– the cram-down feature.

It must be noted that the mere existence and intensity of cram-down may give rise to important differences when facilitating the restructuring of a debtor depending on the State where it is located, and consequently the discrimination between creditors who are nationals of different States and their terms of access to credit for the debtors of different States.

IV. Restructuring & insolvency harmonization and company law harmonization

As early as 2010, INSOL Europe warned in its report that areas where harmonization was necessary *"are affected by non-insolvency law considerations. Therefore, any further consideration of reform in an insolvency law context will have to take into account other important areas that are or may be the subject of European law amendment and reform such as general company law."*

Just like restructuring law cannot be viewed in isolation from insolvency law, restructuring and insolvency law cannot be viewed separately from general corporate law either[8].

As we will see, an important part of a new European restructuring plan should reasonably be focusing on the permeability of the capital structure, that is, the availability of a cram-down procedure[9] to evict out-of-the-money stakeholders and, specifically, shareholders under the supervision of a court granting full guarantees on valuation. It shall also be noted that in the event of cram-down the new capital structure may have to be approved, not by a court of the state in which the company was incorporated, but rather by a court of the state of its Center of Main Interests (COMI), which may be different.

Such interconnections between restructuring, insolvency and corporate law, make harmonization complex. They also justify the application of the EU's principle of subsidiarity : there needs to be a homogeneous treatment of equity cram-down in

7 In the words of H. Eidenmüller and K. Van Zwieten : *"the Commission essentially approaches restructuring law in isolation – in stark contrast to the harmonization agenda sketched out by INSOL Europe and the European Parliament in 2010-2012, which encompassed various aspects of insolvency and restructuring law."* (H. Eidenmüller and K. Van Zieten, "Restructuring the European Business Enterprise : The EU Commission Recommendation on a New Approach to Business Failure and Insolvency", September 2015, ECGI Working Paper Series in Law, Working Paper #301/2015).

8 As has been denounced, for instance in Spain, by PULGAR EZQUERRA (« Reestructuración empresarial y potenciación de los acuerdos homologados de refinanciación » in Revista de Derecho Concursal y Paraconcursal # 22, page 4), the need exists to *« overcome the traditional and radical divorce between insolvency law and company law »*.

9 Furthermore, as has been rightly pointed out by T. Richter ("Reconciling the European Registered Capital Regime with Modern Corporate Reorganization Law : Experience from the Czech Insolvency Law Reform", INSOL Europe Academic Forum, Barcelona 2008, ECFR 2009, pp. 358-369), the possibility of reorganizing the capital structure of a company through a plan crammed down on the existing shareholders should reasonably be considered compatible with the Second Company Law Directive, as long as insolvency concurs.

order to allow any EU court to cram-down shareholders of debtor companies incorporated in different member states.

The reinforcement of the Capital Markets Union and the necessity to deleverage private debt in the Eurozone[10] provide two strong objectives for harmonization in this matter.

V. Choice of model for harmonization – Restructuring valuation and capital markets union

Let us first examine the policy and technical issues raised by choosing between the English and the German-US model.

There are important reasons to lean towards the German-US model, as the 2014 Recommendation of the Commission did in several aspects (stay/moratorium, debtor in possession, cram-down, super-priority financing).

These reasons are :

1) The English model is based on the following dichotomy : on the one hand, a formal insolvency proceeding conceived and, in practice, eminently geared towards liquidation ; on the other hand, a reorganization that can only be carried out in the course of a pre-insolvency procedure and is limited to financial measures because UK legislation does not provide for any major tool addressed at operational restructuring. This dichotomy between a reorganization occurring exclusively during pre-insolvency and an insolvency inevitable leading to liquidation only works for very specific types of financial distress, or in countries with an eminently financial type of economy where holding companies receive much of the financing[11] and channel it to foreign subsidiaries which are operationally restructured in their respective countries[12].

The scheme of arrangement can be viewed as a pilot experience for the theory of “privatization of bankruptcy”. When coupled with pre-pack administration, the scheme is similar to share pledge enforcement[13]. This is true even where such share pledges do not exist. Yet, if the debtor has never granted a pledge on his business, many will find it difficult to accept that it can be taken away from him and other stakeholders in what amounts to a forced sale, especially with relation to non-sophisticated or involuntary co-creditors. The separate but related problem of valuation is further analyzed below.

2) The German model is more similar to that of the majority of continental legislation. The financial crisis and regulatory competition through COMI have brought about the importation of scheme-like instruments by some systems, but they have been stopgap solutions born of the current crisis : the architecture of most continental systems does not follow the English Law dichotomy.

3) A long-term stable regulation should facilitate both financial as well as operational restructurings.

A model that does not provide the necessary legal tools to carry out an operational restructuring at least concurrently to a financial restructuring (through a stay and adequate treatment of executory contracts) is a model that is particularly detrimental to equity, especially when companies must adapt to sudden market changes. It prevents shareholders from fully participating in the redistribution of post-restructuring value. If the operational restructuring is undertaken after the financial restructuring, the greater profits derived from the operational restructuring will only accrue to those who are still stakeholders after the financial restructuring. It is likely that by then, the initial shareholders will have been crammed down.

While efforts are nowadays focused on financial restructuring, operational restructuring has been neglected and its importance understated[14]. Operational restructuring can also be facilitated by legal incentives granted to providers of fresh money.

An excessively creditor-friendly system, which does not maintain a certain balance between the rights of creditors and shareholders (similar to the “level playing field” provided under Chapter 11 in the US), will facilitate credit at the expense of investments and entrepreneurship[15]. Entrepreneurs might look for more benevolent jurisdictions, especially when the blend of debt and equity is increasingly more balanced, and where long term investments in research and development are critical.

In an age of quantitative easing, credit rationing does not seem to be caused by an absence of liquidity, but rather by a

10 Bornhorst F and Ruiz Arranz M (2013), The perils of private-sector deleveraging in the Eurozone : *“In the Eurozone, an accelerated clean-up of private and financial sector balance sheets can help avoid a protracted period of stagnation (see IMF, 2013). But delays and resistance to work out nonperforming loans in the banking system, and lengthy procedures for personal and corporate bankruptcies, increase uncertainty over the extent of the problem, and put further downward pressure on asset prices and firm performance. At the aggregate level, such feedback loops can trigger debt deflation dynamics. Therefore, in addition to providing a supportive macroeconomic environment, targeted policies to support the debt workout should be strengthened (see e.g., Laryea 2010 and Laeven and Lareya 2009).”*

11 Curiously enough, loans to structurally subordinated borrowers do not seem to merit, from the regulatory perspective, a much more cumbersome treatment than to operating borrowers.

12 In an attempt to confine their scope to holding companies, UK Schemes of Arrangement usually also feature the so-called “release of third parties”. Those imply that the UK court purports to release guarantees granted in favor of creditors by other group companies (usually foreign operating companies) different from the scheme holding company. Such a release entails that the scheme would extend its effects over companies that are not a party to the scheme process, and may also infringe legal principles present in certain member states where courts do not have equitable powers (i.e. that the restructuring of the debt of a specific company cannot impair guarantees granted by a third party, unless the latter is included within the perimeter of the restructuring proceeding). For this and other reasons, schemes may face serious problems to be recognized and enforced both in Europe as well as, depending on the Circuit, in US Chapter 15 proceedings.

13 A pre-pack scheme is also similar to the administrative receivership that was (formally) abolished in the UK through the Enterprise Act 2002. The flaws of the administrative receivership seem thus to have phoenixed through the pre-pack scheme.

14 Laryea, Thomas (2010), “Approaches to Corporate Debt Restructuring in the Wake of the Financial Crisis”, International Monetary Fund Staff Discussion Note 10/02 (Washington) : *“To be successful in securing the longer term viability of corporates, debt restructuring will often be accompanied by operational restructuring addressing the structure and efficiency of the firm’s business through closures and reorganization of productive capacity.”*

15 Seung-Hyun Leea, Yasuhiro Yamakawab, Mike W. Penga, Jay B. Barneyc. (2001), How do bankruptcy laws affect entrepreneurship development around the world ? : *“we find that the less the downside risk involved in filing bankruptcy, the more new firms are founded. For policymakers, we suggest that making bankruptcy laws more entrepreneur-friendly will positively affect entrepreneurship development by lowering exit barriers and entry barriers.”*

lack of entrepreneurs and worthy projects for lenders. Sophisticated entrepreneurs are likely to prefer jurisdictions where the valuation of their business will be properly accounted for in the event of distress, especially if they are required to make important long term investments in research and development and face volatile markets turning upside-down overnight, as seems to be the new normal.

4) The availability of a stay is an important feature to provide the debtor with a breathing space while dealing with restructuring. This was recognized in the 2014 Recommendation. The moratorium in the application of *ipso facto* clauses of agreements with critical counterparties is also an important feature, for the same reasons. Both protections are afforded under Chapter 11, but the availability of these and other similar concepts are nevertheless very restricted under English Law : indeed, the scheme of arrangement, in practice, the main restructuring tool used in the UK, lacks such a stay. This lack of a stay is one of the reasons why the UK system may be referred to as "Senior takes all".

Banks should ideally be more focused on granting loans than recovering distressed claims, which can, in fact, sold at a discount. Therefore, rather than allowing bank creditors to enforce their claims against fragile debtors it may be more efficient to enable them to get out of distressed situations by obtaining the highest possible price for their debt.

Hedge funds are the natural purchasers of such distressed debt on the secondary market. They are now replacing banks in insolvency situations. While insolvency was once a market where banks were struggling to minimize loss, it is increasingly becoming a "no banks land" where hedge funds are working to create value and maximize benefits. This is not necessarily negative. Hedge funds have become very nimble players when rescuing corporations[16]. Because they are ultimately interested in the equity, they are also prone to deleverage, keeping the business alive, improving corporate governance and appointing an efficient management[17]. The greater the visibility of a hedge fund regarding the conversion of debt into equity, the higher price it will pay for the distressed debt[18]. It is critical therefore, as we will see later, to provide for the ability to carry out a cram-down of the shareholders during reorganization (provided that shareholders are effectively out-of-the-money).

Going back to the stay, ideally banks should not extend credit simply on the basis of the collateral offered by the debtor and its enforceability, but rather consider the efficiency of the debtor's business. When banks are more focused on accepting certain types of collateral rather than anything else, they encourage a so-called "lazy banks" phenomenon[19], not accustomed to rely on the analysis of the underlying business of their debtors, nor therefore carrying out their function of efficiently assigning credit, i.e. distinguishing who deserves a loan in the light of the greater efficiency of his services –and not merely due to the effectiveness of his security (which may be unrelated to the merits of a certain enterprise, and also stimulate real estate business over all others)–. Still, of course, the fact that secured creditors may be affected by an optional stay or by a certain plan does not mean that secured creditors shall not be granted adequate protection.

One of the priorities of the 2015 Green Paper was to develop the bonds market in Europe. As is well known, the bonds market is much more developed in the US than in the U.K. This is due, among other factors, to the US regulation of insolvency compared with that of the UK. Some actors (such as the European High Yield Association, EHYA[20]) have been recommending to English authorities since 2008 the introduction of features of the US model in England. But English industry, firmly rooted in a bank-based model, has blocked those proposals. However, the UK seems to begin to understand the merits of the US model. This was recently shown by the introduction of a moratorium vis-à-vis the so-called "essential suppliers" – similar to the US concept of "critical vendors" – in the case of administration or company voluntary arrangement[21]). Taking UK as a reference for restructuring and insolvency might not be the best option when the UK itself is starting to look at the US to improve its model. The UK model of restructuring and insolvency has much to learn from the US. Taken as a whole, it is suboptimal considering that administration ends up in liquidation in the majority of cases. Pre-packs are also severely criticized[22] and the

16 In contrast, Banks recently have become heavily influenced in their decisions by financial and regulatory policy to push their distressed borrowers to sell assets rather than reorganize (see Woo, 2011, "Regulatory bankruptcy : how bank regulation causes fire sales", Georgetown Law Journal, 99). When dealing with debtors that are "too big to fail", banks' reluctance to reorganize by equitizing their claims naturally drives to banks keeping debtors overleveraged (the only remaining alternative to equitizing –*i.e.* plain write off– being even worse for the banks).

17 Hotchkiss and Mooradian ("Vulture investors and the market for control of distressed firms", 1997, Journal of Financial Economics, 32) show that the improvement in the debtor's post-restructuring operating performance is greater when hedge funds take control of the restructured firm or sit on the board, suggesting that these investors contribute valuable governance to the debtor.

18 The visibility by managers concerning the possibility that creditors may be converted into new equity-holders in the event of a reorganization entails that the managers themselves avoid power struggles over control rights and manage the company refraining from siding with anything other than the business' interests. In other words, visibility by the managers concerning the possibility of an equity cram-down may improve corporate governance. There is a direct relationship between the flourishing of the bonds market and the perception that corporate governance works properly (Coombes P., and Watson M., "Three surveys of corporate governance", 2000, McKinsey Quarterly 4 (Special Edition).

19 Michael Manove, A. Jorge Padilla and Marco Pagano, "Collateral versus project screening : a model of lazy banks", Winter 2001, RAND Journal of Economics Vol. 32, No. 4, pp. 726–744.

20 Since 2009, the EHYA has been integrated into the Association for Financial Markets in Europe (AFME).

21 See the Insolvency (Protection of Essential Supplies) Order 2015.

22 Prepacks in UK have been severely criticized for not being transparent and competitive and due to the so-called "sweet-heart deals" between management and senior creditors. According to the "Pre-pack empirical review" previous to the "Graham review" (based on sample analysis) approximately 63 % of pre-packs took place with connected parties to the Oldco. In turn, the Sixth Report of the House of Commons Business and Enterprise Select Committee (HC198) suggests that only 1 % of unsecured debt is paid in pre-packs. As laid out in this Report : *"25 Public confidence in the insolvency regime is being and will be further damaged. Prompt, robust and effective action is being needed to ensure that pre-pack administrations are transparent and free from abuse. Unsecured creditors tend to be kept in the dark and recover even less than they would in a normal administration. This causes particular outrage where the existing management buys back the business and continue to trade clear of the original debts. Pre-packs of this kind fuel understandable concerns about illegitimate, self-serving alliances between directors and insolvency practitioners. The interests of unsecured trade creditors must take a higher priority, especially in "phoenix" pre-pack administrations."* Criticism on UK pre-packs gave rise to the so-called "2014 Graham review" and subsequently to a new draft of the Statement of Insolvency Practice 16 (SIP 16), which has been received with skepticism. In fact, the Small Business, Enterprise and Employment Act 2015 has created a reserve power for the Government to make regulations in the future to prohibit pre-packs in case the voluntary measures arising from the Graham Report prove unsuccessful. One can doubt whether, for instance, the NRJ Nabisco transaction would have been

most efficient restructuring instrument in the UK is, in fact, a corporate law tool. By contrast, the US Bankruptcy Code offers a consistent system and simply requires regular updates every four decades[23].

5) As regards financial restructuring, the permeability of the capital structure, and consequently, the ability to cram-down junior stakeholders that are out-of-the-money (usually shareholders) is essential in most major reorganizations. Otherwise, holdouts may jeopardize the entire reorganization, due to the veto power of stakeholders who have lost their economic interests. Does it make sense for restructuring law to be evolving in the direction of removing the veto rights of individual stakeholders, while allowing the most junior creditors (equity holders) to maintain such veto rights in relation with debt for equity swaps ? The answer is clearly no. The need of cram-down is already commonplace[24] and we will not dwell on it[25].

closed for 25 billion $ if the management's initial 17 billion $ "sweet-heart LBO" had been substantiated as an English pre-pack. At the end of the day, a distressed business sale protection of junior creditors resembles that of minority shareholders in takeovers (if minority shareholders protection takes place ex ante in a takeover, one wonders why it should take place ex post in a restructuring –and only if some impaired junior stakeholder, with asymmetrical information, takes the risk to file a challenge). It is questionable that a distressed business sale shall be carried with no open doors and real market contrast, unless such business is inevitably a "melting ice cube" : however, with certain exceptions, the "melting ice cube" may sometimes be a convenient excuse to carry out certain transactions or may be the result of inefficient management (see "The Melting Cube Fallacy", by Michelle Harner at www.creditslip.org). Otherwise, the value preservation of the distressed business can be simply achieved through insolvency regulations on ipso facto clauses and executory contracts (so as to allow the business to maintain the critical contracts in force during a competitive sale process) and new money (so as to allow the business to resort to fresh financing should it need working capital during such competitive process). Once stabilization of distressed businesses is possible through such regulations, sale of distressed businesses can be normalized, and clients and suppliers would not perceive any particular risk or stigma. This would allow for usual M&A (as opposed to truncated) processes to take place, maximizing price and creditors recovery. In an article called "For some, Britain's insolvency laws add to pain" (Reuters, 11 February 2009), Nick O'Reilly, then president of R3, stated that : "*It's because the company is failing, or has failed, that creditors lose money -- not because the business was pre-packed and sold on. In fact, a pre-pack is often the only option available to save a business and jobs and avoid liquidation.*" Nevertheless, when a business is economically viable on a standalone basis, it is difficult to appreciate why it would melt if regulation provides with the necessary toolkit to stabilize such business. In fact, the trend as regards section 363 sales in US points precisely in the direction of restricting to only properly justified cases the application of the "melting ice cube" theory, according to the Final Report and Recommendations released on December 8 2014 by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11.

23 See the Final Report and Recommendations released on December 8 2014 by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 : *"For more than 35 years, the US Bankruptcy Code has served these purposes, and its innovative debtor in possession chapter 11 process, which allows a company to manage and direct its reorganization efforts, is emulated around the globe. As with any law or regulation, however, periodic review of US bankruptcy laws is necessary to ensure their continued efficacy and relevance."*

24 See Rolef J. de Weijs, "Harmonization of European Insolvency Law and the need to tackle two common problems : common pool and anticommons", Center for the Study of European Contract Law, Working Paper Series #2011-16. As explained by the Association of Financial Markets in Europe (AFME) when responding to the consultation of the Commission in relation to the 2014 Recommendation : *"In recent times, parties have realized that making a restructuring dependent upon consents from stakeholders with no economic interest in an enterprise, properly valued, is not conducive to an efficient restructuring. However, practice has differed in the resolution of this issue. Our view is that the question of whether shareholder or junior creditor consents should be conditions to restructurings (which, if not met, would lead to formal insolvency proceedings) will become increasingly important as more complex capital structures predominate. The present position is that practice varies. This ad hoc approach leads to greater uncertainty concerning stakeholders' rights and, ultimately, makes restructurings outside administration more difficult. This issue is too important to be left subject to the vagaries of each individual case. As a policy matter, we do not consider that creditors or shareholders with (on a proper valuation basis) no economic interest in the enterprise should be in a position where their "veto" forces full insolvency proceedings or delays otherwise viable restructurings. In other words, a judicially supervised process is required to allow a restructuring to proceed without the necessity of extracting consent from a class of creditors or shareholders with no economic interest."*

For the equity to be impaired by a reorganization plan, it must be eligible to be included as a class[26], just like any other creditor who is in an unsteady situation due to financial distress, which can easily slip into liquidation or an upsetting the rights of preferential creditors.

However, it is important to point out that, given the probable dilution of the preexisting equity, the equitization of claims must be carried out with guarantees in order not to violate the right of ownership and amount to an expropriation. Thus, equity wipe out shall comply with the rights to a fair trial and to effective remedy. In other words, it should be carried out with full court supervision, rather than private proceedings with minimal judicial intervention and a mere sanction, incompatible with any serious valuation of the enterprise value (as the UK pre-pack schemes has sometimes been criticized for[27]).

A good example of an adequate framework to discuss valuation and the appropriateness of such a serious (albeit necessary) measure as the disenfranchisement of shareholders exists in the US (the country that wrote the book on cram-down), with its Chapter 11 reorganization plan.

The 2014 Recommendation approach to this matter tried to reach a difficult equilibrium. In the words of Eidenmüller and Van Zieten[28] : *"A third crucial deficit of the Commission's Recommendation lies in its minimalist approach to the role of the court in the restructuring process. The RR would like to have it all : a flexible and quick procedure with only minimal involvement of the competent court (see RR No. 7) and at the same time permit potentially massive curtailments of the claims of dissenting creditors with a minority protection standard that*

25 For instance, in Spain, the attempt to obtain an effect equivalent to the equity cram-down by other alternative legal means has been unsatisfactory. The introduction of a legal threat of potential liability for shareholders and directors in the case of unjustified rejection of a lender-led plan has proved insufficient to tackle the problem of hold-out of the equity that is out-of-the-money. By way of example, in the Pescanova case (with a debt exceeding 3 billion and an ebitda of barely 50 million euros), the shareholders assembled at a shareholders' meeting (held after the approval of the reorganization plan by the bankruptcy court) agreed to modify the distribution of capital among stakeholders contained in the previously approved reorganization plan.

26 Impaired shareholders do compose a class under US Chapter 11, and also in Germany since the 2011 reform of the InsolvenzOrdnung (InsO) through the « Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen » (ESUG), which introduced important measures addressed at preventing shareholders to block restructurings of a debtor's capital structure. On the contrary, in a "pre-pack scheme" in the UK, Oldco equity-holders to be crammed-down would not even be entitled to integrate in a class.

27 J. Taylor and N. Stewart, "UK : Cram-down of junior creditors using schemes of arrangement", Chapter 18 in H. Gibbon and Q. Carruthers (eds.), Corporate Restructuring : The Breaking Wave (2009, Thomson Reuters) pp. 103-106.

28 H. Eidenmüller and K. Van Zieten, "Restructuring the European Business Enterprise : The EU Commission Recommendation on a New Approach to Business Failure and Insolvency", September 2015, ECGI Working Paper Series in Law, Working Paper #301/2015.

is not very clearly articulated (RR No. 22 (a) and (c)). This does not work : curtailments of creditor rights can only be justified if the legal standards for these curtailments are clearly defined and full court supervision and control are assured."

Therefore, this suggests that the so-called "hybrid procedures" do not provide sufficient guarantees regarding creditor rights, and less still regarding those of the formal owners of the company.

However, this should not preclude the possibility of minimizing judicial intervention on other aspects : process features should be optional rather than mandatory and apply depending on the specific needs of the restructuring at hand, i.e. those features or measures should be devised so as to work as modules. For instance, a stay should not be automatic but rather optional, so as not to trigger *ipso facto* cross-default clauses in other group companies.

One could think that the success of out-of-court negotiations will depend on the pre-insolvency regulations themselves. However, pre-insolvency regulations rarely provide for efficient cram-down mechanisms, since those necessarily involve more than light court involvement.

On the contrary, the success of out-of-court negotiations depends heavily on the fallback position that each of the constituencies will face should they fail to reach an agreement. Stakeholders are aware that they are bargaining "in the shadow" of insolvency regulations. Indeed, pre-insolvency negotiations do not necessarily require pre-insolvency instruments, but simply clear visibility on all the stakeholders' relative positions in the event of a hold-out, and the subsequent opening of proceedings like Chapter 11[29]. Ignoring this reality will lead to the long run transformation of current light pre-insolvency instruments into full-fledged proceedings, and heavy handed attempts to incorporate necessary cram-down and operational restructuring features. It might therefore be more sensible to improve a Chapter 11-type instrument by providing courts with the power to quickly confirm prepackaged and pre-negotiated reorganization plans[30].

6) Apart from the purely consensual extrajudicial workouts, a model should provide for two types of reorganization plans, in which the majority principle will apply, both "intra-class" (that is, horizontally between claims of the same class), as well as "inter-class" or "cross-class" (that is, vertically across the majority of the impaired classes – or at least one of them, as in the US, with an absolute priority rule ensuring the fairness[31] of the plan) :

a) The reorganization plan shall be approved by the court with the support of the relevant majority of each and every class of creditors : when consensus amongst classes concurs, this is the most desired scenario, since this makes it unnecessary to consider valuation problems and also renders unnecessary the application of the absolute priority rule.

b) The reorganization plan shall be approved by the court although it does not have the support of the majority of each and every class. This is a cram-down situation in the strict sense. This situation requires the application of the absolute priority rule in order to provide the backbone of the reorganization plan and to guarantee that it is "fair and equitable" for a possible dissenting class, i.e. no junior creditor receives anything until the senior creditors are fully satisfied and, as a corollary, no senior creditor receives anything more than the amount of its claim. While the absolute priority rule (or fairness test) plays out at a relative or subjective level and takes as a reference the future enterprise value as a going-concern, the "best interest of creditors" test[32] plays out at an absolute or objective level and takes as a reference the liquidation value.

   It is thus important to distinguish the two different valuations serving as a reference for the purpose of the best interest test (liquidation value) and for the absolute priority rule or fairness test (future value).

   This second valuation shall determine, when compared to the capital structure, which stakeholders are in-the-money and which is the value allocation they are to receive under the reorganization plan. Impaired stakeholders may object to the confirmation of the plan on the basis of a possible breach of the corollary to the absolute priority rule, i.e. when certain stakeholders consider that more senior creditors are getting a higher recovery than the amount of their allowed claims – for instance, due to the value of the

29 Liu, Yan and Christoph B. Rosenberg (2013), "Dealing with Private Debt Distress in the Wake of the European Financial Crisis : A Review of the Economics and Legal Toolbox." International Monetary Fund Working Paper 13/44 (Washington) : *"Fast track court approval procedures refer to those under which the court expeditiously approves a debt restructuring plan negotiated between the debtor and its creditors in a consensual manner before the initiation of an insolvency proceeding. This technique draws upon the most significant advantage of a court-approved restructuring plan—the ability to make the plan binding on dissenting creditors or cram down—while leveraging speedy out-of-court negotiation process. (...) Achieving effective out of court restructuring requires, however, a robust insolvency regime and adequate incentives for creditors and debtors to participate in the restructuring. As out of court restructuring takes place in the shadow of the formal insolvency regime, it is critical to have in place an effective insolvency law, which provides clear benchmarks to incentivize debtors and creditors to reach a restructuring agreement. In addition, a regulatory framework requiring financial institutions to write down the value of distressed debt should be put in place, tax disincentives for debt write-downs or transfer of a distressed loan to a third party should be removed".*

30 US prepackaged reorganization plans and UK pre-packs (or prepackaged administrations) are completely different institutions. While US prepackaged plans are reorganization plans negotiated with creditors before Chapter 11 and confirmed by court swiftly after the opening of the Chapter 11 proceedings, UK prepacks are business sales organized by an insolvency practitioner (IP) before the opening of the administration proceedings and executed by the IP upon his appointment immediately after the administration opening. UK prepack sales are typically made to connected parties of the debtor and with no creditors intervention whatsoever. UK pre-packs evoke bringing one'son to hospital and finding out some hours later that all his organs have been donated with no consent from the parents, without doctors even attempting to operate surgery on him.

31 For a plan to be deemed "fair and equitable" it must abide with the « absolute priority rule », contained in 11USC§ 1129(b)(2)(B)(ii) and 11USC§ 1129(b)(2)(C)(ii). According to the absolute priority rule, a junior stakeholder that is subordinated to a senior stakeholder cannot receive any value under the Plan unless such senior stakeholder is also obtaining under the Plan nothing less –and nothing more– than the value of his allowed claims (relative subordination agreements are recognized within Chapter 11 – 11USC§ 510(a)). Absolute priority rule can be visualized like a series of piled champagne glasses, requiring that the glasses of the senior stakeholders that are on top get filled completely before allowing any value to cascade down to the glasses of lower-ranking stakeholders.

32 The "best interest of creditors" test reminds of the EU Bank Recovery and Resolution Directive (BRRD) "no creditor worse off" principle. Equity wipe-out is thus not a stranger to European law. In fact, importation of certain concepts from the BRRD could be analyzed, such as the general rule of non-suspensive effects of appeals (unless a bond is posted) and/or the limitation of remedies to loss compensation.

post-restructuring equity being attributed to such creditors (when they are the fulcrum security and value breaks in their class).

Valuation thus orders the post-emergence capital structure in the event of cram-down. No complex reorganization can be satisfactorily accomplished without a cram-down feature, and no cram-down can in turn be achieved without clear rules on valuation[33].

The absence of rules on cram-down, valuation and absolute priority can lead to unsatisfactory situations. This is the case notably in the UK and other countries, where :

(i) The disenfranchisement of shareholders is not carried out by virtue of an ad hoc proceeding, but rather by means of an artificial combination of a scheme of arrangement (aimed at rescuing the debtor) and a pre-pack administration (aimed at liquidating the debtor[34]) : the so-called "pre-pack scheme" or "transfer scheme". In other words, it consists of a liquidation of the debtor and a subsequent transfer of its assets and restructured debts to a new company, usually owned by the senior creditors, leaving the rest of the creditors and the shareholders behind. It is a traumatic solution, only valid for holding companies (or simple companies), which can transfer the enterprise as a whole without legal or operational obstacles.

(ii) The lack of a cram-down procedure in the UK is disguised in practice by the formation of an artificial class (including possible dissenters as a minority of a broader and unique class, together with a majority of supporting creditors[35]). The concept of "class of creditors" is a generic concept that English courts have not clearly defined[36]. This is perhaps why it is common to hear that in the UK, class formation is "an art, not a science". However, the risk of gerrymandering is real and a serious disincentive for non-senior creditors[37].

(iii) The lack of procedure, or rules, relating to valuation[38] make it difficult to ascertain where the value breaks and who is in or out of the money[39]. The resulting uncertainties create a real risk of unfair class formation. Few existing precedents in the UK[40] guarantee that English courts will stick to the liquidation value for such purposes. And even if they were to admit going-concern value, they would be reluctant to consider a valuation of the enterprise value higher than the so-called "value today" (that is, the liquidation or fire-sale value), which is a depressed value. This situation creates a model where the "senior takes all". The equity post-restructuring is not distributed among the creditors within the class where the value breaks (the fulcrum security)[41], but among the senior class of creditors[42]. A "Senior takes all" model implies a violation of the absolute priority rule and of its corollary, and renders valuation meaningless. It also implies confusion between the best interest of creditors test (conceived to protect creditors against abusive plans that would entail lower recoveries than liquidation itself) and the absolute priority rule or

33 France and Italy have recently introduced certain instruments in order to wipe-out equity but, paradoxically, with no regulation or guidance in relation with valuation, with the risk of being deemed expropiatory. See S. Vermeille, J. Martínez and F.A. Papon, "A constitutional review of the draft Macron law introducing shareholder eviction under French law : the revolution that didn't happen", March 2015, revue-banque.fr.

34 Although the City of London Law Society considers pre-pack, quite tellingly, as a cram-down mechanism, rather than a liquidation proceeding, in its 18 October 2010 response to the Insolvency Service consultation (paragraph 14 : *"In relation to the restructuring proposals themselves, the Insolvency Service may wish to consider the existing cram-down mechanisms (such as a pre-packaged administration, the company voluntary arrangement or the scheme of arrangement) for binding dissenting creditors"*).

35 One of the arguments used by UK courts to justify one sole class being formed consists in contending that the backdrop of insolvency and the prospect of non-recovery shall unite all the relevant creditors in one sole class. This is shown for instance in the recent judgment that sanctioned the Apcoa scheme (Apcoa [2014] EWHC 3849 (Ch)) : *"Lastly, in considering the composition of classes, I have sought to stand back and assess more generally whether, in the round, and even if I am wrong in my judgment that on analysis there is no difference in the relevant rights so as to require application of the second limb of the test, there was sufficiently more to unite than divide all creditors within a single class so as to make further classes unnecessary (and see Telewest (No 1) at [40]). (...) It seemed and seems to me that the advantage of avoiding insolvency and being able to share in a larger cake would sufficiently outweigh the wish to have a larger share than others in a much smaller cake. (...) Accordingly, whilst I accept that the risk of imminent insolvency is not to be used as a solvent for all class differences, in this case in my judgment it would have caused reasonable Existing SFA Creditors to unite in a common cause."*

36 According to the classic UK definition, a "class of creditors" is to be formed by *"those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest"* (Sovereign Life Assurance Company v Dodd).

37 For instance, three out of five schemes of arrangement related with Spanish companies in the last few years featured one sole class of creditors (and, to date, two out of those five scheme companies did already end up in bankruptcy proceedings in Spain soon thereafter).

38 Taylor and Stewart, *Ibid*. at 23.

39 The Association of Financial Markets in Europe (AFME) explained in its letter to the Commission of March 25, 2014 in relation to the 2014 Recommendation : *"Dramatically different allocations of value arise if a liquidation basis of valuation is used as opposed to various alternative "going concern" bases. There is currently no consistent method or platform for resolving stakeholders' disputes as to the basis of valuation, short of a company entering formal insolvency proceeding. Hence, somewhat crudely, the dynamic that emerges is that often stakeholders are in effect given a choice – accept a particular basis of valuation (and it may be a liquidation valuation, which ignores going concern surplus arising from a successful restructuring) or see the enterprise go into an administration or liquidation proceeding. Ideally, a consistent and harmonized framework should be created for fast judicial resolution of valuation disputes in restructurings"*.

40 See the Re Tea Corporation [1904] 1 Ch. 12 ; My Travel [2004] EWHC 2741 (Ch) and [2004] EWCA Civ. 1734 ; and IMO Carwash [2009] EWHC 2114 (Ch)).

41 Unless a different agreement is reached through the Plan, the stakeholders who should naturally be entitled to equitize their claims are the so-called "fulcrum security" in the US : *i.e.*, only the most senior class of creditors that are not fully repaid according to the plan – in other words, the most senior class in which "the value breaks" (not necessarily, nor usually, the most senior class at the top of the waterfall in absolute terms), because such class is only partially covered by enterprise value. The logic of not allocating the new equity in a different manner than to the fulcrum security (unless an agreement exists amongst the creditor's classes) resides in the fact that the best candidates to efficiently manage the debtor company are not the creditors whose recovery is assured (senior creditors already repaid in full), nor creditors whose recovery expectations are close to nil due to them being "out-of-the-money" : on the contrary, those who would best manage the company are those creditors that still have a certain probability that enterprise value overflows in their benefit, but only if the company is efficiently managed.

42 Hence losing the opportunity to have a really incentivized fulcrum very efficiently managing corporations post-restructuring as the only alternative to maximize value of the main consideration obtained through the reorganization : the equity (as opposed to the UK scenario in which it is the senior class –and not the class where the value breaks- who gets the equity).

fairness test (conceived to allocate enterprise value equitably amongst stakeholders according to the absolute priority rule[43]).

This scenario is in stark contrast to the US, where the absolute priority rule applies and the reasonable fair-market value or "future value" of the company is retained to benefit junior creditors and richer financing structures. Effective guidance on valuation provides a reference to distressed investors as to the level of the pivot (fulcrum) security in order to buy into the debt, but also provides certainty to entrepreneurs as to their possible entitlements in the event of distress. Adequate valuation is also a guarantee for pre-existing lenders against an excessive dilution of their post-restructuring interests by the new money providers.

In other words, the UK has somehow opted for a "Forced Sale" or "Texas Shootout" model[44], as opposed to the US'"Appraisal" model[45]. The less information, involvement and possibilities to object to the underlying valuation[46] are offered to stakeholders, the closer their position will be to the Texas Shootout model.

The prejudice to junior stakeholders derived from not using a future going-concern valuation is increased by the fact that hybrid proceedings (such as the scheme of arrangement) can in practice be initiated (and the plan shall be proposed) by the debtor only. This increases the risk of alliance between majority senior creditors and the debtor/equity to the detriment of junior creditors and the absolute priority rule.

7) The permeability of the capital structure, measured by the availability of a cram-down of the shareholders, presents other important collateral advantages.

Indeed, the risk of dilution of the equity operates as checks and balances mechanism on debtors to discourage them from commencing abusive reorganization processes for the sole purpose of obtaining illegitimate transfers of value at the expense of creditors or other stakeholders, who could turn the situation around to their advantage[47]. In the absence of a consensus on reorganization, the debtor will want to think twice before commencing a frivolous process that is not strictly necessary to restructure the company if shareholders also run the risk of being diluted in the process.

This mechanism is especially relevant in the EU, where the separation between the shareholders and the management is less common or clean-cut than in the US.

This risk of shareholders dilution also indirectly serves three important objectives.

First, no complex and costly judicial oversight (direct or delegated) is necessary to protect creditors from abusive reorga-

43 This in turn justifies why valuation for both tests (best interest and fairness) shall be a different valuation. Indeed, if the main purpose of the reorganization plan is to make a company viable and prevent the loss of value derived from liquidation, then : why should the value to be reallocated amongst stakeholders (through the plan and the absolute priority rule) be liquidation value and not future value ? In other words : does it make sense that the greater value derived from avoiding liquidation (going concern surplus) shall solely benefit senior creditors, just because those would be the only ones to be covered by liquidation value in a no longer existing case of liquidation ? As explained by Crystal and Mokal ("The valuation of distressed companies, a conceptual framework") : *"The primary question is : what is the current value of the company's assets ? If the company in question is promulgating a scheme of arrangement which amounts to a restructuring of its liabilities, it follows, as explained in Section II of this article, that it considers that the value of its business contains a going concern surplus, but that a simple market sale would not capture the entirety of this surplus. The value of the company's assets and undertaking would therefore be maximised by, in effect, 'selling'them to its existing investors in consideration for a restructuring of the company's liabilities to them. This is what the scheme of arrangement is meant to accomplish. It follows that in order to determine which of the company's current investors retain a real economic interest in the company as things currently stand, the value to be determined is the existing going concern value of the company's business, which, after all, is the value the proposed scheme is intended to both preserve and apportion. Assuming that the alternative to the proposed reorganisation would be a liquidation, it is difficult to see the rationale of determining the rights of any of the parties by assuming the very outcome that the scheme of arrangement is intended to avoid, namely, a liquidation of the business and resulting dissipation of the going concern surplus."*

44 Baird, Douglas G. and Bernstein, Donald S., Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain (September 1, 2005). Yale Law Journal, Vol. 115, p. 1930, 2006 ; U Chicago Law & Economics, Olin Working Paper No. 259 : *"The junior investor would have the option to buy out the senior investor for the amount of the senior investor's claim. If the junior investor thought the business worth less than what the senior investor was owed, it would not exercise the option, and the senior investor would end up with the entire business as the absolute priority rule requires. If the junior investor believed the business worth more than what the senior creditor was owed, it would have to pay the secured creditor in full, again vindicating the absolute priority rule. (...) Whether such a mechanism best serves the interests of the parties, however, is not clear. It relies on the junior investor possessing sufficient capital. The junior investor may find it impossible to borrow the full amount from a third party because the third party does not know as much about the business and will therefore lend only a fraction of the business's value. The private information problem that makes a sale of the business unattractive also makes it difficult for the junior investor to borrow the funds needed to buy out the senior investor. (...) In short, there are likely to be practical difficulties in the corporate reorganization context with requiring junior investors to buy out senior investors, and a more practical valuation mechanism is needed."* This "Texas Shootout" approach was actually verbalized in the IMO Car Wash judgment, which sanctioned a scheme that had to argue why the mezzanine was out of the money (IMO Carwash [2009] EWHC 2114 (Ch)) : *"The Mezzanine Lenders have a safeguard in the form of clause 12 of the Intercreditor Agreement. If they really thought that the debts were being sold at an undervalue, or at a price which gave the Senior Lenders a good prospect of a benefit in the future which was unfair to the Mezzanine Lenders (because it deprived them of that benefit) then they could buy out the Senior Lenders and do the restructuring themselves, with the benefits which they claim to flow from the restructuring to the Senior Lenders. They have chosen not to do so. They do not seem to want to run the risk."*

45 Baird, Douglas G. and Bernstein, Donald S., Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain (September 1, 2005). Yale Law Journal, Vol. 115, p. 1930, 2006 ; U Chicago Law & Economics, Olin Working Paper No. 259 : *"Modern Chapter 11 is the equivalent of a provision in a joint venture agreement that calls for the appointment of an appraiser and uses the number that the appraiser sets (or is expected to set) as the baseline against which to measure the rights of the parties. Sophisticated parties often bargain to adopt such mechanisms. A "put" mechanism based on an appraisal is particularly useful when a partner wants to terminate a joint venture, but does not have the liquidity to buy the other partner out, the sine qua non of the dissolution mechanism that uses the I-pick-you-choose "Texas Shootout" approach. Like any other valuation mechanism, however, an appraisal mechanism comes with its own costs. In particular, in the reorganization context, any valuation mechanism that does not involve a transaction that monetizes the senior investor's position (through a sale of the business or a buyout of the position) creates option value in the position of the junior investor. This will be priced into any deal the parties strike, which avoids the need to complete the valuation."*

46 For instance, by allowing valuation challenges against the plan to be initiated by a creditors committee and the derived costs to be considered as administrative expenses.

47 If the valuation is low, the equity could be displaced and thus end up being cut out of the reorganization process commenced by it. If, on the other hand, the valuation turns out to be high, the protection provided by the absolute priority rule should prevent the imposition of a reorganization plan that is too onerous for the rest of stakeholders.

nization processes initiated by debtors when debtors risk being wiped out in the process.

Second, there is no need to define a complex and necessarily controversial prerequisite for the commencement of reorganization such as insolvency or the likelihood of insolvency. This further removes the stigma associated with the commencement of such process and therefore also encourages debtors to resort to it at an earlier stage.

Third, the fact that the debtor has accepted a risk of loss by commencing the reorganization process is a sign of his confidence that he can lead the business out of its current distress and to its maximum future value. This provides justification for the reasonableness of maintaining a system of debtor in possession[48].

8) A sophisticated model for reorganization plans with a cram-down feature might only make sense for large and complex corporations, where liquidation entails a considerable loss of value due to the inefficiencies associated with the transfer of the business as a going-concern : including operational, contractual, tax, administrative difficulties, etc[49]. A reorganization can avoid a formal liquidation of the corporate structure with its inherent loss of value, as well as the sale of the business to a third party at the bottom of the market.

For SME's, however, a simpler process, more geared towards an efficient and straightforward liquidation might be contemplated through a business transfers. When small entrepreneurs really add a particular personal value or knowledge to a business, he would get higher credit than other bidders and outbid them at the auction, regain control of the business free and clear[50], and enhance creditor's recovery. Where creditors are able to participate in the auction (unlike in a UK pre-pack) the "phoenix" phenomenon is far from objectionable, but rather a legitimate deleveraging mechanism. In addition, the manageable size of SMEs minimizes the "Texas Shootout" problem (see footnote #44). Finally, should the entrepreneur lose his business at the auction, its acquirer is likely to offer him equity or other consideration to retain his services if he truly adds value to the business. This system allows for the entrepreneur to be offered the equity his services deserve on a case-by-case market allocated basis. He might otherwise team up with other investors. This system is superior to a system allocating a fix and rigid "prescribed part" to the entrepreneur that might not fit nor be fair in every given situation.

9) Cram-down is a powerful and necessary restructuring tool. However, it must be tied to two important features. On the one hand, proper valuation guarantees must be available to determine which classes of creditors are in or out-of-the-money – and, for fairness test purposes, the valuation should be performed on a future going-concern basis. On the other hand, features like stay/moratorium (on enforcements, involuntary insolvency and/or *ipso facto* clauses), DIP financing and the adequate regulation on executory contracts must be available not only as crucial parts of the restructuring toolkit in their own right but also as an important checks and balances mechanism against the abusive cram-down of junior stakeholders.

Indeed, where these features do not exist, businesses cannot be stabilized, and inefficient outcomes with little justifications are seen as lesser evils : hasty pre-packs and schemes of arrangement lead to forced sales valuations.

In contrast, wherever businesses can be stabilized, there is no need to resort to hasty procedures and valuations.

However, as mentioned earlier there are still lessons to be learned from the swiftness of restructuring in the UK. While swiftness alone cannot be a policy goal, court intervention can be more efficient if it is made optional, depending on the toolkit that is necessary for each case at hand.

For instance :

a) The stay/moratorium may be available at the option of the debtor, rather than automatic, depending on the needs of the restructuring,

b) The DIP financing regime may be available at the option of the debtor,

c) The appointment of an insolvency practitioner may be available only in the following circumstances :

(i) The reorganization plan will impair creditors other than financial creditors (lenders and/or bondholders) ;

(ii) The reorganization plan contemplates in-depth operational restructuring, such as the rejection of executory contracts (in which case special eligibility requirements for the opening of the proceedings may apply, such as financial difficulties or qualified losses foreseen) or labor measures ;

(iii) The debtor is recording operational losses ; and/or

(iv) The debtor is contemplating sales free and clear of debts and liens with respect to relevant parts of the business.

Finally, reorganization and liquidation options should not be irrevocable : a sale of the business as a going concern should be revocable if the price of the sale is not deemed fair by creditors who prefer to allow the implementation of a reorganization plan. Likewise, an actual market test may be driven concurrently with a plan in order to obtain a more accurate valuation basis for the reorganization. Also, bidders at a business auction may be informed that creditors may rescue the business through a reorganization plan at any moment, to give them an incentive to raise their bids. In other words, the ability for creditors to recapture a business from an auction and rescue it through a reorganization plan can be a signal to third party bidders that, even if the business has reached an auction stage, it is not necessarily a lemon.

VI. Concluding remarks

The degree and tools available in a harmonized regime might depend on which of the two current predominant models is best deemed for the EU.

48 Especially if the debtor's period of exclusivity to propose a reorganization plan is limited or can be terminated for cause.

49 For this reason, the "going concern surplus" can be understood, not only as including the difference in value between piecemeal liquidation and going concern, but also as including the possible additional difference in value between the business kept as a going concern through a sale and the business kept as a going concern within the same original debtor entity.

50 The insolvency regulation of some member states, like Spain, prevents entrepreneurs to bid for their own businesses at the auction in case of liquidation, in detriment of such entrepreneurs (whom are excluded from the market) and of creditors themselves (whose auction is deprived of the bidder most likely to offer the higher price for the business, thus prejudicing creditor's recovery).

A model similar to the US or Germany provides an objective basis, the enterprise value, to put each stakeholder in his place. If shareholders are out-of-the-money, creditors are allowed to take control of the company, deleverage and rescue it. This allows viable companies to avoid liquidation when going-concern surplus exists, and to maximize their value and recovery prospects. In this model, entrepreneurs are comfortable that, in the event of distress, they can remain as debtors in possession and have an opportunity to undertake an operational restructuring before or simultaneously with a financial restructuring, optimizing the valuation of their business as well as their new position in the capital structure – an important prerogative which is not available in a UK inspired model of summary judicial intervention based on restructurings limited to financial balance sheets and available during pre-insolvency proceedings only.

Alternative non-banking sources of financing will be reassured to know that, as junior creditors (typically bond holders), in the event of financial distress, the enterprise value of the company will not be reduced to its depressed current value giving senior lenders a “senior take all” privilege to capture all of the remaining and potentially much higher value of the company.

Finally, when facing difficulties of a mostly financial nature, the collective proceedings would provide that, failing an agreement between creditors and shareholders, the valuation of the company will form the basis on which to recompose the capital structure –without affecting workers, clients or suppliers, and –unless an operational restructuring is also necessary– allow for business as usual to be maintained with counterparties of critical executory contracts, thus minimizing the stigma of the proceedings.

In conclusion, the cram-down and valuation mechanisms are not merely relevant to a harmonized regime for insolvency and restructuring law. In order to promote a stronger capital markets union and overcome the known risks of the current bank-based system, it may be wise not to embrace a flawed “senior takes all” model for companies facing financial distress across the EU.