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Is the Relative Priority Rule right for your jurisdiction?

A simple guide to RPR

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The final version of the Directive (EU) 2019/1023 on Restructuring and Insolvency provides for a new rule to assess the fairness of the distribution of value under an accepted plan if an affected class of creditors voted against the plan: the Relative Priority Rule (RPR). It is provided in art. 11 (1) (c) stating that one of the conditions to confirm a plan over the veto of a class is that the plan

> 'ensures that 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'.

As an alternative to the RPR, art. 11 (2) allows Member States to implement an Absolute Priority Rule (APR) stating that the plan must ensure

> 'the claims of affected creditors in a dissenting voting class are satisfied in full by the same or equivalent means where a more junior class is to receive any payment or keep any interest under the restructuring plan.'

As a result, all Member States are faced with the choice of either implementing the RPR or the APR when implementing the Directive into their local restructuring laws. While APR is a concept that has been a part of US law for 80 years and German law for 20 years, the idea of an RPR is not just new. It has also not yet been explained extensively by scholars. If Member States consider implementing such a concept, they should know how it works best. The following quick guide aims at providing this assistance.

[A possible text for an implementation is available at the end of this paper.]

1. The basics: RPR and the 'best-interest-of-creditors test'

First, lawmakers need to understand that any (absolute or relative) priority rule only operates as intended on the basis of the 'best-interest-of-creditors test'. It is this test that provides for the protection of the realisable value of each stakeholder's position – be it a creditor's claim or a shareholder's equity interest - in a restructuring scenario.

In short, the 'best-interest- of-creditors test' protects the value of *existing* entitlements (i.e. ignoring the restructuring) and thereby sets the baseline for a distribution while a (absolute or relative) priority rule is a baseline for determining the fairness of the distribution of the expected (*future*) restructuring surplus achieved under the proposed plan.

The 'best-interest-of-creditors test' was first enacted in § 5103A of reform Act of June 22, 1874 to the US Bankruptcy Act of 1867 and is now defined in art. 2 (6) of the Directive as

> 'a test that is satisfied if no dissenting creditor would be worse off under a restructuring plan than such a creditor would be if the normal ranking of liquidation priorities under national law were applied, either in the event of liquidation, whether piecemeal or by sale as a going concern, or in the event of the next-best-alternative scenario if the restructuring plan were not confirmed'.

Any plan which was not accepted *unanimously* by *all affected* parties would need to pass this test in order to be confirmed by a court under art. 10 (2) (d).

The 'best-interest-of-creditors test' requires a comparison of the distribution to a *dissenting* stakeholder under a contested plan with the payoff this stakeholder could expect in an alternative scenario without a plan. The latter reference point requires a two-step hypothesis:

a) Which is the scenario that would determine the dissenting stakeholder's payoff without the proposed plan?

The Directive provides flexibility here. While under US and German law, the alternative scenario would always be a bankruptcy liquidation of the debtor's assets, the Directive allows for the consideration of the 'next-best-alternative scenario'. Such a scenario could be a piecemeal liquidation under bankruptcy laws, but also a sale of (a part of) the debtor's business as a going concern or, if provided for under national law, an accepted competing plan or even the continuation of the debtor's business without any coercive restructuring measure (in case of a solvent restructuring effort). Which scenario is most realistic would need to be determined by the court asked to confirm the plan over the veto of a party.

b) What is the hypothetical payoff to the dissenting stakeholder in the alternative scenario?

The 'best-interest-of-creditors test' requires a number. It is a mathematical comparison. If the dissenting creditor or shareholder would receive X in the alternative scenario, they must not receive less under the plan. The need for numbers results in the need for a valuation of the debtor's assets. How much would be realised in the alternative scenario (be it a piecemeal liquidation, a going-concern sale or any other scenario)? And how much of this value could be claimed by the dissenting stakeholder in this scenario?

Example 1: If the alternative scenario is a bankruptcy piecemeal liquidation with a distribution to unsecured creditors of 3% and to preferred creditors of 25%, the 'best-interest-of-creditors test' would guarantee a payoff of 3% of this value for unsecured and of 25% of this value for preferred creditors in a restructuring. Any plan which offers less to each of these creditors may be vetoed by any single of these creditors. This protection in form of a veto right does NOT depend on the legislative decision whether to implement the relative or absolute priority rule as the 'best-interest-of-creditors test' would be applied irrespective of the applicable priority rule.

Example 2: If the best alternative scenario in a pre-insolvency restructuring is a going-concern sale outside of formal bankruptcy proceedings, the protected position of dissenting stakeholders depends on their ability to claim the realised purchase price. If it is enough to cover all debt remaining with the selling entity, each creditor would hypothetically receive 100% and must not receive less under the plan; shareholders could receive less than 100% depending on the remaining amount. However, if the price does not suffice to cover all existing debt, the selling entity would probably enter bankruptcy liquidation proceedings and the position of each dissenting stakeholder would be assessed accordingly.

Example 3: The position of a secured creditor with a security interest in assets of the debtor is also safeguarded by the 'best-interest-of-creditors test'. In the relevant hypothetical scenario, the security right might not be affected at all, e.g. by being maintained in a going-concern asset sale to a new entity. Accordingly, any *dissenting* secured creditor must receive the same treatment under the plan. If, however, the next best alternative scenario is a bankruptcy liquidation of encumbered

> assets where secured creditors would be entitled to claim the value of these assets, their expected payoff defines the baseline for the treatment of these security rights and secured claims that a plan could only fall short of if the affected creditor actually agrees. It is the 'best-interest-of-creditors test', not the priority rule, which protects the existing value of any secured claim.

As a result, the 'best-interest-of-creditors test' guarantees the *realisable value* of existing claims and equity rights of dissenting stakeholders against coercive infringements under a restructuring plan. This realisable value is the payoff that such a stakeholder could obtain by either using the applicable enforcement law or initiating (involuntary) bankruptcy proceedings (*individual* enforcement of claims).

The realisable value does not include value which is only generated by the cooperation of stakeholders. This concerns the value which can only be realised in a restructuring of the debtor (*reorganisation surplus*).

> *Example 4*: If the alternative scenario is a going-concern sale realising the going-concern value of the debtor's business, a restructuring might not even create extra value (surplus). Thus, the protection of dissenting creditors under the 'best-interest-of-creditors test' is strong. If, however, the value of a business is tied up in contractual rights, licences or personal (customer) data which are not or not easily transferrable, the surplus of a restructuring of the debtor can be significant.

The reorganisation surplus is a value which is only generated if a restructuring is achieved. This requires cooperation. Stakeholders must support the business as a going-concern by providing future finance, workforce, supplies, licenses, rental space etc. Most of these contributions cannot be enforced by an individual creditor or shareholder. The resulting value realised by cooperating is not a value realisable by individual enforcement actions based on existing claims. No single creditor, not even a bank, is able to enforce all of these contributions based on their claim in right of previous financing. Any restructuring is a new effort of stakeholders creating new value (see *Madaus*, Eur Bus Org Law Rev (2018) 19:615–647), not just another form of debt collection (contra *Tollenaar*, Pre-Insolvency Proceedings, OUP 2019). It's a fresh start by means of cooperation.

2. Is cooperation useful?

Any restructuring plan is a bet on the debtor's future returns, i.e. the value of its assets and of its future income. Will an individual remain healthy and employed? Will a business flourish again? Any proposed restructuring plan assumes a certain future development and distributes expected future value. The discussion of a fair distribution scheme assumes that the plan actually makes the right assumptions and predictions of a future development in a world of uncertainty. However, predictions of the future are difficult and, as Nobel Prize winning economists have highlighted, the cognitive illusion if validity also affects financial experts when asked to predict the future development of the value of a firm (see e.g. Daniel Kahneman, Thinking, Fast and Slow, 2011, 212-215). There is a real chance of experts getting it wrong and many failed restructurings seem to provide proof for scepticism. At the same time, getting it wrong is costly. The protection of dissenting creditors depends on the fact that the plan gives them more than they would receive in an alternative scenario. If, however, the plan scenario does not play out as predicted, the expected distribution is not achieved.

Awareness of the risks of predictions seem to favour a normative approach that leaves this risk in the hands of those stakeholders whose investments are at risk. The stakeholders who are asked to cooperate based on the plan scenario should decide whether they agree to trust in these predictions in the light of the costs and possible losses involved. A strong actual support across classes of affected stakeholders to cooperate according to the plan would indicate that this cooperation is useful and should be pursued.

More specifically, such an approach would indicate that Member States should refrain from implementing the option in art. 11 (1) (b) (ii), which allows a plan confirmation based on the actual support of only one class, possible consisting of only one stakeholder, based on the assessment of a fair distribution of value by the confirming court. Instead, a majority of classes as provided in art. 11 (1) (b) (i) seems more adequate to ensure that the restructuring efforts are useful.

3. The scope of any priority rule in a cramdown and the case for a relaxed RPR

While the ‘best-interest-of-creditors test’ protects the realisable value of a claim or right of a dissenting party, it does not provide any guideline for the distribution of the reorganisation surplus.

> *Example 5*: If the alternative scenario is a bankruptcy piecemeal liquidation with a distribution to unsecured creditors of 3% and to preferred creditors of 25%, but the restructuring of the debtor would maintain a future income that could potentially pay all debt over the course of a number of years, access to the future income is the key factor in a plan distribution.

A fair distribution of the access to the future income of the restructured debtor would recognise that this value is based on the cooperation of stakeholders. Any guideline for a fair distribution should indeed stimulate cooperation by disapproving schemes which distribute the value to a single class or a small group amongst all cooperating stakeholders. To the contrary, such a guideline would need to ensure a fair share of the generated value for all cooperating stakeholders.

Recognising the reorganisation surplus as a cooperation premium would intuitively indicate that simply sharing this surplus *pro rata* under all stakeholders who contribute is fair. However, some cooperating stakeholders may expect a different distribution based on their legal entitlements. Indeed, not all stakeholders have the same legal position in relation to the debtor and, thus, not all stakeholders contribute the same way. Such differences may justify and even require a differentiated distribution in order to avoid a discrimination. The distribution of the reorganisation surplus under the plan is only fair if (a) all classes have agreed to the distribution or (b) if the dissenting class is not discriminated against.

Which entitlements justify which differentiated treatment? Stakeholders who contribute in the same way can expect to be rewarded in the same extent by the plan. So their pre-petition legal entitlements towards the value of the business matter as they define their contribution to the cooperation exercise.

These differences are already reflected in the classification of claims and rights under the plan.

Example 6: If certain creditors enter into business relations with the debtor only on the basis of being paid first (senior credit or preferential non-bankruptcy statutory claims), they would reasonably expect a similar treatment when cooperating in a restructuring. On the other hand, if all creditors understand that the success of the business mostly depends on the entrepreneur running and owning it (e.g. the restaurant chef or the 'Steve Jobs' of a company), they would probably accept a plan with a favourable treatment for such key stakeholders.

Based on these assumptions, the structure of a fairness test should, first, look at the expected treatment of classes of stakeholders with relevant different legal entitlements towards value in a (future) business. Second, deviations should be considered appropriate where special circumstances demand for it.

a) The relative priority rule – an anti-discrimination-based fairness test

The first part of the test would thus reflect the different legal entitlements as reflected in the classes formed by the plan.

As a result, a plan is discriminating a dissenting class if such a class would receive less than a class of the same rank or only the same as a junior class. This definition of an unfair discrimination is reflected in art. 11 (1) (c). It is the definition of the 'relative priority rule' and simply reflects the relative pre-petition expectations of all stakeholders towards the access to the value of the business. In contrast to the 'absolute priority rule', it does not prescribe a distance or even a multiplier for the plan distributions to classes with different ranks. This is left to the discretion of the stakeholders in each case and set by the majority accepting the plan.

Example 7: The 'relative priority rule' would simply require that any senior dissenting class must receive or retain a higher value on behalf of their claim than the mezzanine and junior assenting classes, i.e. senior should get x% if mezzanine will get y% and juniors z%, where x>y and x>z. Combined with the effects of the 'best-interest-of-creditors test', the mathematics for a plan distribution would form as follows (simplified):

> A senior creditor class could expect 100 in the alternative scenario (a bankruptcy liquidation), while the unsecured creditors could expect 40. Junior creditors and shareholders would receive nothing in that scenario. The plan must give the senior class value equal to 100 and all unsecured creditor classes value equal to 40 in order to pass the 'best-interest-of-creditors-test'. The cooperation of junior creditors and shareholders could be awarded by the plan as long as classes senior according to non-bankruptcy law receive more than these stakeholders. The necessity of applying both the 'best-interest-of-creditors-test' and the fairness test (relative priority rule), a plan may only be confirmed over the veto of a dissenting class of unsecured creditors, if (1) the plan distributes value to this class of at least 40 [best interest test], (2) does not give more value to any other class of unsecured creditors [no discrimination compared to same ranking stakeholders], and (3) does not leave value with a junior class or shareholder class above 39 [more favourable treatment compared to juniors]. Indeed, a plan that leave shareholders, for instance, with value equal to 20 and junior creditors with value equal to 21 while giving a dissenting class of unsecured creditors 40 could be confirmed.

As a result, no junior or shareholder class could ever receive value equal to or exceeding the value distributed to a more senior class unless such a class is voting to accept such a distribution. A contested restructuring plan would always need to distribute more value to more senior classes. That means, in particular, that a dissenting class of unsecured creditors can effectively veto a plan that would leave value with shareholders and secured creditors while paying nothing to unsecured creditors. Such a veto right does not require implementing the 'absolute priority rule'. It would be guaranteed under a 'relative priority rule'.

Example 8: The implementation of the 'absolute', not the 'relative priority rule' introduces a specific distance between classes of different ranks to the fairness test. Using the example above (example 8), a plan that that leaves shareholders, for instance, with value equal to 20 and junior creditors with value equal to 21 while giving a dissenting class of unsecured creditors 40 could be not be confirmed because the standard of the absolute priority rule demands any dissenting senior class to be paid in full (equal to 100) before any value can be left with any more junior class. As a result, any plan wishing to leave value with a more junior class or shareholders would need to pay a dissenting more senior class in full. So the distance between the ranks is 100 – not more, not less. As such a treatment of more senior classes is a 'more favourable' treatment, any plan designed under the standard of the absolute priority rule would also meet the standards of a relative priority rule.

b) Is a deviation from the RPR benchmark justified – a '*relaxed* RPR?

With the 'relative priority rule' governing the first part of the fairness test, the second part would consider deviations from this rule as the circumstances in an individual case might require more flexibility for a fair solution.

Example 9: The success of the future business depends on the continued contribution of the entrepreneur holding all equity rights in the debtor company. Alternatively, a small business company shall receive a debt relief and no creditor is interested in taking an equity position in the new firm (e.g. due to legal risks, for instance, in case of a partnership, or due to liability or subordination risks for shareholder lenders). If the plan would leave equity untouched in both cases, equity holders would receive value under the plan equal to 100% to their pre-petition rights, while creditors would not be paid in full. Both under an 'absolute' and 'relative priority rule', such a distribution could not be confirmed over the veto of any creditor class regardless of the value of their claims.

For these kind of situations, any priority rule is too strict as it prevents to leave equity rights untouched whenever a creditor class objects. While the impetus of both rules to protect expectations based on pre-petition priority is justified for most cases, especially those with financial investors holding equity positions instead of debt, both rules may prove unnecessarily prohibitive in other cases where most (but not all) parties agree that it makes sense to leave shareholder positions untouched.

Following this line of though, the last sentence of art. 11 (2) allows for a general derogation from any priority rule if 'necessary in order to achieve the aims of the restructuring plan and where the restructuring plan does not unfairly prejudice the rights or interests of any affected parties.' In addition, art. 11 (1) subparagraph 2 provides for an exception for SME. These options should be used carefully and narrowly by lawmakers in order to design an exception to the priority rule only for cases, in which a deviation is substantially justified in the eyes of the court. Apart from such extraordinary cases, exceptions are neither justified for all SME cases nor should they provide for relief from other parts of the cramdown test ('best-interest-of-creditors-test', accepting majority of classes), as those preconditions are essential in all cases of a contested plan. Overall, a 'relaxed relative priority rule' should govern the fairness test in cramdown situations.

4. The effects of a 'best-interest-of-creditors-test' + relaxed RPR approach

The main effect of the 'relative priority rule' is protection against discrimination. The reorganisation surplus must be distributed in a fair manner reflecting that any restructuring is an act of cooperation. At the same time, the legitimate expectations of affected stakeholders for a larger piece of the cake are respected without neglecting the contributions of other stakeholders.

The main comfort of a 'relative priority rule' is flexibility. With the enforceable value protected under the 'best-interest-of-creditors test' and any discrimination between pre-petition ranks eliminated, the distribution of the reorganisation surplus may award the cooperation of stakeholders in a restructuring in many different ways. This flexibility reflects the outcomes that are actually negotiated and concluded in restructuring practice in all jurisdictions – including those where the law provides for an 'absolute priority rule'. Even more, no 'relative priority rule' hinders a majority of stakeholders in any given case to agree on a distribution based on an 'absolute priority' concept. A plan that pays senior credit in full and unsecured credit partially while distributing nothing to other junior classes is consistent both with the confirmation standards of the absolute and the relative priority rules.

Finally (and contrary to Seymoure/Schwarcz, *Corporate Restructuring under Relative and Absolute Priority Default Rules: A Comparative Assessment*, 2019, SSRN: https://ssrn.com/abstract=3498611 or http://dx.doi.org/10.2139/ssrn.3498611), the application of any cramdown test requires a valuation of the debtor's firm in the next-best-alternative scenario for the 'best-interest-of-creditors test'. The extra costs and procedural risks of a dispute on valuation exists in all restructurings regardless of the way that the priority rule for a cramdown test is designed and it should work as an incentive to favour consensual plan solutions also under a 'relative priority rule'.

5. How to implement the 'best-interest-of-creditors-test' + relaxed RPR approach

The actual implementation of the 'relative priority rule' is easy as it only requires to copy art. 11 (1) (c) into local law. The functionality of such a rule is, however, dependant on a framework of tests as this guide has explained. Lawmakers would be well-advised to also include art. 11 (1) (b) (i) when copying the mandatory rules in art. 11 (1) (a) and (d). In addition, this guide obviously assumes that shareholders are parties to the plan and that equity rights may be affected by the plan, so art. 12 does not apply.

If a lawmaker wishes to further detail the cramdown test and its priority rule in particular, they may find orientation in the sec. 1129 (b) of the U.S. Bankruptcy Code. An expanded version of art. 11 (1) (c) could then read as follows:

> 'it ensures that any dissenting voting class is adequately participating at the restructuring surplus distributed under the plan. The court may find this to be the case:
>
> a) With respect to a class of secured claims, if the plan provides

(i) that the holders of such claims retain these claims and the rights securing such claims, whether the property subject to such rights is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims;

(ii) for the sale of any property that is subject to the rights securing such claims, free and clear of such rights, with such rights to attach to the proceeds of such sale, and the treatment of such rights on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.[1]

b) With respect to a class of unsecured claims, if the plan provides

(i) that no holder of any claim or interest will receive or retain under the plan property of a value exceeding the allowed amount of such claim,[2]

(ii) (I)that each holder of a claim of such class receive or retain on account of such claim property of a value equal to the allowed amount of such claim;[3] or

(II) that the holder of any claim or interest of the same rank is not treated more favourably under the plan,[4] and

(III) that the holder of any claim or interest that is junior to the claims of such class will receive or retain under the plan on account of such junior claim or interest property of less value.[5]

The debtor or equity interest holder may retain additional value where the court finds sufficient ground to deviate from the priority rule in subsection (ii) based on the overall fairness of the plan.[6]

c) With respect to a class of shareholders/equity interest holders, if the plan provides

(i) that each holder of an interest of such class receive or retain on account of such interest property of a value equal to the value of such interest, and

(ii) that the holder of any interest of the same rank is not treated more favourably under the plan.[7]

[1] This section a) describes the right of secured lenders to claim the realisable value of their security right – either by retaining their legal position or by extending it to the proceeds or by providing the indubitable equivalent in value of such claims.

[2] The plan may only pay a class more than 100 if all classes agree.

[3] The plan can bind a dissenting class if they are paid in full.

[4] The plan can bind a dissenting class if they are not discriminated compared to other classes of the same rank (‘*at least as favourable treatment of equally ranking creditors*’).

[5] The plan can bind a dissenting class if they are not discriminated compared to junior classes by an equal or worse treatment (‘*more favourable treatment of higher ranking creditors*’).

[6] The plan can bind a dissenting class even when deviating from the relative priority rule if this is justified in the interest of all stakeholders (‘relaxed’ priority rule).

[7] The plan can bind a dissenting class of shareholders if they receive the realisable value of their rights and if they are not discriminated compared to other classes of the same rank.