CORPORATE RESTRUCTURING UNDER RELATIVE AND ABSOLUTE PRIORITY DEFAULT RULES: A COMPARATIVE ASSESSMENT

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The European Union recently adopted a Restructuring Directive intended to facilitate the reorganization of insolvent and other financially troubled firms. Although the central goal of the Directive parallels that of chapter 11 of U.S. bankruptcy law—to protect and maximize the value of financially distressed but economically viable enterprises by consensually reorganizing their capital structure—the Directive introduces an innovative but controversial option: that EU Member States can decree that reorganization negotiations should be subject to a relative priority default rule, in contrast to the type of absolute priority default rule used by chapter 11. EU officials argue that relative priority is not only fair but also provides the flexibility that is needed pragmatically to restructure a troubled firm. This Article explains why relative priority can inadvertently undermine the incentives needed to achieve a successful restructuring, and why absolute priority provides a more effective default rule for reaching a negotiated consensus. Additionally, the Article illustrates why the Directive's standard not only may be unfair to creditors but also might discourage debt investments in the European Union.

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I. INTRODUCTION

This Article assesses the relative priority approach in the European Union's new Restructuring Directive ("Directive")[1] from the comparative perspective of U.S. bankruptcy law—especially chapter 11 of that law, which facilitates the debt restructuring of financially troubled firms.[2] The goal of the Directive parallels that of chapter 11, but in a European Union Member-State context: to provide a framework for guiding the enactment of EU Member-State national laws to facilitate the debt restructuring of insolvent or near insolvent firms.[3] This Article hereinafter will use the term "debtor" to reference both a financially troubled firm being restructured under chapter 11 and a firm being restructured pursuant to the Directive.

Our baseline for comparison is the so-called absolute priority standard employed by chapter 11. Absolute priority is a distributional rule that specifies how the value of a reorganized debtor is to be allocated among its pre-bankruptcy creditors and shareholders. It specifies that a claim held by a senior class of creditors or shareholders is to be paid in full before any payment is made to any junior

1. Council Directive 2019/1023, 2019 O.J. (L 172) 18 (EU) [hereinafter Directive].
2. *See* 11 U.S.C. §§ 1101–1195.
3. The Directive seeks to ensure that "viable enterprises and entrepreneurs that are in financial difficulties have access to effective national preventive restructuring frameworks which enable them to continue operating." Directive, *supra* note 1, Recital 1, at 18.

class.[4] The theoretical justification for this rule is that it implements the contractual payment priorities that would obtain outside bankruptcy.[5]

Chapter 11 does not, however, make absolute priority mandatory for consensually negotiated plans. A plan proponent that can muster the requisite support among each class of creditors and shareholders may confirm a consensual plan that adopts a different distributional rule.[6] And, indeed, most chapter 11 cases are resolved consensually.[7] But if the parties cannot reach a negotiated outcome, a plan may be confirmed via cram down: the bankruptcy court may confirm the plan notwithstanding the objection of an impaired class of creditors or shareholders, upon a showing that the plan meets all of the other requirements set forth by chapter 11, including conformity with absolute priority[8] (unless otherwise specifically stated, this Article hereinafter uses the term "cram down" to refer generically to any nonconsensual reorganization plan, whether under chapter 11 or the Directive[9]). Absolute priority therefore serves as a default rule that influences chapter 11 negotiations.

The most striking feature of the Directive's framework is relative priority.[10] As in chapter 11, the Directive does not require consensually adopted plans to adhere to any particular distributional rule. Member States, however, can choose from a menu of distributional rules to apply as the default rule for cram down.[11] First offered is relative priority: "Member States should be able to protect a dissenting class of affected creditors by ensuring that it is treated at least as favourably as any other class of the same rank and more favourably than any more junior class."[12] A separate recital of the Directive explains that Member States

4. 11 U.S.C. § 1129(b)(2). Thus, absolute priority is sometimes analogized to a waterfall. *See, e.g.*, Vincent S.J. Buccola, *The Janus Faces of Reorganization Law*, 44 J. CORP. L. 1, 7 (2018). Value paid out under the plan must completely satisfy the pool of claims at the highest tier of the waterfall before descending to each successive tier. *Id.*

5. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 213–14 (1986); Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 115–16 (1939); *In re* Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935) (stating that a secured creditor's bargain is that it gets "[its] money or at least the property" and thus bankruptcy cannot deprive it of that "unless by a substitute of the most indubitable equivalent").

6. 11 U.S.C. §§ 1126(c), 1129(a)(8).

7. Richard M. Hynes, *Reorganization as Redemption*, 6 VA. L. BUS. REV. 183, 187–88, 220 (2011).

8. 11 U.S.C. § 1129(b)(1).

9. The term cram down is sometimes written, synonymously, as cramdown and cram-down. In the EU, the term "cross-class cram down" is commonly used to describe the same phenomenon in which a bankruptcy court or other tribunal approves a reorganization plan notwithstanding the dissent of one or more classes of creditors or shareholders. We use the term cram down to encompass this also.

10. R.J. de Weijs, A.L. Jonkers, & M. Malakotipour, *The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)*, Amsterdam L. Sch. Legal Stud. Rsch. Paper No. 2019-10, 7 (2019); Centre for the Study of European Contract Law Working Paper No. 2019-05. For convenience, we refer to the standard adopted by the Directive simply as "relative priority" throughout this Article. We do not mean to imply that this standard is comparable to the notion of relative priority that has been described by some U.S. academics, *see, e.g.*, Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 812–13 (2017), or the related standard that was employed by some courts in the early years of the U.S. corporate insolvency regime, *see* James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127, 130 (1928).

11. *See* Directive, *supra* note 1, Recital 4, at 19.

12. *Id.*, Recital 55, art. 11 (2), at 28, 45.

may derogate from the absolute priority rule if fairness requires that shareholders keep interests under the plan even though more senior classes are not paid in full.[13] Only as a second option does the Directive offer Member States the choice of applying an absolute priority default rule in common with the chapter 11 default rule.[14]

To counter the challenge that relative priority does not respect contractually-agreed payment priorities, EU officials argue that relative priority is not only fair but also provides the flexibility needed to restructure a debtor in a pragmatic way.[15] This Article argues, in contrast, that relative priority can undermine the incentives needed to try to facilitate a consensual, negotiated debt-restructuring plan. As Professors Ayres and Gertner observe, some provisions of contract law function as penalty default rules, which encourage parties to negotiate contract terms to avoid the unpalatable default rule.[16] Chapter 11 works in this fashion. Cram down is undesirable under chapter 11 because, as will be explained, it is expensive and uncertain.[17] Moreover, being subordinated to more senior classes, junior creditors and shareholders are incentivized to consent to a negotiated reorganization plan that offers them some recovery.[18]

Relative priority is unlikely to work in the same fashion. Furthermore, whatever "fair" otherwise means in the fraught context of insolvency—in which, by definition, at least some stakeholders must go unsatisfied—it is unclear that relative priority is necessarily fair to creditors. Relative priority might also make debt investments in the European Union unattractive.

II. RELATIVE PRIORITY IN THE DIRECTIVE

The Directive, originally proposed by the EU Commission, entered into force on July 16, 2019, following adoption by the European Parliament in March 2019 and by the EU Council in June 2019.[19] Member States are required to implement the Directive by July 2021.[20] The Directive marks a watershed in European insolvency law.[21] The previous Insolvency Regulation addressed recognition of insolvency proceedings within the EU and the jurisdiction of Member-

13. *Id.*, Recital 55, at 28.

14. *Id.*

15. *See, e.g.*, Salla Saastamoinen, Dir. for Civ. & Com. Just., Directorate-General for Just. & Consumers, European Comm'n, Address at the 19th Annual Conf. of the Int'l Insolvency Inst. (June 18, 2019) [hereinafter III Annual Conference].

16. *See generally* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

17. *See infra* Section III.B.1.

18. *See infra* Section III.B.1.

19. Directive, *supra* note 1, Recital, art. 35, at 18 n.3, 55; Proposal for a Directive of the European Parliament and of the Council on Preventive Restructuring Frameworks, Second Chance and Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures and Amending Directive 2012/30/EU, COM (2016) 723 final (Nov. 22, 2016) [hereinafter Proposal].

20. Directive, art. 34, *supra* note 1, at 55.

21. In the U.S., the term "bankruptcy" is used for any type of proceeding under title 11 of the U.S. Code, whether commenced by an individual or a corporation, that is unable to pay its debts or otherwise seeks the protections of the Bankruptcy Code. "Insolvency" is used to describe a situation of financial distress and not to

State courts, but did not impose substantive legal standards upon Member States.[22] The Directive aims to make insolvency procedures shorter, more efficient, and less costly.[23] The focus is on restructuring viable businesses: "Above all, the proposal aims to enhance the rescue culture in the EU."[24] Commentators have noted the influence of chapter 11 on many of the Directive's provisions.[25] "Strong similarities" include giving control over the restructuring to the debtor itself, staying collection efforts during the restructuring's pendency, and requiring counterparties to perform the debtor's unexpired contracts.[26] Indeed, the fact that the Directive permits cram down—a mechanism to approve a reorganization plan absent consent from each class of impaired creditors and shareholders—is attributed to chapter 11's influence: "[t]he proposal contains old chapter 11 favourites such as cram-down of dissenting creditors, cross-class creditor cram-down and the 'best interests of creditors' test."[27]

As originally drafted in 2016, the Directive resembled chapter 11 in one additional respect: how cram down of dissenting creditors was to be implemented. It provided, as does Section 1129 of chapter 11, that a plan that is not consensually adopted must "ensure . . . that a dissenting class of creditors is paid in full before a more junior class can receive any distribution or keep any interest

refer to a judicial proceeding: within the definition of the Bankruptcy Code, an entity is insolvent if the sum of its debts exceeds the fair value of its assets. 11 U.S.C. § 101(32); *see also* U.C.C. § 1-201(23) (setting forth other, broader definitions of insolvency). A debtor may be, but is not required to be, insolvent. In the EU, the term bankruptcy is not consistently used, but may be reserved for debt-relief proceedings for consumer or individual debtors. Insolvency may be used to describe both the situation of financial distress in which a business unable to pay its debts finds itself, and the judicial proceedings that exist to address such distress. *See* Regulation (EU) 2015/848 of the European Parliament and of the Council, art. 2(4), Annex A, 2015 O.J. (L 141) 19, at 30, 60–63 [hereinafter Insolvency Regulation] (defining and listing Member State insolvency proceedings as of 2015). Restructuring proceedings that may be available to debtors that are not currently insolvent do not yet exist in many Member States; the Directive will require their introduction for the first time. Such proceedings have been variously referred to as "pre-insolvency" or "preventive restructuring" frameworks. *See, e.g.*, Carla Stamegna, Eur. Parl. Rsch. Serv., *New EU Insolvency Rules Give Troubled Businesses a Chance to Start Anew*, PE.623.548 (June 2018); Directive, *supra* note 1, Recital 1, at 18. In this Article, we generally use the term bankruptcy to encompass all such proceedings.

22. Insolvency Regulation, *supra* note 21; Proposal, *supra* note 19, at 9. The Regulation also included provisions requiring Member States to implement some procedural standards for insolvency proceedings, but was for the most part, as described here, concerned with international private law issues. *See* Insolvency Regulation, Recital 6, *supra* note 21, at 19.

23. Proposal, *supra* note 19, at 5; Directive, *supra* note 1, Recital 6, at 19.

24. Proposal, *supra* note 19, at 6.

25. *See, e.g.*, Gerard McCormack, *Corporate Restructuring Law–A Second Chance For Europe?*, 42 EUR. L. REV. 532, 537 (2017) ("The proposal has been spoken of as Europe's response to chapter 11 of the US Bankruptcy Code."); Nicolaes W.A. Tollenaar, *The European Commission's Proposal for a Directive on Preventive Restructuring Proceedings*, 30 INSOLVENCY INTEL. 65, 66 (2017) ("The proposed preventive restructuring procedure is inspired by the UK scheme of arrangement and the plan procedure contained in Ch.11 of the US Bankruptcy Code."); Susan Block-Lieb, *Reaching to Restructure Across Borders (Without Over-Reaching), Even After Brexit*, 92 AM. BANKR. L.J. 1, 33–34 (2018); Bo Becker, *The EU's Insolvency Reform*, VOX: CEPR POLICY PORTAL (June 27, 2019), https://voxeu.org/article/eu-s-insolvency-reform [https://perma.cc/MT4D-RSZ3] ("The introduction of the Directive was motivated by slow reform progress in member states, and is inspired by Chapter 11 of the US Bankruptcy Code.").

26. McCormack, *supra* note 25, at 537.

27. *Id.* at 549.

under the restructuring plan."[28] Member States, in other words, were required to implement an absolute priority default rule. The EU Commission explained that:

> The absolute priority rule serves as a basis for the value to be allocated among the creditors in restructuring. . . . The absolute priority rule makes it possible to determine, when compared to the capital structure of the enterprise under restructuring, the value allocation that parties are to receive under the restructuring plan on the basis of the value of the enterprise as a going concern.[29]

The final text of the Directive, as adopted in 2019, is very different. Recital 56 explains that Member States should be able to derogate from the absolute priority rule if they consider it "fair" that shareholders keep certain interests under the plan despite a more senior class being obliged to accept a reduction of its claims.[30] To that end, to "ensure that dissenting classes of affected creditors are not unfairly prejudiced under the proposed plan," Recital 55 of the Directive gives Member States a choice between enacting a relative priority or absolute priority default rule for cram down:

> Member States should be able to protect a dissenting class of affected creditors by ensuring [in a relative priority sense] that it is treated . . . more favourably than any more junior class. Alternatively, Member States could protect a dissenting class of affected creditors by ensuring [in an absolute priority sense] that such dissenting class is paid in full if a more junior class receives any distribution or keeps any interest under the restructuring plan (the 'absolute priority rule').[31]

Member States that choose to enact a relative priority default rule must require that a cram down restructuring 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."[32] It thus appears that a cram down plan could be deemed binding on a debtor's creditors if, among other less onerous and relevant conditions, higher ranking classes of debt claims and

28. Proposal, recital 28, *supra* note 19, at 30; *see also* Proposal, art. 11(1), *supra* note 19, at 45 ("Member States shall ensure that a restructuring plan which is not approved by each and every class of affected parties may be confirmed . . . where the restructuring plan: . . . (c) complies with the absolute priority rule."); *cf.* 11 U.S.C. § 1129(b)(1) ("[T]he court . . . shall confirm the plan . . . if the plan . . . is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."); 11 U.S.C. § 1129(b)(2)(B)(ii) (clarifying that the "fair and equitable" condition requires that, for each class of unsecured claims, "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . ."); *see, e.g.*, Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 115–16 (1939) ("The words 'fair and equitable' . . . are words of art which . . . had acquired a fixed meaning . . . . '[A]ny arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.' This doctrine is the 'fixed principle' according to which . . . the character of reorganization plans was to be evaluated.") (quoting Louisville Trust Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 684 (1899)); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 207 (1988) ("[T]he Code provides that a 'fair and equitable' reorganization plan is one which complies with the absolute priority rule. . . .").

29. Proposal, Recital 28, *supra* note 19, at 30.

30. Directive, *supra* note 1, Recital 56, at 28.

31. *Id.*, Recital 55, at 28.

32. *Id.*, art. 11(1)(c), at 45.

equity interests simply receive better treatment than lower ranking classes.[33] That outcome contrasts with an absolute priority default rule, under which Member States would require "that 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."[34]

Allowing Member States to choose this relative priority alternative to absolute priority is a dramatic change to the originally drafted Directive. Several reasons have been advanced to justify the change. An October 2018 revised draft of the Directive included a note explaining, "[t]he cross-class cram-down mechanism was new to a number of Member States and raised some concerns."[35] Some Member States feared that absolute priority—and the associated requirement of a valuation—would make approval of a plan "more burdensome and costly" and thus render restructurings "more restrictive if not impossible."[36] Relative priority was thought to provide "more flexibility" to Member States in implementing cram down.[37] An EU-funded report, also published in 2018, provided two additional justifications. First, relative priority would discourage holdout creditors who might otherwise "free-ride on others' sacrifice by being paid in full while those others accepted a haircut."[38] Second, by making it easier for shareholders to receive value under the plan, relative priority might incentivize earlier and more frequent resort to restructuring.[39]

Neither the EU's own materials nor the report include any substantive discussion on how relative priority is intended to work in practice. That is consistent with the notion that the Directive's provision for relative priority represents a political compromise, designed to reassure Member States for whom the introduction of reorganization procedures breaks new ground by giving them the flexibility to alter traditional insolvency distributional rules.[40] In particular, the Directive and associated materials are silent on what provision for senior creditors will be sufficient to satisfy Article 11's requirement that they be treated "more favourably" than junior-priority creditors or shareholders, or in what situations it may be "fair" to permit shareholders to retain a stake in the restructured business even though some creditors remain unpaid—details that are apparently for Member States to work out.

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33. *Infra* Section IV.A; *see also* de Weijs et al., *supra* note 10, at 17–19.

34. Directive, *supra* note 1, art. 11(2), at 45.

35. Note from Presidency to Council Regarding Proposal for a Directive on Preventive Restructuring Frameworks, art. 2(e), 12536/18, at 5 (Oct. 1, 2018), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CONSIL:ST_12536_2018_INIT&qid=1598811998793&from=EN [https://perma.cc/ZL86-8MUM] [hereinafter Note from Presidency to Council]. *But see* de Weijs et al., *supra* note 10, at 10–11 (suggesting that easing priority rules is a solution that is not well crafted to address concerns over the novelty of cram down in Europe).

36. Note from Presidency to Council, *supra* note 35, at 5.

37. *Id.* at 6.

38. BEST PRACTICES IN EUROPEAN RESTRUCTURING: CONTRACTUALISED DISTRESS RESOLUTION IN THE SHADOW OF THE LAW 46 (Lorenzo Stanghellini et al. eds., 2018) [hereinafter BEST PRACTICES].

39. *Id.*

40. *See, e.g.*, MARYAM MALAKOTIPOUR, DEVIATING FROM ABSOLUTE PRIORITY 6 (2020).

III. PRIORITY AND THE NEGOTIATION OF PLANS

A. The Advantages of a Consensual Plan

Chapter 11 values consensual negotiation of reorganization plans.[41] "The [U.S. Bankruptcy] Code establishes a process and provides incentives to encourage the parties to resolve cases through the development of consensus around one of many plausible plans."[42] As with many other areas of the law, the Bankruptcy Code ("Code") recognizes that, within a properly structured framework, parties may reach better outcomes—and should do so in more efficient fashion—if they resolve a dispute on their own terms rather than via adjudication.[43] Bankruptcy represents something of a special case for this principle. "Consensual" plans need not be fully consensual. The Code merely requires that a plan be approved by each class of substantially similar (e.g., *pari passu*) creditors and shareholders, such approval evidenced by a supermajority vote of more than one-half in number and at least two-thirds in amount of the voting class members.[44] Dissenting class members are individually protected by the (admittedly minimally valuable) requirement that they receive no less under the plan than they would receive in a piecemeal liquidation of the debtor.[45]

Within these bounds, chapter 11 does much to create suitable conditions for the negotiation of a fair and efficient settlement. All parties are provided with appropriately detailed information regarding the debtor's circumstances to enable them to evaluate any proposed plan.[46] The debtor—presumptively best placed to formulate a successful plan—begins with exclusive control over the plan process, but may lose that exclusivity if it delays too long in proposing a

41. AM. BANKR. INST. COMM. TO STUDY THE REFORM OF CHAPTER 11, FINAL REPORT AND RECOMMENDATIONS 182 (2014) [hereinafter ABI CHAPTER 11 COMMISSION REPORT] ("Although disputes arise and not every chapter 11 is consensual, commentators typically describe 'the goal of a Chapter 11 restructuring [as achieving] a consensual plan of reorganization.'").

42. Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors' Committees*, 43 UCLA L. REV. 1547, 1568 (1996).

43. *See id.* at 1625; *see also* Marc Galanter & Mia Cahill, *"Most Cases Settle": Judicial Promotion and Regulation of Settlements*, 46 STAN. L. REV. 1339, 1371–78 (1994); Stephen McG. Bundy, *The Policy in Favor of Settlement in an Adversary System*, 44 HASTINGS L.J. 1, 37–58 (1992).

44. 11 U.S.C. § 1126(c). A class is also deemed to have accepted the plan if it is determined not to be impaired by its treatment under the plan. § 1126(f).

45. 11 U.S.C. § 1129(a)(7). Liquidation valuations in connection with § 1129(a)(7) are routine and usually involve minimal judicial attention. *See* Diane Lourdes Dick, *Valuation in Chapter 11 Bankruptcy: The Dangers of an Implicit Market Test*, 2017 U. ILL. L. REV. 1487, 1498 (2017); *see also* Scott F. Norberg, *Classification of Claims Under Chapter 11 of the Bankruptcy Code: The Fallacy of Interest Based Classification* 69 AM. BANKR. L.J. 119, 143 n.134 (1995) ("Although the best interests test always requires valuation of a firm, this valuation is conceived as pro forma, while a valuation under the cramdown provision would normally require a more extensive appraisal."). Where the debtor is clearly insolvent, there may be no valuation at all. Chaim J. Fortgang & Thomas Moers Meyer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1106 (1985) (noting the requirement of liquidation valuation is "nominal" as "[g]enerally, . . . liquidation value is so low that distributions under the plan clearly exceed the section 1129(a)(7) minimum, and no formal valuation is necessary.").

46. 11 U.S.C. § 1125. In practice, the value of these disclosures may be overstated. Assuming the plan in question is proposed or supported by the debtor, disclosures prepared by the debtor may be self-serving. And if the case in fact settles, the debtor's valuation of itself will not be put to the test. *See* Dick*, supra* note 45, at 1492–96.

plan that others can support.[47] And parties take advantage of this framework. Research shows that cram down in large chapter 11 cases—those most frequently studied and, in any event, the cases in which one might presume that parties have the greatest incentive to fight over distributional issues—is rare.[48] In other words, consensual plans are the norm for chapter 11.

The potential benefits of consensus are readily discernible. Most obviously, a consensual plan conserves resources. Litigation and procedural costs, both for the debtor and for the official committee of unsecured creditors, are paid out of the bankruptcy estate as administrative expenses—claims with priority over other unsecured claims that accordingly dilute creditor and shareholder recovery.[49] Cases in which parties' entitlements in a cram down must be litigated are associated with much higher costs.[50] For example, in one sizeable chapter 11 case that involved cram down litigation,[51] counsel for the debtor alone expended $1,788,247.50.[52]

Parties also favor negotiated resolutions because a consensual plan can be confirmed more quickly than a plan that requires a contested confirmation hearing.[53] A prolonged bankruptcy proceeding may be harmful to the debtor. In addition to potentially increasing the direct costs of the bankruptcy case—most significantly, professional fees[54]—bankruptcy imposes significant indirect costs.[55] Ongoing bankruptcy proceedings may discourage suppliers or customers from dealing with the debtor.[56] Regulatory regimes may limit the debtor's business

47. 11 U.S.C. § 1121.

48. *See* Hynes, *supra* note 7, at 187–88, 220.

49. 11 U.S.C. §§ 327, 503(b)(1), 1103. In the less frequent cases in which an equity committee is appointed, their fees and expenses are also paid out of the estate. § 1103. Additionally, the debtor's credit agreements may obligate it, at least under some circumstances, to reimburse the litigation costs of key creditor constituencies.

50. Stephen J. Lubben, *What We "Know" About Chapter 11 Cost Is Wrong*, 17 FORDHAM J. CORP. & FIN. L. 141, 180 (2012).

51. To be sure, in the largest of cases, the fees, while substantial in dollar amount, may be insignificant in comparison to the estate's other obligations. *See* Stuart Gilson, *Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. APPLIED CORP. FIN. 23, 26 (2012). One estimate is that the total of all direct costs of a bankruptcy case typically amounts to less than five percent of asset value. *Id.*; *see also* Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 285 (1990) (suggesting that direct costs average 3.1% of the total of the book value of debt and market value of equity).

52. Fee Application of Willkie Farr & Gallagher LLP, *In re* MPM Silicones LLC, No. 14-22503, Dkt. 1266 (Bankr. S.D.N.Y. Dec. 8, 2014). These are fees attributable to confirmation as a whole; the debtor would still have had to expend some portion of that amount had the plan been confirmed consensually. The debtor was also represented, as is customary in large chapter 11 cases, by financial and restructuring advisors paid out of the estate, as was counsel to the unsecured creditors' committee.

53. *Cf.* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 147 (1990).

54. *See* Gilson, *supra* note 51, at 26. Some scholars have suggested that the length of a chapter 11 case is only weakly correlated with professional costs. Lubben, *supra* note 50, at 184.

55. Gilson, *supra* note 51, at 26 (suggesting that indirect costs may amount to as much as 10% to 25% of a firm's pre-bankruptcy stock market value).

56. *See* Gilson, *supra* note 51, at 26.

options during the pendency of the case.[57] Management will likely be distracted from other business problems.[58]

Finally, a consensual plan may enhance the debtor's image. One study suggested that participants in the bankruptcy process believed that a negotiated conclusion to the case would increase confidence in the reorganized debtor.[59] "If the various interests visibly 'make peace,' it may help to convince customers, suppliers, and most importantly potential lenders that the company's problems have been resolved to everyone's satisfaction and that the company has rebounded from its crisis."[60] If claims against the debtor are not traded and the debtor expects to continue to do business with its creditors after reorganizing, a consensual plan may help to preserve relationships.

Because a consensual negotiated debt-restructuring plan is preferable to a cram down, the law needs to supply incentives to motivate parties to try to reach consensus. Absent incentives, holders of senior-priority creditor claims and equity interests would lack motivation to yield value to holders of more junior claims and interests.[61] Instead, they would likely insist upon payment in full of whatever distribution they were entitled to under applicable distributional rules—for chapter 11, payment in full before any junior creditor or shareholder receives any value.[62] Holders of those more junior priority claims and interests, in turn, would have no incentive to consent to a plan that paid them little or nothing.

B. Chapter 11's Default Rule

Chapter 11 addresses this conundrum by imposing a default rule that would apply in a cram down, absent the parties reaching a consensual, negotiated debt-restructuring plan.[63] That default rule is one that most, if not all, of the parties

57. *Id.*
58. *Id.*
59. LoPucki & Whitford, *supra* note 53, at 152.
60. *Id.*
61. LoPucki & Whitford's pathbreaking study suggested, though, that creditors routinely yielded value to equity in U.S. bankruptcy settlements absent any strictly economic justification. *Id.* at 142. Equity could expect to receive a distribution even in cases in which unsecured creditors received only fractional payment. *Id.* They concluded that a culture among bankruptcy judges and bankruptcy professionals, under which consensual plans were simply the "responsible, appropriate means for accomplishing reorganization" was responsible for these outcomes. *Id.* at 154–58, 195. Those professionals operated with sufficient independence from the actual economic stakeholders that they could enforce amongst themselves norms in favor of settlement. *Id.* If that were once the case, chapter 11 culture has now changed. *See* Douglas G. Baird, *Chapter 11's Expanding Universe*, 87 TEMP. L. REV. 975, 976 (2015). In insolvent debtor cases, equity rarely receives anything. *Id.* at 979. And in general, chapter 11 practice more frequently involves sophisticated creditor constituencies made up of repeat players acutely tuned towards value maximization in each individual case. *Id.* at 983–85.
62. *See* LoPucki & Whitford, *supra* note 53, at 130.
63. For example, the legislative history of the Bankruptcy Code explains that "[t]he bill does not impose a rigid financial rule for the plan. The parties are left to their own to negotiate a fair settlement. . . . Only when the parties are unable to agree on a proper distribution of the value of the company does the bill establish a financial standard." H.R. Rep. No. 95-595, at 224 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6183–84.

normally want to avoid, because it requires a full valuation of the restructured debtor as a going-concern.[64]

The traditional model for a corporate reorganization is that equity in the debtor is transferred from pre-petition shareholders to creditors in order to repay claims.[65] In a cram down, the absolute priority rule is followed: creditors share in the debtor's equity according to their state-law priorities, with pre-petition shareholders retaining only what is unnecessary to pay creditors in full.[66] For insolvent debtors, pre-petition shareholders would be wiped out.[67]

To apply the absolute priority rule to a cram down plan that transfers equity, the equity must be valued.[68] Unless that valuation occurs in the marketplace pursuant to an auction or other sale procedure, the value must be determined by the bankruptcy court.[69] As explained below, parties understand that such a valuation is likely to be hotly contested, thereby diminishing their ultimate recovery. This creates the penalty default rule that motivates parties to try to avoid cram down and reach a consensual plan.

1. The Undesirability of Valuation

First, the valuation required in cram down is costly. In a large case, valuation invariably requires expert testimony, in addition to potentially extensive discovery and briefing. One international observer characterized the American courtroom during a valuation hearing as a "battlefield of experts."[70] A contested confirmation thus potentially reduces the value available for distribution to creditors and shareholders. Although these valuation costs sometimes are relatively small compared to the total asset pool,[71] the perception that valuation is prohibitively expensive appears to motivate consensual plans.[72]

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64. *See* 11 U.S.C. § 1129(b) (describing "cram down" in which a reorganization plan may be confirmed over the dissent of certain classes). That feature of cram down was understood by the Bankruptcy Code's drafters:

> Simply put, the bill requires the plan pay any dissenting class in full before any class junior to the dissenter may be paid at all. The rule is a partial application of the absolute priority rule now applied under chapter X [one of the predecessors to chapter 11] and requires a full valuation of the debtor as the absolute priority rule does under current law. The important difference is that the bill permits senior classes to take less than full payment, in order to expedite or insure the success of the reorganization.

H.R. Rep. No. 95-595, at 224 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6184.

65. *See, e.g.*, Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 127 (1986).

66. *See* LoPucki & Whitford, *supra* note 53, at 130.

67. Bankruptcy thus operates as what has been called a "day of reckoning." Baird, *supra* note 65, at 127; *see also* DOUGLAS BAIRD, ELEMENTS OF BANKRUPTCY 59 (6th ed. 2010).

68. *See* LoPucki & Whitford, *supra* note 53, at 130; Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1940–44, 1951 (2006).

69. LoPucki & Whitford, *supra* note 53, at 130; Baird & Bernstein, *supra* note 68, at 1952.

70. Jongho Kim, *Bankruptcy Law Dilemma: Appraisal of Corporate Value and Its Distribution in Corporate Reorganization Proceedings*, 29 NW. J. INT'L L. & BUS. 119, 137 n.87 (2009).

71. *See* Gilson, *supra* note 51, at 26.

72. *See* LoPucki & Whitford, *supra* note 53, at 144 ("The expense of litigating the value of the company was cited by many interviewees [bankruptcy lawyers] as a reason for allowing equity to share in the distribution." (citation omitted)).

Second, a consensual, negotiated plan avoids the uncertainty inherent in a valuation for a contested confirmation. Bankruptcy judges are not valuation experts. Yet cram down tasks them with trying to master a valuation process that is "more art than science."[73] Multiple valuation methodologies are standard in chapter 11—chiefly valuation based on a discounted cash flow ("DCF") analysis, on comparable companies, and on comparable transactions[74]—but the parties cannot predict how much weight will be given to each approach.[75] Ayotte and Morrison note that some courts, for example, dismiss—or at least give less weight to—DCF as less reliable than other approaches; others view DCF as an essential component of any valuation.[76] The potential variance is enhanced because the inputs based on which the judge must make conclusions are the often self-serving analyses prepared by the parties and their experts.[77]

Under the mandatory distributional rule that applies in cram down, for example, a more senior creditor has an incentive to argue for a lower valuation because it will then become entitled to a greater share of the equity of the reorganized debtor; a junior creditor or shareholder is incentivized to argue for a higher valuation.[78] And it appears that these two camps may enjoy roughly equal amounts of success in persuading bankruptcy courts of their position.[79] The net

73. ABI CHAPTER 11 COMMISSION REPORT, *supra* note 41, at 181.

74. *See, e.g.*, Hon. Christopher S. Sontchi, *Valuation Methodologies: A Judge's View*, 20 AM. BANKR. INST. L. REV. 1, 14 (2012).

75. In one influential valuation case, *In re* Exide Technologies, 303 B.R. 48, 59 (Bankr. D. Del. 2003), the chapter 11 debtor and the official committee of unsecured creditors both submitted valuations based on each of the standard approaches. The bankruptcy court's ultimate conclusions differed from both parties' submissions:

TABLE 1

	DCF Analysis	**Comparable Companies**	**Comparable Transactions**	**Valuation Conclusion**
Debtor	$1.023 billion - $1.254 billion	$897 million - $1.076 billion	$986 million - $1.086 billion	$950 million - $1.05 billion
Creditors	$1.583 billion - $1.836 billion	$1.515 billion	$1.1 billion - $1.5 billion	$1.5 billion – 1.7 billion
Bankruptcy Court	$1.583 billion - $1.836 billion	$1.355 billion - $1.449 billion	$1.204 billion	$1.4 billion - $1.6 billion

See id. at 61–66.

76. *See* Kenneth Ayotte & Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 166 U. PA. L. REV. 1819, 1836–37 (2018).

77. "Attempts at manipulating valuations to serve the self-interest of the litigants is common." *Id.* at 1822. Ayotte and Morrison conclude, for example, that DCF is particularly prone to manipulation by parties and experts. *Id.* at 1822, 1834–38.

78. *See* Baird & Bernstein, *supra* note 68, at 1951 n.55. Even in cram down cases, there may be some potential for priority skipping—for example via a "gift" from senior creditors to a class multiple levels below them in the priority structure (although current law generally holds such plans to be impermissible unless consensual), or as a result of jockeying for position that occurred earlier in the bankruptcy case. *See, e.g.*, Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1250–63, 1280–81 (2013); *In re* Armstrong World Indus. Inc., 432 F.3d 507, 514 (3d Cir. 2005); Dish Network Corp. v. DBSD N. Am., Inc., 634 F.3d 79, 92 (2d Cir. 2011); *infra* notes 192–195 and accompanying text. But these priority-jumps do not alter the negotiation incentives described here: in a gifting case, for example, although a junior class, the gift recipient is not incentivized to argue for a low valuation because its recovery comes entirely out of the distribution that would otherwise be made to the gifting senior class.

79. Bernard Trujillo, *Patterns in Complex System: An Empirical Study of Valuation in Business Bankruptcy Cases*, 53 UCLA L. REV. 357, 370 (2005) (describing results of study concluding that "the court picks either the debtor's number or the creditor's number . . . about equally" and rarely splits the difference between

result is substantial uncertainty—as both Congress and the bankruptcy courts themselves have acknowledged.[80] "Reorganization folklore" thus holds that valuation is "a guess compounded by an estimate."[81] Even if that overstates the problem, uncertainty in the valuation process is ineradicable given the number of assumptions that underlie any given valuation.[82]

Valuation uncertainty motivates parties to reach consensual plans. For example, it imposes risks upon senior creditors that prompt them to compromise by yielding value to junior creditors, rather than insisting upon full payment.[83] Otherwise-out-of-the-money junior creditors are thereby incentivized to support the reorganization. Another way of thinking about this is that valuation uncertainty creates "option value" for junior creditors—the ability to impose on the senior investor the risk that the appraiser will settle on a value for the business that is at the high end of the range of variance."[84] Baird and Bernstein illustrate this option value using the hypothetical bankruptcy of a firm that has two classes of creditors.[85] Both senior and junior creditors believe the firm to be worth $250.[86] The senior creditor is owed that same amount.[87] Under chapter 11's default distributional rule, it is entitled to receive $250—or all of the equity in the reorganized debtor—and the junior creditor is entitled to receive nothing.[88] At first glance, the senior creditor has no incentive to compromise and accept a

the parties). It appears that "courts thoughtfully consider valuation disputes and do not simply resolve such matters by splitting the difference." ABI CHAPTER 11 COMMISSION REPORT, *supra* note 41, at 181. Regardless, there is clearly wide variance in the manner in which courts resolve cases. *Id.*

80. The Bankruptcy Code's legislative history suggests that imperfections of the valuation process were a significant reason behind Congress's decision to allow for negotiated plans that departed from the absolute priority rule and thus did not require a valuation. H.R. Rep. No. 95-595, at 222 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6181 ("In a reorganization where time is of the essence, the length and uncertainty of the valuation process is no longer justified in every case."). It also understood that the court must arrive at valuations based on the parties' self-serving submissions. *Id.* ("Though valuation is theoretically a precise method of determining the creditors' and stockholders' rights in a business, more often the uncertainty of predicting the future required in any valuation, is a method of fudging a result that will support the plan that has been proposed."). Courts agree. *See, e.g.*, *In re* Mirant Corp., 334 B.R. 800, 848 (Bankr. N.D. Tex. 2005) ("At best, the valuation of an enterprise like Mirant Group is an exercise in educated guesswork. At worst it is not much more than crystal ball gazing."); JP Morgan Chase Bank, N.A. v. Charter Commc'ns Operating LLC and CCO Holdings, LLC, 419 B.R. 221, 234 n.9 (Bankr. S.D.N.Y. 2009) ("[V]aluation judgments include multiple subjective elements"); *In re* Mallard Assocs., 8 B.R. 820, 825 (Bankr. S.D.N.Y. 1981) ("Therefore, in cases of valuation, for purposes of 'cram-down', the Court quite expectantly receives a 'low' valuation of the premises from the debtor and a 'high' valuation by the creditor's appraiser."); Peltz v. Hetten, 279 B.R. 710, 737–38 (D. Del. 2002) (valuing business in connection with fraudulent transfer suit brought in bankruptcy: "[s]imply put, when it comes to valuation issues, reasonable minds can and often do disagree. This is because the output of financial valuation models are driven by their inputs, many of which are subjective in nature.")

81. Baird & Bernstein, *supra* note 68, at 1942 n.32; *see* H.R. Rep. No. 95-595, at 222 (1977) *reprinted in* 1978 U.S.C.C.A.N. 6179, 6181 (attributing remark to Professor Peter Coogan).

82. Baird & Bernstein, *supra* note 68, at 1952.

83. *Id.* at 1959; *see also* Baird, *supra* note 10, at 814 ("Parties, of course, can bargain in the shadow of bankruptcy and avoid its costs, but bargaining is never costless. Absolute priority requires bargaining over the size of the haircut that junior creditors must take by virtue of accelerating the exercise date of their option.").

84. Baird & Bernstein, *supra* note 68, at 1960.

85. *Id.* at 1956.

86. *Id.* at 1955.

87. *Id.*

88. *Id.* at 1956.

lesser distribution than payment in full.[89] Meanwhile, the junior creditor has no incentive to agree to a plan than follows the default distributional rule—because it will receive nothing.[90]

In practice, if the senior and junior creditors cannot agree on a plan and proceed to a contested confirmation, the firm must be valued by the bankruptcy court. Baird and Bernstein assume, for these purposes, that bankruptcy courts are as proficient at valuation as any independent, third-party expert appraiser.[91] If the firm were to be valued one hundred times, the median valuation arrived at by the bankruptcy courts would be $250.[92] Nonetheless, all of the factors that contribute to valuation uncertainty mean that, in any given instance, the bankruptcy judge may arrive at a valuation than is higher or lower than the median. If the bankruptcy judge values the business at less than $250, the outcome is unchanged.[93] The junior creditor will still receive nothing. But if she values the business at more than $250, the senior creditor must share its distribution with the junior creditor (who receives the difference between the bankruptcy court's valuation and the secured creditor's $250 claim).[94]

The junior creditor's right to force a valuation hearing by objecting to a proposed plan therefore has value. If the precise distribution of possible judicial valuations were knowable in advance, then the amount of this option value could be calculated exactly.[95] But even though the precise valuation risk in any given case is unknowable, it still influences bargaining. A senior creditor negotiating a reorganized plan is incentivized to yield some value to junior creditors in order to "buy" the option from them—that is, to induce the junior creditors to agree to a consensual plan and forego the possibility that a bankruptcy judge at a cram down hearing will reach a high-side valuation of the business that allows them unwarranted participation in the plan.[96] The senior creditor is better off yielding value in this way rather than simply taking its chances at a valuation hearing, even assuming that it must buy the junior creditors' option at its "full" value because it can thus avoid not only the risk of a high valuation, but also the direct and indirect costs associated with a contested plan confirmation.[97] The risks and costs associated with a nonconsensual reorganization thus combine to encourage negotiation and settlement.

2. *Valuation as a Penalty Default Rule*

Chapter 11's approach in this respect parallels the Ayres-Gertner observation that "lawmakers may be able to undercut the incentives for . . . strategic rent-

89. *Id.* at 1954.
90. *Id.*
91. *Id.* at 1956.
92. *Id.*
93. *Id.*
94. *Id.*
95. *See id.* at 1956, 1956 n.62.
96. *Id.* at 1959.
97. *Id.* at 1959–60.

seeking by establishing penalty defaults" that encourage parties to contract around the default.[98] Ayres and Gertner supplement the traditional understanding that default rules in contract should reflect what the parties would have contracted for had they addressed the issue—a normative justification that, in the so-called creditors' bargain theory, is also often applied to bankruptcy's default rules.[99] They posit that a different penalty default rule is appropriate when parties could negotiate more cheaply ex ante rather than submit to ex post adjudication by a court—especially when the reason why an issue remains unaddressed rather than pre-negotiated is because one party has strategically withheld information in the hope of gaining an advantage.[100] Rather than attempting to predict the favored outcome of the parties, the penalty default encourages the parties to opt-out of the default.[101] In so doing, the penalty default focuses on the party that might otherwise be tempted to exploit private information; it discourages that party from strategically exploiting her advantage by remaining silent.[102]

The classic and much-discussed example of a penalty default rule is the common law contract rule of *Hadley v Baxendale*.[103] The rule provides that a breaching party is not responsible for consequential loss caused by his breach unless the damages were foreseeable.[104] In this case, the purpose of the rule is to encourage the parties to contract in advance regarding the scope of the damages that will accrue following any breach of contract.[105] In the absence of a penalty default rule, a party that is particularly susceptible to damages might refrain from disclosing that fact while contracting, understanding that its counterparty would likely respond by increasing the contract price, but hoping that, in the event of a default, it could nonetheless recover its full damages from a court.[106] The penalty default discourages such "strategic rent-seeking"—instead, the susceptible party is incentivized to reveal its special circumstances to ensure that its losses are fully covered, even if that coverage is reflected in the contract price.[107] In turn, understanding that coverage for such losses must be contracted for, the counterparty is not incentivized to waste resources on unnecessary precautions when dealing with parties who remain silent about their potential losses out of fear that a breach might prove unexpectedly costly.[108]

98. Ayres & Gertner, *supra* note 16, at 127.
99. *Id.* at 93; *see, e.g.*, JACKSON, *supra* note 5, at 17.
100. Ayres & Gertner, *supra* note 16, at 93, 97–100.
101. Barry E. Adler, *The Questionable Ascent of* Hadley v. Baxendale, 51 STAN. L. REV. 1547, 1549 (1999).
102. *Id.* at 1550.
103. *Id.* at 1549–50; Ayres & Gertner, *supra* note 16, at 101; Hadley v. Baxendale [1854] 156 Eng. Rep. 145.
104. Ayres & Gertner, *supra* note 16, at 101.
105. *Id.* at 101–03.
106. *Id.*
107. *Id.* at 94.
108. *Id.* at 102; *see* Kathleen G. Noonan, Jonathan C. Lipson, & William Simon., *Reforming Institutions: The Judicial Function in Bankruptcy and Public Law Litigation*, 94 IND. L. REV. 545, 569–70 (2019).

Bankruptcy fits the model of a penalty default. First, as we have explained, it is a situation in which it is desirable that parties resolve disputes among themselves rather than resorting to judicial determination.[109] Bankruptcy courts are not experts in the task of valuing insolvent or financially distressed business. They can only inexactly determine what the parties—with more time and freer access to information—may be able to fix with greater precision. And requiring court resolution of cram down disputes, of course, also requires an expenditure of scarce judicial resources. Moreover, the potential for strategic concealing of information or other misbehavior in bankruptcy is high.[110] Many of the parties to a bankruptcy case may be creditors or other stakeholders who have dealt with the debtor at arms-length and do not have intimate knowledge of its operations or the ability readily to assess its value.[111] A default rule that encourages agreement both on the value of the debtor, based on information disclosed among the parties, and on the appropriate distribution of that value, is therefore socially optimal.

The default rule of absolute priority influences all parties to behave well in light of the specter of a valuation hearing. And the prospect of such a hearing incentivizes senior creditors, who might otherwise insist on payment in full, to compromise rather than risk a valuation outcome that allocates a greater portion of the debtor's value away from them and to junior classes.[112] The "penalty" of absolute priority, though, is most felt by the debtor's shareholders, who face likely exclusion from recovery under the plan.[113] Among parties in interest, shareholders have the greatest familiarity with the debtor's business and are most likely to have information regarding the debtor's true worth.[114] Management, who prior to the insolvency have been acting on behalf of shareholders, have the greatest ability to disrupt the reorganization.[115] By placing the greatest likelihood of loss in the event of a contested confirmation on shareholders, absolute priority encourages them, and by extension, the debtor itself, to work towards a compromise plan.[116]

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109. *See infra* Section III.A.

110. *Cf.* Ayres & Gertner, *supra* note 16, at 127 (explaining that penalty default rules may be useful to address situations in which a better-informed party withholds information in order to achieve a better outcome in a negotiation).

111. *Id.* at 103.

112. Structuring cram down as, in effect, a penalty default rule was a key innovation of the Bankruptcy Code. Under chapter X of the old Bankruptcy Act, the relevant predecessor to chapter 11 of the Bankruptcy Code, a plan could only be confirmed if it complied with absolute priority. Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. L. 441, 442 (1984). Assessing the validity of a plan therefore required a valuation in every case. *Id.* That costly and expensive requirement discouraged resort to chapter X. *Id.* Chapter 11 not only allows parties to consensually resolve bankruptcy but also utilizes the penalty default rule of valuation to incentivize that consensus outcome.

113. Noonan, *supra* note 108, at 569–70; de Weijs et al., *supra* note 10, at 19.

114. De Weijs et al., *supra* note 10, at 22.

115. Noonan et al., *supra* note 113, at 566.

116. *See id.* at 570 ("The APR is a core distributional norm, providing that dissenting unsecured creditors may be bound to the plan provided that all junior interests are eliminated. This has the effect of forcing those most likely in historic control of the debtor (shareholders) either to propose a plan that in fact induces widespread support or to give up their rights. The prospect of an imposed plan—a 'cramdown'—operates as a penalty default,

IV. THE CONSEQUENCES OF RELATIVE PRIORITY

A. *Negotiation Incentives*

1. *Valuation and Negotiation Incentives*

By failing to provide a penalty default rule, relative priority under the Directive undermines the incentives needed to try to facilitate a consensual, negotiated plan. As a preliminary matter, analysis of how relative priority will function is impeded because the standard that a senior class be treated "more favourably" than a junior class is extremely unclear.[117] Although the Directive does not so specify, we assume that this test is financial. To be sure, de Weijs et al. question the coherence of a purely financial test.[118] They argue, for example, that a secured creditor cannot be said to receive more favourable treatment than an unsecured creditor merely because its financial recovery is relatively greater; that relatively greater recovery might disregard the right of the secured creditor to receive priority payment from the collateral, a right for which the secured creditor bargained and in exchange for which it presumably offered the debtor a lower rate of interest.[119] De Weijs et al. also note that the logical conclusion of this line of reasoning—that because secured or other senior creditors have bargained for priority, treating them "more favourably" means paying them in full before others are paid—would collapse the test back into the absolute priority standard to which it purports to be an alternative.[120]

Although sympathetic with these views of de Weijs et al., our analysis of relative priority focuses on plan negotiation incentives. We assume that the Directive's relative priority standard would regard senior classes as being treated "more favourably" than junior classes if they receive a greater percentage distribution on their claims than any junior class.[121] Thus if a debtor owed $200 to senior creditors and $500 to subordinated creditors, relative priority would be satisfied if the senior creditors were paid $150 (or seventy-five cents on the dollar) and subordinated creditors were paid $350 (or seventy cents on the dollar), even though the distribution to subordinated creditors is larger.[122]

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a rule that threatens a suboptimal outcome in order to induce the better-informed parties to disclose information that might lead to a better result.").

117. *See* de Weijs et al., *supra* note 10, at 17–19.

118. *Id.* at 22.

119. It is also likely that a more open-textured test—for example, one that acknowledged that a secured creditor receiving a 70% distribution on account of its claim is not treated more favorably than an unsecured creditor who receives a 69% distribution—would be particularly difficult for bankruptcy courts or tribunals to apply in a predictable fashion, or for parties to understand and take into account when bargaining. *Id.* at 18.

120. *See id.*

121. *Id.* (suggesting this among one of a number of possible distributional rules).

122. In contrast, a rule that simply requires the face amount paid to senior creditors to exceed that paid to junior creditors seems calculated to produce arbitrary results. Consider two plans that each propose to pay $1 million to a senior creditor and $500,000 to junior creditors. In the first case, the senior creditor is owed $5 million and the junior creditors $2 million. In the second case, the amounts owed are reversed. Although the face amounts paid under the plans are the same, the economics of the creditor groups' recoveries in each case are very different.

We are uncertain, though, how the Directive's relative priority standard would be met when comparing distributions made to creditors with distributions made to shareholders in a cram down plan. The Appendix to this Article explains the difficulty of making that comparison.[123] For purposes of analyzing relative priority from the standpoint of plan negotiation incentives, however, we need only ask whether that comparison would require a valuation of the debtor. In the analysis below, we first assume it would not, and thereafter assume that it would, require such a valuation.

If the relative priority standard would not require a valuation of the debtor, the debtor easily could formulate a plan that is favorable to shareholders. For example, consider a firm that has an approximate value of $250, with a senior creditor owed $125 and a junior creditor owed $125. Under relative priority, the debtor might propose a plan that awards 40% of the equity in the reorganized debtor to the senior creditor, 35% to the junior creditor, and 25% to shareholders. Assuming that all other applicable requirements are met, the plan appears confirmable on its face.[124]

Next, assume that the relative priority standard *would* require a valuation of the debtor for a cram down plan. The Directive suggests, but does not clearly specify, that a valuation would be required.[125] Any such valuation would not have to be nearly as precise, however, as a valuation required for applying absolute priority. That is because absolute priority contemplates that a creditor or shareholder receives value exactly equal to, and no greater than, its claim or interest before any junior party receives any value.[126] A valuation conducted for applying a relative priority rule might be sufficient if it merely sets a ceiling value—e.g., the debtor is worth no more than $X. Using the above example, relative priority would be satisfied if the plan distributes 40% of $X to the senior creditor, 35% of $X to the junior creditor, and 25% of $X to shareholders. The ceiling value allows the bankruptcy court or tribunal to determine, for example, that paying the senior creditor 40% of $X does not give it a greater than 100% recovery. But otherwise, no information about the value of the reorganized company is necessary. A ceiling valuation would likely be inexpensive (and might, in any event, be evaded by fixing in cash the amount to be paid to a—presumably senior—creditor class whose recovery under the plan potentially approaches payment in full). It seems comparable to the current practice in chapter 11, in which valuation that merely needs to set a floor value is routine and relatively inexpensive.[127] Indeed, even consensual chapter 11 plans regularly require such

123. *See infra* Appendix.

124. The Appendix to this Article explains why we believe this plan's treatment of shareholders should conform with the Directive's relative priority default rule. Specifically, it is likely sufficient that the plan provides greater recovery in absolute terms to junior creditors than to shareholders.

125. The Directive provides that valuation should be confined to contested plans: "The judicial or administrative authority shall take a decision on the valuation of the debtor's business only where a restructuring plan is challenged by a dissenting affected party . . . ." But it does not state that a valuation is mandatory in such cases. Directive, *supra* note 1, art. 14(1), at 46–47.

126. Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229, 231 (1990).

127. *See* discussion *supra* note 45 and accompanying text.

a valuation. In practice, however, little judicial effort is expended in this exercise.[128] Such a valuation would not, therefore, serve as a penalty default rule.

2. *Control of the Reorganization and Negotiation Incentives*

The fact that the Directive gives the debtor exclusive control over formulating the plan further undermines incentives to negotiate a consensual plan. In chapter 11, at the commencement of the case, the debtor is the only party who may propose a plan.[129] But the Code contemplates the loss of exclusivity if the debtor cannot confirm a plan within six months (or does not file a plan within four months of commencing the case).[130] Although that exclusivity period often is routinely extended by bankruptcy courts,[131] the potential loss of exclusivity may nonetheless cause the debtor to be more prepared to compromise and yield value to other constituencies.[132] Furthermore, the inability to formulate a successful plan can lead to the debtor's liquidation,[133] providing a further incentive to compromise.

The Directive strongly presumes debtor exclusivity in formulating cram down plans.[134] A cram down plan may be confirmed only "upon the proposal of a debtor or with the debtor's agreement."[135] Although Member States may limit this consent requirement such that it applies only to cases involving small and medium sized businesses ("SMEs"),[136] that exception likely swallows the rule entirely. The Directive itself suggests that 99% of businesses within the EU qualify as SMEs.[137] Member States are not required to adopt any particular definition of SME,[138] but they are referred to EU legislation and Commission recommendations that include within that category businesses with up to 250 employees and with annual balance sheet totals of as much as €43 million.[139] The assumption, then, is that the vast majority of debtors—and, in some Member States, all

128. Dick, *supra* note 45, at 1491 (discussing often cursory nature of valuations conducted for purposes of section 1129(a)(7)'s "best interests" tests); Fortgang & Meyer, *supra* note 45, at 1106 (explaining that valuation for purposes of best interests test is often omitted).

129. 11 U.S.C. § 1121(b).

130. § 1121(c).

131. Exclusivity may be extended upon a showing of good cause up to a maximum of twenty months (or eighteen months if the debtor has not proposed a plan). § 1121(d).

132. *Cf.* Fortgang & Meyer, *supra* note 45, at 1106 (explaining that numerous sources of pressure encourage parties to compromise in bankruptcy, including the impact of delayed resolution on the debtor's business).

133. 11 U.S.C. § 1112(b).

134. Absent cram down, the Directive requires that debtors be permitted to propose plans, but it also permits Member States to provide that "creditors and practitioners in the field of restructuring have the right to submit restructuring plans . . . ." Directive, *supra* note 1, art. 9(1), at 44.

135. *Id.* art. 11(1), at 45.

136. *Id.*

137. *Id.*, Recital 17, at 21.

138. *Id.*, Recital 18, at 21.

139. *Id.*; Commission Recommendation of 6 May 2003 Concerning the Definition of Micro, Small and Medium-sized Enterprises 2003/361, 2003 O.J. (L 124) 36, 39 (EC); *see also* Directive 2013/34, of the European Parliament and of the Council of 26 June 2013 on the Annual Financial Statements, Consolidated Financial Statements and Related Reports of Certain Types of Undertakings, 2013 O.J. (L 182) 19, 28 (defining SME to

debtors—will enjoy a right of veto over any plan of reorganization that a creditor or some other third party might propose.

"Debtor," in this context, could mean either the firm's prepetition shareholders or its management.[140] Because their interests are aligned,[141] both have every incentive to insist that the maximum value feasible be transferred to shareholders.[142]

3. *The Incentive to "Squeeze" Intermediate Classes*

Relative priority appears to promote an additional outcome that is disfavored under chapter 11 principles—that is the potential for senior and junior classes to combine to enhance their recoveries at the expense of intermediate classes. Such has been the United States' experience in bankruptcy or insolvency cases that do not take place in the shadow of absolute priority. The concept of a "fixed principle" according to which the fairness of reorganizations should be evaluated originated in railroad reorganization cases in which secured bondholders arranged to acquire the assets of insolvent railroads in a collusive foreclosure sale, sharing equity in the reorganized railroad with shareholders but entirely excluding unsecured creditors.[143] The same basic paradigm has animated later disputes over the applicability and extent of absolute priority.[144] In one of its most prominent recent bankruptcy decisions, therefore, the Supreme Court considered (and rejected) a settlement and structured dismissal seeking to resolve a bankruptcy

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include businesses not exceeding two of: (a) a balance sheet of €20,000,000; (b) net annual turnover of €40,000,000; or (c) an average of more than 250 employees during a financial year).

140. Directive, *supra* note 1, Recital 53, at 27 ("In the case of a legal person, Member States should be able to decide if, for the purpose of adopting or confirming a restructuring plan, the debtor is to be understood as the legal person's management board or a certain majority of shareholders or equity holders."). In the former case, Article 12 of the Directive might somewhat qualify the right of veto, in requiring that Member States ensure that shareholders excluded from the voting process should not be permitted unreasonably to block a plan, but it is unclear whether this is intended to override the requirement for debtor agreement to a cram down plan set forth in Article 11. *Id.*, art. 12(1), at 46.

141. Jesse M. Fried, *Insider Trading Via the Corporation*, 162 U. PA. L. REV. 801, 804 (2014) (observing that managers frequently own significant shares in the debtor).

142. In some cases, new management may be installed prior to a bankruptcy that is focused on protecting the interests of some other class. For example, covenants in loan or bond agreements may permit creditor groups to replace corporate officers in the event of financial distress. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1223–36 (2006). Under the Directive's relative priority default rule, in those cases, management would be just as incentivized to use its blocking power to prevent adoption of a plan of reorganization unfavorable to its preferred class as it would be to block a plan unfavorable to shareholders in the ordinary case.

143. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 505–08 (1913); Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 116–17 (1939) (definitively stating that the "fixed principle" of "fair and equitable" treatment said to originate in *Boyd* was one of absolute priority). *See generally* Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. & FIN. L. 581 (2016) (describing the evolution of *Boyd*'s fixed principle and absolute priority).

144. *See, e.g.*, Bank Am. Nat. Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 444 (1999). Absolute priority responds to "concern with 'the ability of a few insiders, whether representatives of management or major creditors, to use the reorganization process to gain an unfair advantage." *Id.* (quoting from early legislative history of the Bankruptcy Code) (disapproving settlement and structured dismissal resolving bankruptcy case in which secured creditors resolved claims asserted against them by the bankruptcy estate by making settlement payment to unsecured and lower priority tax creditors, but paying nothing to priority employee creditors).

case in which secured creditors resolved claims asserted against them by the bankruptcy estate by making settlement payments to unsecured creditors and lower priority tax creditors, but paid nothing to priority employee creditors.[145] Even though the *Jevic* settlement did cut in the tax authorities, thirty-five states submitted a brief to the court arguing that so unpopular a class of creditors would likely be frequent victims of future attempts at priority-skipping: "[a]fter all, paying taxes will rarely be viewed as desirable by other creditors . . . ."[146] In similar fashion, national labor and public interest legal groups noted that *Jevic*-type settlements would leave groups of the smaller, less sophisticated creditors—the least well able to protect their rights—ripe for exclusion.[147]

Relative priority invites exactly the same dynamics. In order to confirm a cram down plan, a debtor must ordinarily secure the approval of at least one senior class of creditors.[148] And, of course, the Directive requires that senior creditor classes be treated more favorably than junior classes.[149] The debtor's incentive, therefore, is to offer the most favorable terms possible to the most senior classes of creditors (who must be treated well in any event) in order to induce them to support the plan which it has otherwise structured to provide the minimum recovery to junior creditors (whose support can readily be dispensed with in the absence of a default rule that penalizes the failure to reach consensus) and the maximum recovery to shareholders.

Of course, none of these critiques should be overstated. The EU Commission and Member States may conclude that the benefits that flow from the debtor control over the restructuring process (whether that is understood as control by equity or management) and distributional rules that increase the potential for old equity to retain a stake in the reorganized debtor outweigh any costs associated with decreased settlement. Similarly, even though chapter 11's policy choices have generally been to the contrary, Member States may be willing to accept the possibility that intermediate creditors see reduced recoveries in reorganizations. Member States might, for example, theorize that healthy capital markets require robust recoveries in insolvency for senior secured creditors who are likely to be composed of lenders who might otherwise opt not to extend loans, while junior classes—whether tax creditors, employees, or general unsecured creditors such as trade creditors—will likely have less choice about extending credit to the debtor, or at least that the harms caused to such creditors are outweighed by the benefits of allowing shareholders to keep value in reorganizations. That policy choice is for Member States. The choice, though, must be made after due consideration of the likely consequences of reordering ordinary bankruptcy priorities.

145. Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017).

146. Brief for State of Illinois et al. as Amici Curiae Supporting Petitioners, at 20, Czyzewski v. Jevic, 137 S. Ct. 973 (2017) (No. 15-649).

147. Brief for National Employment Law Project et al. as Amici Curiae Supporting Petitioners, at 10, 20–21, Czyzewski v. Jevic, 137 S. Ct. 973 (2017) (No. 15-649).

148. Directive, *supra* note 1, art. 11(1)(b), at 45.

149. *Id.*

B. Fairness

We do not believe that relative priority will produce fairer outcomes. Whatever "fair" in the context of a restructuring means, it is unclear that relative priority is necessarily fair to creditors.

1. Theoretical Fairness Concerns

First, relative priority could allow the debtor's shareholders to shed corporate debt without losing control of the reorganized business. As discussed, the Directive gives the debtor control over proposing a cram down plan.[150] As next illustrated, a cram down plan could comply with relative priority even if it gives an insolvent debtor's shareholders *all* of the post-restructuring equity.

Suppose the value of a reorganized debtor firm is $250. It owes $50 to a secured creditor and a total of $500 to unsecured creditors. The firm has $50 in cash which it proposes to use to pay the secured creditor in full, thus securing that creditor's agreement to the plan. Thereafter, the plan may be crammed down over unsecured creditors' objections so long as those creditors are treated "more favourably" than the shareholders. (Ordinarily, a cram down plan must be approved by either a majority of the voting classes of affected parties, including at least one class of secured creditors or other creditors senior to the general unsecured creditors' class, or at least one class of creditors that would not be completely out of the money if ordinary liquidating priorities were applied.[151] In a case with only two classes of creditors, the consent of one class is sufficient for cram down to be approved, assuming other requirements are met.[152]) The shareholders wish to retain full control of the reorganized debtor—or, in other words, to receive a distribution of equity worth $250. Under relative priority, shareholders must compensate unsecured creditors more than $250 in order to achieve that objective. This might be accomplished by selling existing assets or, perhaps most easily, by raising new capital using the post-reorganization, newly unencumbered equity in the firm as collateral.[153] If shareholders can achieve this, they may fully retain their interests, in effect sacrificing *no* value while unsecured creditors recover only 50% on their claims and see the balance discharged.[154]

150. *Id.*

151. *Id.*

152. Directive, *supra* note 1, Recital 54, at 28.

153. Such a scenario does not implicate the so-called new-value doctrine (which has sometimes been described as an exception to absolute priority) under which shareholders receive equity in a reorganization in exchange for new capital which they contribute to the reorganized enterprise. *See, e.g.*, Bank Am. Nat. Tr., 526 U.S. 434, 442 (1999) (so-called "new value exception" may be permissible so long as the sufficiency of shareholders' contribution is subject to a market test). The shareholders are not contributing any new value; they are simply borrowing money in order to pay the claims of more senior classes.

154. The plan is summarized in the table below. As explained in the Appendix, we assume that the recovery of shareholders under the plan must be compared to that of junior creditors in absolute, rather than relative, terms:

Examples of strategic or exploitative resort to insolvency might be even more extreme if creditors in a cram down may be forced to accept promises of future payment rather than immediate payment in cash or equity—as the Directive itself appears to contemplate.[155] Instead of selling assets or borrowing money so that creditors are paid at the time of the reorganization, the debtor in the previous example might propose to pay secured creditors in full with a stream of payments with a present value of $50, and unsecured creditors with a stream of payments with a present value of $255 (or whatever amount is necessary to satisfy relative priority's requirement that they be treated more favorably than equity). Shareholders can then keep all of the equity in the reorganized debtor, valued at only $250. In such a case, shareholders would have successfully used insolvency to improve the financial condition of the debtor. The debtor entered insolvency owing $550 and can exit owing only $305. Presumably, the reduced debt-service payments improve its overall financial health, and thus fulfill the EU Commission's aims of preserving jobs and avoiding the loss of the debtor's aggregation of skills and experience.[156] Yet, it is hard to view this as a desirable outcome given that the shareholders have accomplished that end without themselves sacrificing any value.

Thus, at worst, relative priority operates as a "subsidy to highly leveraged structures."[157] Shareholders in an over-leveraged debtor may calculate the precise amount of debt that the company must reaffirm in insolvency in order to both secure buy-in from the requisite number of creditor classes and pass the "more favourable" test, and may then secure a discharge of the rest. Equally, because shareholders and management may be confident that they will be minimally penalized in the event of insolvency—with the ability to retain full control

TABLE 2

Class:	Claim:	Plan Provision:	Value of Recovery:
Senior creditor	$50	$50 in cash	100% of claim
Junior creditor	$500	$250 in cash	50% of claim
Shareholders	N/A	100% of equity in reorganized business (valued at less than $250)	N/A (but receives less in absolute terms than junior creditors)

155. The Directive does not specifically state that a promise of payment over time may satisfy relative priority's more favorable treatment standard, but does state, in the context of the alternative absolute priority's requirement that dissenting classes be paid in full, that "Member States should have discretion in implementing the concept of 'payment in full,' *including in relation to the timing of the payment*, as long as the principal of the claim and, in the case of secured creditors, the value of the collateral are protected." Directive, *supra* note 1, Recital 55, at 28 (emphasis added). That is mostly consistent with chapter 11. With the exception of a few classes of priority claimants, most significantly including employee wage claims, who have the right to demand payment in cash, 11 U.S.C. § 1129(a)(9), chapter 11 does not require immediate payment of senior classes to satisfy absolute priority. Creditors may instead be promised a stream of payments with a present value, as of the effective date of the plan, equal to the value of their collateral (for secured creditors) or the total amount of their claim (for unsecured creditors). § 1129(b)(2). The key difference is that it is unclear whether the Directive's minimum standard requires payment of the present value of a claim, or merely its face amount.

156. *See* Directive, *supra* note 1, Recital 2, at 18.

157. De Weijs et al., *supra* note 10, at 15–17.

of the company—relative priority may foster excessive risk-taking or other morally hazardous behavior on their part.[158] Even if the EU Commission believes that "fairness" in insolvency is best served by routinely allowing shareholders to participate in reorganizations, it has not provided a justification for outcomes of this nature. The baseline assumption is that in each of these cases, shareholders in a liquidation would receive nothing.[159] The fairness of permitting such shareholders instead to retain all of the value in the company, while taking value from creditors without their consent, is certainly open to question.

These fairness concerns are particularly evident in cases involving solvent debtors. The EU Commission has emphasized that the Directive's restructuring mechanisms must be made available to potential debtors that are not balance-sheet insolvent.[160] Firms should be able "to address their financial difficulties at an early stage, when it appears likely that their insolvency can be prevented and the viability of the business can be ensured."[161] Indeed, some defenders of relative priority have attempted to distinguish the Directive's restructuring proceedings from chapter 11 on the basis that the Directive contemplates a new category of "pre-insolvency" restructurings.[162] For such proceedings, it is claimed, the analogy to chapter 11 is inapt and the absolute priority rule inappropriate.[163] In fact, solvent debtor cases are not uncommon under chapter 11.[164] A court-supervised restructuring is a useful collective remedy and may prevent financial problems from worsening: for example, businesses facing mass tort claims may wish to gather plaintiffs into a single forum and fund a single settlement of those claims rather than face many years of continued and expensive litigation.[165] Equally, however, chapter 11 recognizes the danger of strategic resort to insolvency.[166] The absolute priority rule mitigates that danger by requiring repayment of creditors in full for shareholders to keep their equity in the debtor; chapter 11 should not allow shareholders simply to seize value from others higher in the

158. *Cf.* Steven L. Schwarcz, *Too Big to Fool: Moral Hazard, Bailouts, and Corporate Responsibility*, 102 MINN. L. REV. 761, 761 (2017) (observing the problem of moral hazard that "persons protected from the negative consequences of their risky actions will be tempted to take more risks.").

159. *See* Directive, *supra* note 1, Recital 54, at 28.

160. *See id.*, Recital 2, at 18.

161. *Id.*, Recital 24, at 22.

162. *See, e.g.*, Stephan Madaus, *Die Neue European Relative Priority Rule der Restrukturierungsrichlinie*, RESTRUKTURIERUNGSRECHT (Mar. 12, 2019) (Ger.), https://stephanmadaus.de/2019/03/12/die-neue-european-relative-priority-rule-der-restrukturierungsrichtlinie-das-ende-des-europaeischen-insolvenzrechts/ [https://perma.cc/NUV9-9YGP].

163. *See, e.g.*, *id.*; Bob Wessels, *The Full Version of My Reply to Professor de Weijs et al.*, DR. BOB WESSELS BLOG (Mar. 22, 2019), http://bobwessels.nl/blog/2019-03-doc10-the-full-version-of-my-reply-to-professor-de-weijs-et-al/ [https://perma.cc/J6ES-8EAD]. *But see* Vasile Rotaru, DROIT ET CROISSANCE, THE RESTRUCTURING DIRECTIVE: A FUNCTIONAL LAW AND ECONOMICS ANALYSIS FROM A FRENCH LAW PERSPECTIVE 15–16, 48 (2019).

164. *See* Robert J. Keach, *Solvent Debtors and Myths of Good Faith and Fiduciary Duty*, 23-10 AM. BANKR. INST. J. 36 (Dec. 1, 2004), https://www.abi.org/abi-journal/solvent-debtors-and-myths-of-good-faith-and-fiduciary-duty [https://perma.cc/EFK8-42H6].

165. *See, e.g.*, *In re* Dow Corning Corp., 244 B.R. 673, 677 (Bankr. E.D. Mich. 1999).

166. *See, e.g.*, *In re* Integrated Telecom Express, Inc., 384 F.3d 108 (3d Cir. 2004).

capital structure.[167] The Directive, in contrast, would appear to permit shareholders in a *solvent* firm to shed debt or liability without themselves giving up any value. The Directive does recognize the potential for "misuse" and thus proposes gatekeeping access to restructuring proceedings behind a test of "likelihood of insolvency."[168] Certainly, however, relative priority creates considerably greater incentives for strategic resort to insolvency than an absolute priority regime.

To some extent, this danger may be mitigated because one consequence of a cram down plan that gives all of the debtor's equity to its pre-insolvency shareholders would appear to be the return of valuation.[169] In most cases, however, that will be the kind of ceiling valuation described above, rather than the precise valuation required in a cram down.[170] Unlike plans that split equity among the various constituencies in the case, to assess the plan described above, the bankruptcy court or other relevant authority must compare the value of the equity awarded to the shareholders with the scheme of payments that is to be made to creditors. But it need only determine that the value of the equity does not exceed payments made to more senior classes. Shareholders have, therefore, at least some incentive to compromise given the potential undesirability of a valuation hearing—whether to avoid the direct litigation costs, or because valuation uncertainty creates a risk that they must "buy" the equity in the reorganized debtor with larger payments to creditors than they would like. In cases in which negotiation fails, however, it is worth noting that the shareholders' goal at a valuation hearing is exactly the opposite as under absolute priority. Shareholders who are seeking to retain the debtor's equity benefit from a *low-side*, not a high-side, valuation. In cases in which management appointed by pre-insolvency shareholders remains in place, or shareholders are otherwise able to control insolvency proceedings, relative priority thus creates the risk of abusive behavior designed to make the debtor seem *less* valuable.[171]

Last, we emphasize that we do not mean to imply, by stating that relative priority permits shareholders comparatively easily to procure a plan that favors their interests, that such an outcome is comparable to a negotiated plan under an absolute priority default rule. An absolute priority default rule conserves value by encouraging a negotiated outcome in which litigation over the plan is not required. This permits a speedier exit from bankruptcy and, likely, higher recoveries for the parties.[172] Because relative priority dispenses with the requirement for a full, going-concern valuation in a cram down, it lacks a penalty default rule that

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167. Chapter 11 also requires that a solvent debtor show a good faith purpose for commencing a bankruptcy case. *In re* SGL Carbon Corp., 200 F.3d 154, 163–65 (3d Cir. 1999).

168. Directive, *supra* note 1, Recital 24, at 22; *cf. id.* art. 4(1), at 39.

169. *Id.*, Recital 49, at 27.

170. *See supra* notes 127–28 and accompanying text.

171. *Cf.* de Weijs et al., *supra* note 10, at 17 (noting that shareholders' ability to offer creditors only liquidation value incentivizes shareholder behavior that keeps liquidation value low, including by keeping valuable assets in bankruptcy-remote entities or engaging in "value-destroying" behavior). *But cf.* Dick, *supra* note 45, at 1499 (arguing that the incentive in a chapter 11 case of a creditor group that has taken control of the debtor prepetition is also to try to obtain a low-end valuation).

172. A.B.A., BUS. BANKR. COMM., REPORT OF THE SELECT ADVISORY COMMITTEE ON BUSINESS REORGANIZATION 10 (2001).

would incentivize settlement. Parties are incentivized to stand firm in arguing for the maximum distribution permissible under the rules. Even without the requirement of a valuation hearing, however, that is likely to be an inefficient outcome. The need for judicial resolution is likely to prolong bankruptcy cases, and, accordingly, increase the direct and indirect costs to which debtors are subject.[173] Equally, because the adequacy of distributions must be litigated, bankruptcy cases are likely to be more expensive than if resolved consensually. Nor does the relative priority default rule serve to discourage strategic behavior by shareholders, as is the case under absolute priority—rather, as we have explained, it is likely to increase the potential for such behavior (as well as to increase the potential for pre-bankruptcy morally hazardous behavior[174]).

3. *Evidence of Unfair Outcomes*

Even as the fairness of relative priority is open to question at a theoretical level, so too is there empirical evidence for the unfairness of a relative priority rule. The debt-restructuring law of Brazil lacks absolute priority in the equivalent of a cram down.[175] A plan of reorganization may be confirmed absent the consent of all classes of creditors so long as it is approved by a sufficient number of creditors and does not discriminate as among creditors within the dissenting class.[176] There is no substantive requirement that senior classes receive full payment—or, indeed, any payment—before junior classes are paid.[177] Brazil also guarantees to the debtor the exclusive right to propose a reorganization plan.[178] The combination of debtor exclusivity and the lack of an absolute priority default rule causes Brazilian insolvency proceedings to be much lengthier than U.S. bankruptcies.[179] Substantively, it results in plans that largely leave in place the debtor's existing equity.[180] Indeed, one of us has been informed that when a debt-

173. *Supra* notes 54–55 and accompanying text.

174. *See supra* note 158 and accompanying text.

175. Lei No. 11.101, de 9 de Feveriro de 2005, COL. LEIS REP. FED. BRASIL (arts. 45, 58) (Braz.); *see, e.g.*, Jeffrey M. Anapolsky & Jessica F. Woods, *Pitfalls in Brazilian Bankruptcy Law for International Bond Investors*, 8 J. BUS. & TECH. L. 397, 429, 429 n.231 (2013).

176. Anapolsky & Woods, *supra* note 175, at 429. The voting requirements for a cram down plan are (1) approval by creditors holding half of the total amount of claims; (2) approval by two of the three classes provided for under Brazilian law; and (3) approval by over one-third of the creditors in the class that rejected the plan. *Id.*

177. *Id.*

178. *Id.* at 423–24.

179. Jessica Nowak, *The Power Struggle: Shareholder Rights in Brazilian Corporate Bankruptcy*, 25 U. MIA. INT'L & COMP. L. REV. 339, 349 (2018).

180. Giuliano Colombo & Thiago Braga Junqueira, *Ten Years of the Brazilian Bankruptcy Law: Some Lessons Learned and Some Wishes for Improvement*, 1 EMERGING MKT. RESTRUCTURING J. 11, 12–13 (2016), https://www.clearygottlieb.com/-/media/organize-archive/cgsh/files/emerging-markets-restructuring-journal/debut-issue-2016/3ten-years-of-the-brazilian-bankruptcy-code--lessons-challenges-and-prospects.pdf [https://perma.cc/2G42-94LX] (finding that the debtor exclusivity in Brazil forces creditors to approve unfavorable plans and that a debtor's management and equity retain control of the company under Judicial Reorganization); Jamie Mason, *Bye-Bye Brazil?*, DEAL (Nov. 6, 2015), https://www.davispolk.com/files/graulich.the_.deal_.brazil.dec15.PDF [https://perma.cc/S24P-SX3R] (finding that the debtor exclusivity in Brazil permits the controlling shareholder to retain valuable equity rights).

restructuring case is filed in Brazil, the debtor's stock price actually rises.[181] Because Brazil's restructuring law lacks even relative priority, it is an imperfect analog to the Directive. Nonetheless, it suggests, as we have argued in this Article, that weak priority rules will tend to produce both lengthier and more costly bankruptcy proceedings, and high recoveries for shareholders at the expense of creditors.

Finally, to the extent that the effect of relative priority is to depress creditor recoveries, debt investments in the European Union may become less attractive.[182] No insolvency system can be considered separate and apart from its ex ante effects on market participants.[183] There is abundant evidence that lenders' expectations of their potential recovery in the event of a liquidation affects their willingness to lend.[184] When Sweden, for example, experimented with a rule that permitted secured creditors in a liquidation to recover only 55% of the value of the collateral encumbered by floating liens, the ability of businesses to take on long-term debt quickly reduced.[185]

To be sure, the Directive guarantees that creditors receive at least as much in a reorganization as they would have received in a liquidation.[186] As observed, however, the value of that protection is minimal.[187]

181. III Annual Conference, Discussion between Steven L. Schwarcz and Francisco Satiro, Professor of Commercial Law, University of Sao Paulo Law School.

182. Arguably, therefore, Member States that add a relative priority reorganization mechanism alongside pre-existing liquidation regimes only make their lending climate more attractive. But while, in any individual case, a lender may be better off with a relative priority reorganization than with a liquidation, the overall impact on lenders' recoveries is uncertain given that the likely—and, indeed, the intended—effect of the Directive is to encourage more frequent resort to insolvency. Shareholders currently have strong incentives to avoid liquidation. As the EU Commission recognizes, the shadow of liquidation may have undesirable consequences—businesses may not take steps effectively to address financial difficulties while still manageable because shareholders fear the consequences of insolvency. At the same time, a restructuring law that is too solicitous of shareholders' interests, or too tolerant of strategic behavior, may work to disincentivize investment. It is unclear that the Directive strikes the correct balance. *See generally* Directive, *supra* note 1.

183. Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 589–92 (1998).

184. *See, e.g.*, Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer, & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (finding that legal regimes with weak investor protections inhibit firms' access to external finance); Jun Qian & Philip E. Strahan, *How Law and Institutions Shape Financial Contracts: The Case of Bank Loans*, 62 J. FIN. 2803, 2804 (2007) ("For example, as creditor's ability to take collateral increases, bank loans are more likely to be secured by collateral, and tend to have longer maturity and lower interest rates."); Daniela Maresch, Annalisa Ferrando, & Andrea Moro, *Creditor Protection, Judicial Enforcement and Credit Access* 2, 9–10 (Eur. Cent. Bank Working Paper Series No. 1829, 2015).

185. Geraldo Cerqueiro, Steven Ongena, & Kasper Roszbach, *Collateral Damage? On Collateral, Corporate Financing and Performance* 23 (Eur. Cent. Bank Working Paper Series No. 1918, 2016).

186. Directive, *supra* note 1, Recitals 2, 49, at 18, 27; *cf.* Anapolsky & Woods, *supra* note 175, at 402, 426.

187. *See supra* note 45 and accompanying text (explaining that protection in the context of a chapter 11 cram down).

V. THE COMMISSION'S UNDERSTANDING OF RELATIVE PRIORITY

A. *Relative Priority Compared to Chapter 11*

One problem with analyzing relative priority under the Directive, as this Article has observed, is that it is far from clear what the relative priority provisions of the Directive actually mean—or, indeed, what exactly motivates them.[188] There is no systematic study explaining how the Directive will, or even should, work in practice.[189] Nor has scholarly commentary on relative priority included in-depth analysis of the Directive's actual provisions. Defenses of the Directive's approach frequently invoke chapter 11.[190] Yet, to the extent the EU Commission has attempted to analyze the Directive's consequences, it incorrectly compares relative priority to chapter 11's priority provisions.

For example, the Commission's analysis of relative priority appears to focus on how relative priority comports with chapter 11's priority provisions.[191] If any provisions of chapter 11 lack absolute priority, then (the Commission's argument goes) chapter 11 is a relative priority rule, and thus the Directive's relative priority should be a rational approach.[192] As this Article has made clear, chapter 11 only imposes absolute priority as a default rule. The majority of chapter 11 plans are confirmed on a consensual basis.[193] Chapter 11 permits consensual plans freely to depart from absolute priority and to implement whatever distributional rule the parties choose.[194] In other words, chapter 11's absolute priority default rule is designed to motivate consensual plans, *not to ensure that such plans respect absolute priority*.[195]

188. *See* Rotaru, *supra* note 163, at 20 (arguing that the Directive "lack[s] a clear coherent intellectual foundation").

189. R.J. de Weijs, A.L. Jonkers, & M. Malakotipour, *A Reply to Professor Madaus*, CORP. FIN. LAB BLOG (Mar. 15, 2019), https://corporatefinancelab.org/2019/03/15/a-reply-to-professor-madaus-the-new-european-relative-priority-from-the-preventive-restructuring-directive-the-end-of-european-insolvency-law/ [https://perma.cc/QS62-HSLH].

190. *See* Rotaru, *supra* note 163, at 20 (arguing that the Directive "lack[s] a clear coherent intellectual foundation"); *see also* Stephen Lerner & Silvia Belovicova, *How Does the EU Restructuring Directive Compare to Chapter 11?*, NAT'L L. REV. (Nov. 6, 2019), https://www.natlawreview.com/article/how-does-eu-restructuring-directive-compare-to-chapter-11 [https://perma.cc/9BX9-UA6H].

191. *Cf.* de Weijs et al., *supra* note 10, at 1.

192. The above argument is inferred by Steven L. Schwarcz based on his observations at the III Annual Conference, *supra* note 15.

193. *Cf.* ABI CHAPTER 11 COMMISSION REPORT, *supra* note 41.

194. *See* Lubben, *supra* note 143, at 582–84.

195. Even in cases of cram down, absolute priority is not truly "absolute." U.S. bankruptcy law creates special priority status for favored groups of creditors. *See id.* at 602–03. Bankruptcy courts and practitioners have also, over time, come to incorporate features within chapter 11 that are accepted because they are believed to increase the likelihood of a successful and value-maximizing reorganization, but are nonetheless inconsistent with absolute priority in a strict sense. The bankruptcy court might, for example, permit a debtor to "roll-up" its prepetition obligations to a lender, granting such debt super-priority status, in exchange for the lender's agreement to extend debtor-in-possession financing that might otherwise not be available. Roe & Tung, *supra* note 78, at 1251–52. Similarly, bankruptcy courts routinely approve payments at the beginning of the bankruptcy case of the debtor's so-called "critical vendors"—typically suppliers without whose continued business the debtor could not function—again in effect transforming such unsecured claims into first-paid, super-priority claims, on the theory that the reorganization is benefited by ensuring those vendors are motivated to continue doing business

B. The "Best-Interests" Test

Officials of the EU Commission also argue that the Directive's relative priority rule should protect creditors because it has a separate 'best-interest' test.[196] In a U.S. context, this test is virtually meaningless as real protection because it only requires that each nonconsenting creditor receives at least as much in the plan as it would receive in a chapter 7 liquidation[197]—a very low bar, and one that should be irrelevant to a reorganizing debtor's plan.[198] The Directive's best-interests test, described in Recital 52, starts out the same way: "[s]atisfying the 'best-interest-of-creditors' test should be considered to mean that no dissenting creditor is worse off under a restructuring plan than it would be . . . in the case of liquidation . . . ."[199]

Recital 52, however, continues on to explain that its reference to liquidation is not necessarily limited to "piecemeal liquidation," the chapter 7 standard, but also may include liquidation through a "sale of the business as a going concern" or some other "next-best-alternative scenario" to a restructuring plan.[200] The going-concern standard could provide greater protection for dissenting creditors. If the best-interests test is implemented so that Member State courts must make precise findings of fact to determine how much creditors would recover in a going-concern sale, then it might operate as a penalty default rule.[201] It is unclear, though, whether EU Member States need to enact that alternative standard in their national law. Recital 52 states merely that Member States "should be able to choose one of those thresholds when implementing the best-interest-of-creditors test in national law."[202] It is ambiguous whether the "thresholds" referenced are the piecemeal-liquidation versus liquidation as going-concern tests, to liquidation as against the "next-best-alternative" test, or to all three options. Nor is it clear whether Member States' choices are constrained by the nature of their preexisting liquidation or other insolvency procedures. Article 2(6) of the Directive, containing the substantive definition, suggests that may be the case, stating that the test requires that a creditor be no 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

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with the debtor. *Id.* at 1254–57. In fact, jockeying for priority among creditors might fairly be characterized as one of the central dynamics of chapter 11 reorganizations. *See id.* at 1236–43, 1270–79.

196. *See* Axel Krohn, *Rethinking Priority*: *The Dawn of the Relative Priority Rule and a New 'Best Interest of Creditors' Test in the European Union* 16, SSRN (June 20, 2020), https://ssrn.com/abstract=3554349 [https://perma.cc/LR32-KZY2].

197. 11 U.S.C. § 1129(a)(7).

198. *See supra* note 45 and accompanying text (explaining why this test provides only minimal protection).

199. Directive, *supra* note 1, Recital 52, at 27.

200. *Id.*

201. *See* Krohn, *supra* note 196, at 14. Krohn observes, however, that the interplay between an enhanced best-interests test and relative priority risks impeding negotiation because parties lack a single clear guideline for negotiation; instead, they must "negotiat[e] a sweet spot between two uncertain hypothetical values." *Id.* at 17–18.

202. Directive, *supra* note 1, Recital 52, at 27.

if the restructuring plan were not confirmed."[203] Whether the best-interests test will actually protect dissenting creditors, therefore, is at best murky. Member States would need carefully to implement the best-interests tests before it could serve to increase the minimal negotiation incentives that a relative-priority default rule creates.

C. Holdout Creditors

Proponents of relative priority additionally suggest that it will discourage holdouts among creditors (or at least provide a means for circumventing them).[204] The holdout problem is a "type of collective action problem in which certain creditors, such as vulture funds, refuse to agree to a reasonable debt restructuring plan that proposes to change critical terms, hoping to receive more than their fair share of a settlement."[205]

For the proponents' suggestion to be tenable, relative priority would have to address the holdout problem better than does absolute priority under chapter 11. That is unlikely because, as discussed below, chapter 11 very effectively solves the holdout problem through supermajority class voting. Indeed, a cram down default rule is irrelevant to the solution.

The debtor's ability to group creditors in classes and to obtain each class's approval by a supermajority vote[206] is otherwise generally sufficient to prevent holdout creditors from preventing a reorganization that is generally attractive to the class. And, if anything, the Directive gives debtors more classification flexibility than chapter 11.[207] The Directive suggests, for example, that an SME debtor might be permitted to group all its creditors into a single class.[208] A majority in amount of the claims within that class may be sufficient for approval (although Member States may also require approval by a majority in number of creditors within the class).[209] That flexibility should allow the debtor to "designate large enough classes of claims to prevent vulture funds (or similar holdouts),

203. *Id.*, art. 2(6), at 38. The text of Article 2(6) might also conceivably be read as a conjunctive test, requiring that the creditor *both* be no worse off than under a liquidation (either piecemeal or by a going concern sale as state law provides) *and also* no worse off than under the next-best-alternative to the plan, assuming that is something different. That interpretation, however, would seem to conflict with Recital 52, which suggests that Member States may make a choice in how they implement the best interests test.

204. BEST PRACTICES, *supra* note 38, at 46–47; *cf.* Wessels, *supra* note 163.

205. Steven L. Schwarcz, *Sovereign Debt Restructuring: A Model-Law Approach*, 6 J. GLOBALIZATION & DEV. 343, 345 (2016).

206. *See supra* note 44 and accompanying text (observing that supermajority voting under chapter 11 is a vote of more than one-half in number and at least two-thirds in amount of the voting class members).

207. *Compare* Directive, *supra* note 1, art. 9(4), at 44 (ensuring affected parties are treated in separate classes reflecting sufficient commonality of interest, in accordance with relevant national law), *with* 11 U.S.C. § 1126(d) (stating a class of interests has accepted a plan if it is accepted by holder of such interests that hold at least two-thirds of allowed interest of such class).

208. Directive, *supra* note 1, Recital 45, art. 9(4), at 26, 47.

209. *Id.*, Art. 9(4), at 44.

as a practical matter, from purchasing enough claims to block a restructuring plan or otherwise control the voting."[210]

Our intention here is not to provide a focused critique of the Directive's classification provisions. Rather, we observe that, in light of the considerable power that the Directive affords debtors to bind dissenting creditors, a relative priority default rule should be unnecessary, and indeed appears to be irrelevant, to discourage holdout behavior.

D. Small and Medium Sized Businesses

Finally, relative priority has been defended on the basis that it will lead to better outcomes in cases involving SMEs by making it easier for pre-insolvency owners to retain equity in the enterprise.[211] Indeed, the language of the Recitals suggests this may have been among the EU Commission's foremost concerns in shaping the Directive and, perhaps, relative priority. The Recitals express concern, for example, that SMEs (which, under the Commission's definition, form the vast majority of debtors) are more likely to be liquidated than restructured because, while bearing higher costs than large enterprises, they do not have the financial resources to take advantage of effective but costly restructuring procedures.[212]

It is additionally theorized that owners of a distressed small business might otherwise avoid insolvency proceedings even if the business might successfully be restructured and continue to operate as a going concern because the restructuring would necessarily wipe out their ownership stake; presumably, the business owner will instead press on despite headwinds until troubles have mounted to the point that the business must be liquidated.[213] And restructuring small businesses that depend heavily on the expertise or efforts of their owners may be impossible if the restructuring means that the owner's role is eliminated.[214]

Here, commentators have diagnosed a genuine problem, but relative priority is the wrong solution. A small, closely-held business may represent the personal efforts of an individual owner (or family or small group of individuals) in a way that is not usually true of shareholders in a larger enterprise. In the ordinary case, the shareholders' status as residual owner of the firm—entitled to all the upside generated after the form has met its obligations—justifies the shareholders' position as the first group to suffer losses when those obligations cannot be

210. Schwarcz, *supra* note 205, at 360. Dissenting creditors may still be protected by the best interests of creditors test. Directive, *supra* note 1, art. 10(2)(d), at 45. As we have discussed, however, the value of that protection is minimal. *See supra* notes 45, 152 and accompanying text.

211. BEST PRACTICES, *supra* note 38, at 46–47; *see* Ignacio Tirado & Riz Mokal, *Has Newton Had His Day? Relativity and Realism in European Restructuring*, 74 EUROFENIX 20, 22 (2018–2019), https://abi-globalinsolvency.s3.amazonaws.com/resource-articles/Eurofenix_74_Winter_2018-2019-EU-Cross-Class_Cram-Down.pdf?aVaD9SrC976VS1fkJlM4UGu_KrXfveu3 [https://perma.cc/338U-UA2Y].

212. Directive, *supra* note 1, Recital 17, at 21; *cf.* ABI CHAPTER 11 COMMISSION REPORT, *supra* note 41, at 12 (discussing a common critique of chapter 11, that the high cost of restructuring may be out of reach of small businesses).

213. *See* BEST PRACTICES, *supra* note 38, at 46–47.

214. *See* Tirado & Mokal, *supra* note 211, at 22.

satisfied.[215] That calculus may differ when the business is the livelihood of its individual owner.[216] Equally, a traditional reorganization in which some or all of the equity in the firm is transferred to its former creditors may be impractical because creditors—and, in particular, trade and industry creditors—may not want to hold equity in an otherwise closely-held business.[217]

The United States has recently recognized these realities by amending chapter 11 to permit small business debtors to choose to be treated in similar fashion to an individual consumer debtor.[218] Consistent with a focus on closely-held businesses that represent an individual or family's sweat equity, eligibility for new subchapter V of chapter 11 is limited to businesses (other than real estate businesses) with less than $2.7 million dollars in aggregate liabilities.[219] Distributions to creditors in such a case are made based on a so-called "best efforts" principle, rather than according to absolute priority.[220] Debtors may keep their assets (including the business's equity) if they devote their disposable income to repaying creditors as much as is possible for a set period of time—typically between three to five years—pursuant to a court approved repayment plan.[221] The funds paid out under the plan are paid in accordance with absolute priority but the debtor's prepetition equity is not disturbed.[222] This system has the additional advantage that plans of reorganization may be both highly standardized and approved in more streamlined proceedings, such that litigation costs and other fees associated with reorganizations may be substantially less than in a traditional reorganization.

In contrast, the Directive's relative priority approach applies to debtors of any size—and thus to large institutional shareholders as much as family business owners.[223] Nor would it be justified for Member States to adopt a rule of relative

215. *See* BEST PRACTICES, *supra* note 38, at 32.

216. *See, e.g.*, *Small Business Bankruptcy: Assessing the System: Hearing Before the Subcomm. on Oversight, Agency Action, Fed. Rts. and Fed. Cts. of the S. Comm. on the Judiciary*, 115th Cong. (2018) (statement of Craig Goldblatt, Partner, Wilmer Cutler Pickering Hale & Dorr LLP), https://www.judiciary.senate.gov/imo/media/doc/Goldblatt%20Testimony.pdf [https://perma.cc/E7ZL-XA74]; *see also* Michelle Craig, *The New Value Exception: A Plea for Modification or Elimination*, 11 EMORY BANKR. DEV. J. 781, 812, 816–17 (1995) (calling for small business owners to be permitted to retain value in bankruptcy cases based "sweat equity" and provisions that support such an exception).

217. *See* Craig, *supra* note 216, at 807.

218. *See* 11 U.S.C. §§ 1181–1195 (subchapter V of chapter 11). Chapter 12 of the Bankruptcy Code, substantially identical in approach, has been available to owners of family farms or fisheries since 1986. §§ 1201–1232.

219. 11 U.S.C. §§ 101(51D), 1182. This threshold has been temporarily raised to $7.5 million by the CARES Act. *Id.*; Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, § 1113, 134 Stat. 281, 310 (2020).

220. Ralph Brubaker, *The Small Business Reorganization Act of 2019*, BANKR. L. LETTER., Oct. 2019, at 1, 14.

221. *Compare* 11 U.S.C. §§ 1181–1195 *with* §§ 1301–1330 (providing for similar court-approved repayment plans for individual debtors). At the end of the plan period, the debtor receives a discharge of most categories of debt. § 1192. Excluded are long term debts, such as mortgage debts, on which the last payment due postdates the last payment to be made under the plan. *Id.*

222. 11 U.S.C. § 1191.

223. *See* Directive, *supra* note 1, Recital 1, at 18 (noting Directive application to both entrepreneurs and enterprises).

priority limited only to SMEs. First, as we have explained, the EU definition of an SME likely sweeps far more broadly than under chapter 11, and thus cannot be justified based on the same concern for individual sweat equity.[224] And even in cases involving small, closely -businesses, the Directive's relative priority standard does not even guarantee that small business owners will be able to keep the equity in their businesses, since they must first provide "more favourable" treatment to all senior classes of creditors.[225] For some small business debtors, that may be prohibitively expensive. Additionally, as we have noted, by discouraging settlement, relative priority makes the process of achieving such a plan more contentious and expensive. The more complex and bespoke a restructuring mechanism, the more likely it is to be out of the reach of a distressed small business.

VI. Conclusion

As one commentator has noted, the Directive is something of an intellectual hotchpotch.[226] Regardless, we favor its central professed goal of maximizing the value of a financially distressed but economically viable enterprise through reorganization as a going concern, as an alternative to a value-destructive liquidation.[227] Chapter 11 has its flaws, but it generally works well to maximize that value.[228] The Directive's key proposed innovation over chapter 11, using relative priority as a default rule, however, cannot be justified by any principle of value maximization.

Relative priority under the Directive also appears to reflect a belief that fairness requires a commitment within insolvency law itself that all stakeholders should share losses in the event of financial distress, rather than beginning from a presumption (albeit a rebuttable one) that losses should fall according to underlying nonbankruptcy rights and priorities. As we have explained in this Article, we believe that a relative priority default rule is antithetical to fairness. But we recognize that others may differ on that issue. What does seem undeniable is that relative priority will scramble the usual incentives that shape bargaining in insolvency, which takes place in the shadow of an absolute priority default rule. It seems that the Directive's "innovative" relative priority default rule has not benefited from sufficient thought or study. We believe that its consequences are likely to be undesirable.

Chapter 11 facilitates reorganizations with lower transaction costs because all parties are likely to agree that a consensual resolution is preferable to resolution by the bankruptcy court applying the perhaps heavy-handed default rule for which the Code provides. Relative priority both lifts that shadow and creates

224. *See supra* notes 136–39 and accompanying text.
225. *See* Directive, *supra* note 1, Recital 55, at 28.
226. *See* Rotaru, *supra* note 163, at 20.
227. *See* Directive, *supra* note 1, Recital 2, at 18.
228. *See* Gilson, *supra* note 51, at 23–25.

opportunities for strategic maneuvering by debtors at the expense of other, disfavored classes. We think that is likely to lead to more litigious and thus more expensive insolvency proceedings—exactly the opposite of the EU Commission's professed goal.[229] If Member States follow the Commission's lead and adopt relative priority, it is too early to predict what the broader consequences will be. The evidence is clear, however, that open and accessible lending markets require robust and reliable protections for creditors.[230] If we are correct that relative priority will adversely disrupt lenders' expectations, then it may make borrowing in the EU both more difficult and more expensive.

APPENDIX

This Appendix explains the difficulty of applying a relative priority standard when comparing distributions made to creditors with distributions made to shareholders in a cram down plan.

As the Article explains, we assume that the general methodology for analyzing whether a plan of reorganization complies with relative priority will be to compare the percentage recovery under the plan for senior classes to that provided for junior classes. A plan that provides that senior creditors recover sixty cents on the dollar (or 60% of the value of their claims) while junior creditors recover forty cents on the dollar (or 40% of the value of their claims) complies with relative priority because the percentage recovery of the senior creditor class exceeds the percentage recovery of the junior creditor class. We explain in the Article that a plan structured in this way does not require a precise valuation of the debtor, but merely an imprecise ceiling valuation; for this reason, there is no penalty default rule to discipline negotiation over the plan.[231]

The greater difficulty arises when comparing creditor distributions to equity distributions. Here, the more logical variant of relative priority discussed above breaks down because a distribution to equity cannot readily be measured as a percentage recovery. Equity's claim on a business is simply the residual value after all other claims are satisfied.[232] From that perspective, attempting to compare a plan of reorganization's distributions to creditors and to equity would be like comparing apples to oranges.

In theory, a comparison might be accomplished by trying to value the equity in the business immediately before (or as of the moment of the commencement of) the insolvency proceeding—the time at which the claims of creditors are fixed. This methodology would require valuation hearings in cram down cases, as in chapter 11, at least in cases in which a distribution to equity is proposed. In practice, however, it does not appear that conventional methods to

229. *See* Directive, *supra* note 1, Recital 6, at 19.
230. *Id.*, Recitals 45–47, at 26.
231. *See supra* notes 123–28 and accompanying text.
232. *See, e.g.*, WILLIAM T. ALLEN & REINIER H. KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 146 (5th ed. 2016).

value equity's ownership rights to the business are workable. The Directive permits firms to restructure only if they have a "likelihood of insolvency,"[233] and thus are presumably struggling or unable to pay their debts as they come due. But a traditional DCF analysis assumes the business's ability to keep operating as a going concern.[234] A DCF analysis builds from a business's estimated future cash flow; the value of that income stream for a business that cannot keep operating without an insolvency proceeding is likely zero or close thereto (subject only to the option value attributable to a possible turnaround).[235] Even if insolvency is not imminent, there are additional complicating factors in conducting such a valuation, including the need to account for the increased cost of capital for a distressed business.[236] Similarly, valuation based on comparable companies or transactions poses difficulties. The closer a business is to insolvency, the more likely the business "has a figure for net earnings, operating income, or operating cash flow that is not meaningful (i.e., negative, positive but very small, or extremely unstable)."[237] It will be difficult to find good comparables for such a business that can themselves be reliably valued.[238]

Another possible standard to try to assess whether a distribution to a creditor class is "more favourable" than that made to equity would be crude: simply to compare the raw amounts paid under the plan.[239] For example, a creditor class that would be paid 200 dollars under the plan would be deemed to be treated more favorably than equity so long as the value of the property distributed to shareholders is less than 200 dollars.[240] Again, a plan of reorganization can be crafted that satisfies this standard without requiring a valuation of the debtor.

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233. Directive, *supra* note 1, Recital 24, art. 4(1), at 22, 39.

234. ASWATH DAMODARAN, INVESTMENT VALUATION 437 (3d ed. 2012).

235. *Cf. id.* at 632 (explaining that alternative valuation techniques must be used in such a situation).

236. Israel Shaked & Allen Michel, *Valuing the Financially Distressed Firm*, 18 AM. BANKR. INST. J. 34, 35 (1999).

237. *Id.* at 34.

238. *See id.*

239. One other possibility might be to cap the amount of equity that shareholders may retain in the debtor according to the recovery of the next most senior class. For example, if general unsecured creditors will recover seventy cents on the dollar under the plan, then shareholders may retain no greater than 70% of the equity in the reorganized debtor under the plan. We are not aware of any proponent of relative priority that has endorsed this possibility, but at least one commentator has suggested it as a possible way of implementing the Directive's standard. Alexander Bornemann, German Ministry of Justice, Remarks at the Conference on Deviating from Absolute Priority, University of Amsterdam (Feb. 24, 2020) (notes on file with Jonathan M. Seymour); Alexander Bornemann, "The Debate over Priority Rules Read Through the Lense of National Lawmakers" (presentation, Conference on Deviating from Absolute Priority, University of Amsterdam, Feb. 24, 2020), https://acle.uva.nl/binaries/content/assets/subsites/amsterdam-center-for-law--economics/conferences/apr-conference-2020/bornemann_apr_fin.pdf [https://perma.cc/CZ45-299Y]. This approach likely again requires only imprecise floor and ceiling valuations; for example, if shareholders are to retain 70% of the equity in the reorganized debtor, the bankruptcy court must establish that distributions to creditors will result in them being paid at least seventy cents on the dollar, but it need not know the creditors' exact recovery. We also believe this approach potentially poses significant fairness problems—for example, in a case in which shareholders seek to retain 70% of the equity in a reorganized debtor of very great value while paying the next most senior creditor class 70 cents on the dollar on a comparatively much smaller claim.

240. Professor Stephan Madaus, one of the most prominent proponents of relative priority, has suggested that the "more favourable" standard could be applied in this way. Stephan Madaus, Remarks at the Conference on Deviating from Absolute Priority, University of Amsterdam (Feb. 24, 2020) (notes on file with Jonathan M.

Seymour). This standard also could be satisfied by comparing equity distributions in an all-equity plan as, for example, with a plan that proposes to distribute 40% of the equity in the reorganized debtor to senior creditors, 35% to junior creditors, and 25% to shareholders. No valuation would be needed to know that the junior creditors would recover more in absolute terms than the shareholders; it is evident that a 35% share in the equity of a business is worth more than a 25% share.