Pre-insolvency proceedings

Normative foundation and objective

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What are pre-insolvency proceedings?

- Plan procedure
- Outside “traditional” full-fledged insolvency proceedings (not “out of court”)
- Coercive measure / interference with rights

No justification for interference outside insolvency

Three examples:

- Stay
- Syndicated loan: loan matures, two lenders are willing to extend, the third wishes (and needs) repayment
- Junior stakeholders are out-of-the money on the basis of the enterprise value as per today, but the company is cash flow solvent and the junior stakeholders still have a realistic prospect of recovering their exposures in the future (option value)

So what then is pre-insolvency?

- Debtor is insolvent or there is *no realistic prospect of averting insolvency*
- “Likelihood of insolvency” insufficient

Interference only justified when debtor is unable to pay

Why is interference justified when the debtor is unable to pay?

Bankruptcy in general (social contract or creditors' bargain theory):

- Upon inability to pay: a cascade of uncoordinated individual actions might ensue
- Uncoordinated individual enforcement actions can result in value destruction
- Creditors lose their individual enforcement rights (interference)
- Replaced by collective enforcement system – coordinated enforcement
- Collective system enables creditors to better realise their rights (higher recoveries)
- Creditors can thus be deemed to agree to collective system *ex ante* (social contract)

NB! the collective system is <u>not</u> aimed business rescue as a policy objective in itself, but is aimed at improving the enforcement and realisation of existing rights (which might and oftens does require business rescue)

Justification for pre-insolvency proceedings

- Pre-insolvency proceedings are an insolvency instrument; the interference is only justified in insolvency on the basis of the same principles as for insolvency:

  The interference is not intended to limit the ability of creditors to realise their rights for the benefit of some other policy objective (e.g. business rescue as such), but the interference is intended only to organise and coordinate enforcement in order to improve the ability of creditors to realise their rights.

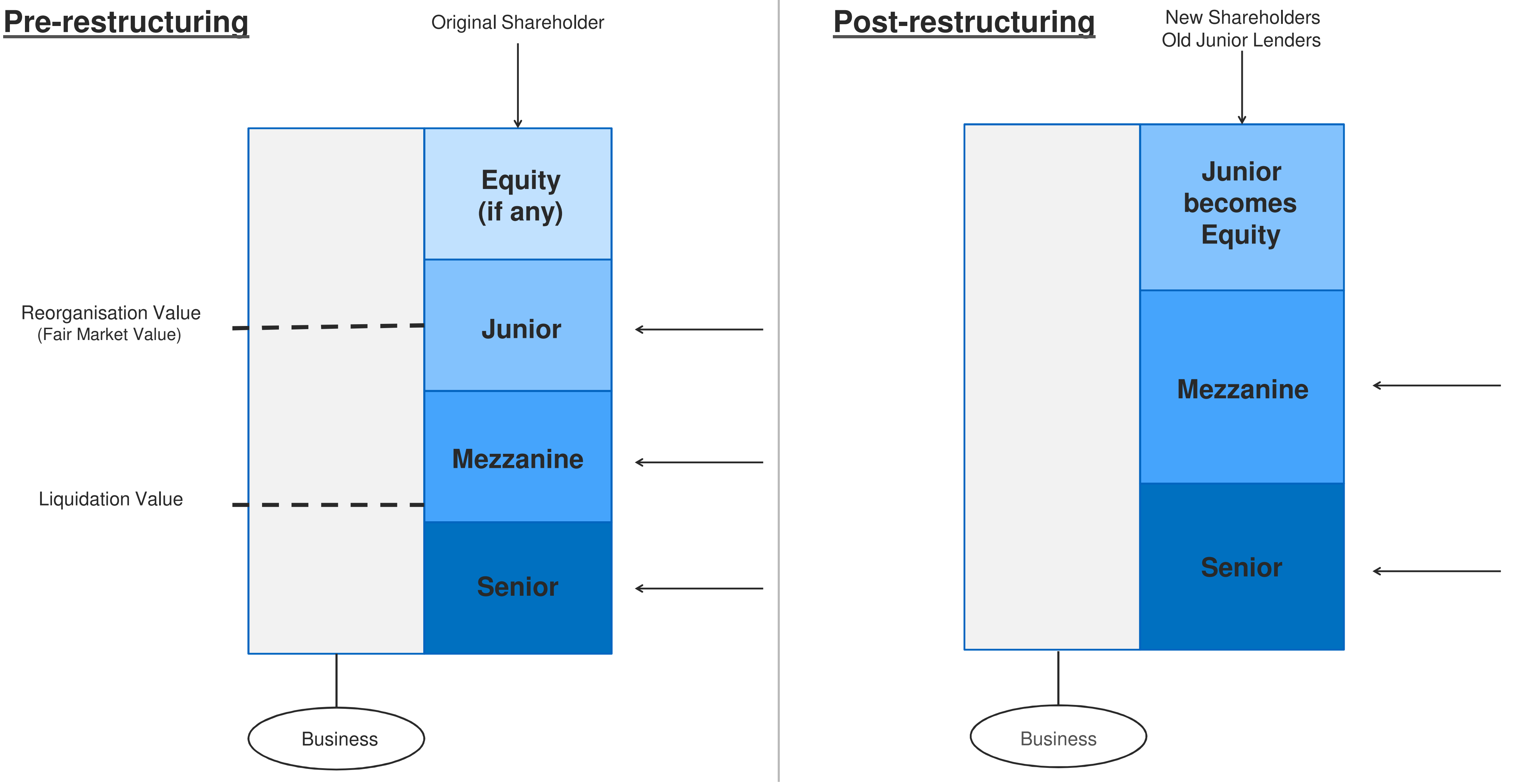
- No subgroup may be worse off and the stakeholders as a whole must be better off, than without the instrument (Pareto efficiency standard).

- The deemed e*x ante* consent can then be assumed.

What does this imply?

- Being a collective enforcement instrument, means, by definition, that pre-insolvency proceedings are an instrument of the creditors (just like ordinary insolvency proceedings are)
- Logically, this means that creditors should have the ability to initiate the use of the instrument, at least if the debtor (controlled by the shareholder) refuses to or seeks to abuse it to transfer wealth from creditors to shareholders
- The increased value that is realised with the instrument (reorganisation value) in principle has to be distributed in accordance with the existing order of priority (improved realisation of existing rights, no redistribution of rights)
- Special safeguards are required to ensure that no subgroup is worse off than without the instrument

Distributing value in a restructuring



Efficient mechanism required to eliminate non-interests

- A restructuring often involves or elicits a “fight” between shareholders on the one hand and creditors on the other over the value of the business. This “tug of war” harms the business and destructs value.

- In order to respect existing (priority) rights, preserve value and facilitate business rescue, an efficient mechanism is required to resolve this “fight”

- Out-of-the money parties should have only two venues to oppose a restructuring:
  i) the test for insolvency or pre-insolvency (and thus the justification for the use of elimination powers)
  ii) valuation (i.e. determining whether they have an interest or not)

- Any other venues are not necessary and can be abused by out-of-the-money parties to frustrate or delay the process and create a hold-out position, which harms the business, destructs value and leads to a transfer of wealth from creditors to shareholders

- Most importantly, shareholders should not be able to use their control over the debtor to prevent a plan being proposed that reflects the underlying positions (i.e. eliminates shareholders’ interests). If a fair plan, that respects existing rights, is not proposed by the debtor (controlled by the shareholder), creditors should have the right to propose an own plan

- The more efficiently out-of-the money rights can be eliminated, the less destruction of value, the less transfer of wealth and the more effective the instrument as a restructuring and business rescue tool

No one worse off principle (Pareto efficiency)

- No one worse off principle: need to pay attention to the position of those who would receive a cash distribution in a liquidation. They could be worse off under the terms of a restructuring. Creditors who would receive nothing in liquidation, can never be worse off in a restructuring

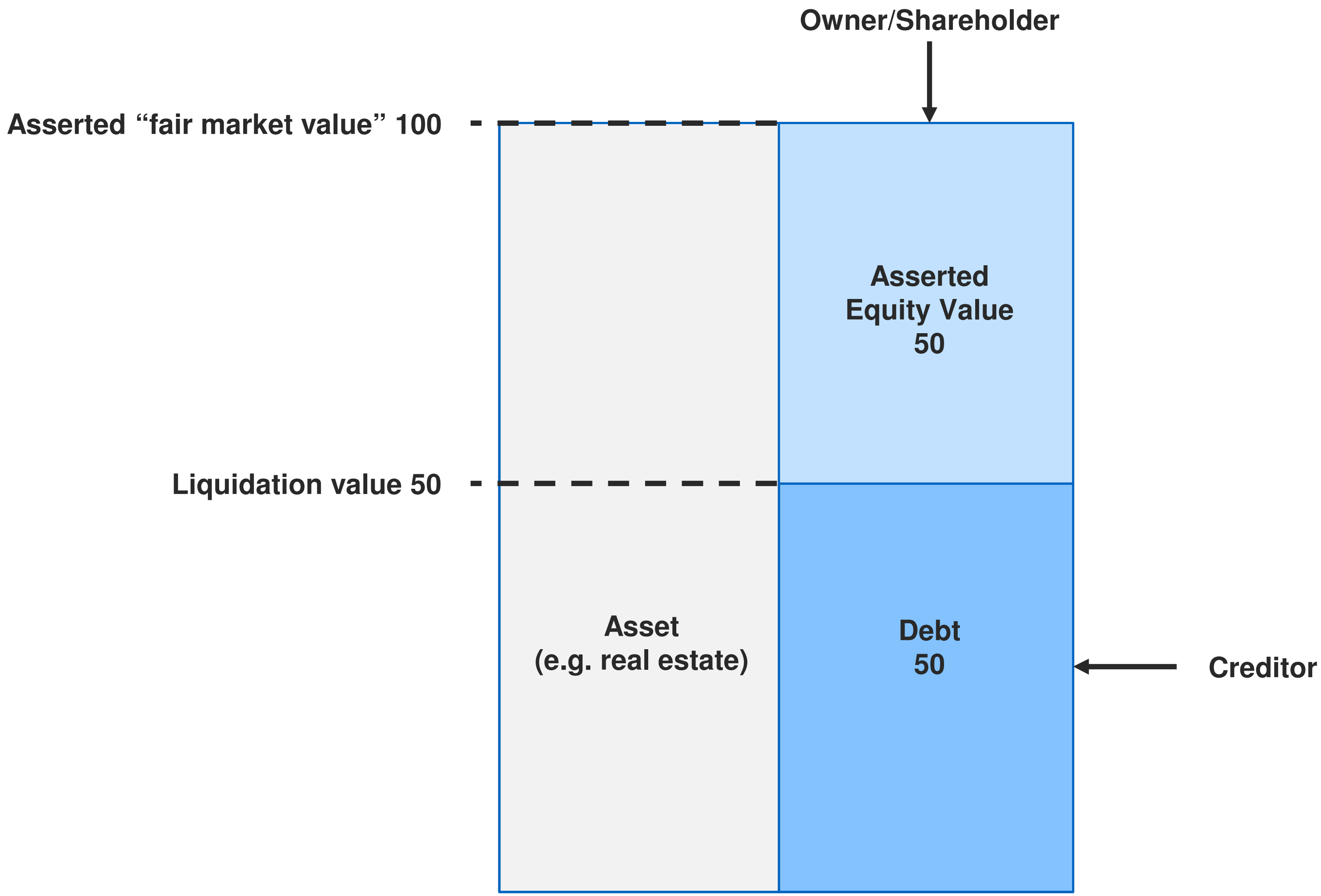
- In a restructuring parties will generally be required to take a non-cash distribution

- Having to take non-cash instead of cash can be a hardship, e.g. because

  - Need or preference for liquidity
  - Prolongation of risk exposure
  - Risk of undercompensation

- In order not to be worse off under the terms of the restructuring, creditors who would receive cash in a liquidation would in principle have to be offered cash under the terms of the restructuring (unless a majority of the affected creditors prefers non-cash)

No one worse off principle (Pareto efficiency)



Balance between creditors’ and “debtor’s” interests?

- The debtor (as a legal entity) has no independent economic position or interest. The question is rather: what is the balance between creditors’ and shareholders’ interests?

- Contrary to common belief, “debtor friendly” is not necessary to facilitate business rescue. A “creditor friendly” system can be equally and even better equipped to facilitate business rescue. “Debtor friendly” systems often give shareholders a hold-out position, which delays the process, leads to transfer and destruction of value and complicates business rescue.

- As said, the aim of the instrument should <u>not be to limit</u> creditors’ rights for the purpose of business rescue, but to organise and coordinate the exercise of rights in a fashion that enables creditors <u>to better realise</u> their rights, e.g. through a restructuring.

- Draft directive is slightly too tilted towards “debtor” (i.e. shareholder) friendly, mainly because:

    - Creditors do not have the right to propose a plan (permanent exclusivity in favour of debtor)
    - Inadequate protection of the right to cash of creditors who would receive cash in liquidation

Five key principles

1. Coercive measures are only justified in insolvency or pre-insolvency
2. Pre-insolvency proceedings are an insolvency instrument: they provide a collective enforcement instrument aimed at providing creditors with an alternative (better) mechanism for realising their existing rights than through formal liquidation (e.g. by restructuring the business).
3. An efficient mechanism is required to eliminate rights of out-of-the money stakeholders in order to respect existing (priority) rights, facilitate business rescue and preserve value (right of creditors to propose a plan + cross-class cram down + efficient judicial valuation process)
4. The value that is realised with a restructuring (reorganisation value) must in principle be distributed in accordance with the existing order of priority, unless a majority within each affected class consents to a different distribution
5. Creditors who would receive cash in a liquidation, must in principle be offered the option to receive a similar amount in cash under the terms of the restructuring, unless a majority within the relevant “in-the-money” class consents to a different distribution