

The New European “Relative Priority”: An Analysis of its Impact in the EU Restructuring Directive and Dutch Insolvency Regime

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On June 6, 2019 the European Council formally adopted the directive on preventive restructuring frameworks, on discharge of debt and disqualifications, on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (the “**EU Restructuring Directive**”).¹ The formal vote of the European Council marks the end of the legislative procedure after the proposed EU Restructuring Directive was adopted by the European Commission on November 22, 2016. The directive on preventive restructuring frameworks will now be formally signed and enter into force twenty days following its publication in the Official Journal of the European Union. Member States will then have two years to implement the EU Restructuring Directive (plus an additional year if they encounter particular difficulties during implementation). Likely implementation date would thus ultimately be June/July 2021 or, in special cases 2022.

The EU Restructuring Directive is a minimum harmonization directive. It introduces a set of principles along with more targeted rules in some specific cases, while allowing Member States to go further when transposing the rules into national law. This article is mainly focused on the purpose of introducing a preventive restructuring framework (including a restructuring plan) in all Member States. The EU Restructuring Directive has primarily been inspired by Chapter 11 of the U.S. Bankruptcy Code and provides for a cross-class cram down provision in respect of dissenting classes of capital providers.

Initially, the EU Restructuring Directive prescribed the application of the “absolute priority rule” in the context of the cram down provision. However, the final version of the EU Restructuring Directive includes the ability of Member States to opt for a certain “relative priority rule” (the “**European Relative Priority Rule**”). Under the European Relative Priority Rule, dissenting voting classes are to be treated at least “as favourably” as any other class of the same rank and “more favourably” than any junior class. Although the European Relative Priority Rule aims to provide for more restructuring flexibility, it is not only very different from the concept of the “relative priority rule” as developed in U.S. literature (and can thus be misleading), but it may actually lead to forum shopping within the EU, which is contrary to the objective of the harmonization of European preventive restructuring frameworks.

Following an analysis of the EU Restructuring Directive, we provide an update and summarize the mechanics of the envisaged Dutch pre-insolvency scheme. For the purpose of the Dutch pre-insolvency scheme, a draft bill was made public in 2017. It is currently expected that the revised and official bill will be submitted to the Dutch Parliament this summer.

Absolute Priority Rule	European Relative Priority Rule
A dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan	Dissenting voting classes are to be treated at least “as favourably” as any other class of the same rank, if the normal ranking of liquidation priorities under national law were applied, and “more favourably” than any junior class

Overview of the EU Restructuring Directive

The overall objective of the EU Restructuring Directive is to reduce the most significant barriers to the free flow of capital stemming from differences in Member States’ restructuring and insolvency frameworks and to enhance the rescue culture in the EU. Furthermore, the directive also aims to reduce the amount of non-performing loans (NPLs) on banks’ balance sheets and to prevent the accumulation of such NPLs in the future.

THE MAIN PURPOSES OF THE EU RESTRUCTURING DIRECTIVE ARE:

1. to ensure that Member States have a preventive restructuring framework, which includes a restructuring plan;
2. to ensure that entrepreneurs have a second chance through an effective debt discharge mechanism; and
3. to ensure that Member States put in place measures to increase the efficiency of restructuring, insolvency and discharge of debt procedures more widely.

With respect to the preventive restructuring framework, the EU Restructuring Directive indicates that Member States must provide debtors with access to a preventive restructuring framework that enables them to restructure, with a view to preventing insolvency and ensuring their viability, in case there is “a likelihood of insolvency” (but importantly where insolvency proceedings which could end in the liquidation of the debtor under national law have not yet been opened in respect of the debtor).

Some key features of the restructuring framework include:

- Debtor in possession: Member States shall ensure that debtors accessing preventive restructuring procedures remain totally, or at least partially, in control of their assets and the day-to-day operation of their business.
- Stay of individual enforcement actions (including secured claims and preferential creditors, except for employees’ claims unless payment of these is guaranteed for the duration of the preventive proceeding): the initial duration of a stay of individual enforcement actions shall be limited to a maximum period of no more than four months, but Member States may permit courts to extend it to a total duration of not more than 12 months. Such a stay shall suspend, for the duration of the stay, the opening, at the request of one or more creditors, of insolvency proceedings which could end in the liquidation of the debtor.



- Continued performance of essential executory contracts: Member States shall provide for rules preventing creditors to which the stay applies from withholding performance or terminating, accelerating or, in any other way, modifying essential executory contracts to the detriment of the debtor, for debts that came into existence prior to the stay, solely by virtue of the fact that they were not paid by the debtor.²
- Prohibition of *ipso facto* clauses: creditors are not allowed to invoke *ipso facto* clauses which make reference to negotiations on a restructuring plan or a stay or any similar event connected to the stay.
- Initiative: the debtor will have the right to submit a restructuring plan. Member States may also provide that preventive restructuring frameworks provided for under the EU Restructuring Directive are available at the request of creditors and employees' representatives, subject to the agreement of the debtor. Member States may limit that requirement to obtain the debtor's agreement to cases where debtors are SMEs.
- New financing and interim financing: Member States shall ensure that new financing and interim financing are adequately protected, i.e., new financing and interim financing shall not be declared void, voidable or unenforceable.

- Voting in classes, including the “best-interest-of-creditors test”³ and a cross-class cram down provision (to be explained below).

The Relative Priority Rule under the EU Restructuring Directive

Initially, the cram down provision in the 2016 draft of the EU Restructuring Directive was predominantly based on the absolute priority rule as applicable in Chapter 11.⁴ At the end of 2018 and at a fairly late stage in the legislative process, an amendment was made in respect of article 11 (*cross-class cram down*) of the EU Restructuring Directive. In order to let a plan become binding upon dissenting voting classes, the restructuring plan essentially has to fulfill the following conditions:

“1. [...] (c) it 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; and

(d) no class of affected parties can, under the restructuring plan, receive or keep more than the full amount of its claims or interests[...].”

“2. By way of derogation from point (c) of paragraph 1, Member States may provide 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.”

Although a plan cramming down dissenting classes has to be proposed by the debtor or with the debtor’s consent, Member States may limit the requirement to obtain the debtor’s agreement to cases where debtors are Small and Medium Enterprise (SME) Businesses, basically making it possible that creditors propose a certain plan.

The introduction to the October 2018 draft provides the following explanation for the revised cross-class cram down provision:

“The cross-class cram down mechanism was new to a number of Member States and raised some concerns[...] [the fear for the consequences of the absolute priority rule] has been addressed in the compromise text by providing an alternative option for Member States to introduce a different benchmark - a ‘relative priority rule’ - to protect dissenting creditor classes when using a cross-class cram down mechanism[...] This provides Member States with more flexibility in implementing this rule.”

Furthermore, recital (55) of the EU Restructuring Directive indicates that 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.

Consequently, this optionality was introduced and the European Relative Priority Rule was added in article 11 of the EU Restructuring Directive. As a result, Member States are now free to opt for the absolute priority rule (article 11 section 2(a)) or the “more favourably” approach (relative priority rule; article 11 section 1(c)). Although the “relative priority rule” is presented as the default rule, Member States may choose to prescribe the “absolute priority rule.”

The responses to this amendment were mixed. Some say that it creates the desired optionality and counters disadvantages of the absolute priority rule,⁵ others argue that this test of “more favourably” will inevitably lead to an arbitrary analysis and thus more uncertainty. More specifically, it is argued that it is unclear how the test should be applied. For example, the position of shareholders (who qualify only as residual claim holders which position cannot be measured by a pay-out percentage – and it thus seems difficult to establish whether creditors have been treated “more favourably” than shareholders). In addition, looking at only pay-out percentages does not

seem to be sufficient in order to fully compare the financial position of respective classes. Lastly, looking at absolute pay-out amounts at class level may not be fair when taking into account the outcome in relative terms (i.e., lower class receiving slightly lower absolute amount, but perhaps resulting in a substantially higher pay-out percentage).⁶

The European Relative Priority Rule seems to enable the redistribution of value, allowing for the reshuffling of pre-bankruptcy rights in a manner that is unpredictable. This is incompatible with the desire to create legal certainty for investors, and thus undermining the Commission’s pursuit of a true capital markets union. The optionality of the various parts of the EU Restructuring Directive (amongst others this choice between the absolute priority rule and the European Relative Priority Rule) can create considerable differences between preventive restructuring frameworks throughout the European Union. It is expected that these disparities will continue to incentivize forum shopping within the EU.⁷

Developments in the Netherlands: New Dutch Restructuring Scheme

In accordance with these European developments, the Netherlands is one of the Member States that has already been preparing for the introduction of a mechanism for implementing out of bankruptcy, private restructuring plans. The respective bill will be a revised version of the public draft that was published for consultation in September 2017. It is currently expected that the bill will be submitted to the Dutch Parliament this summer.

At the moment, Dutch law does not provide for an effective scheme-like restructuring mechanism. Debtors can only offer a compulsory composition plan to their creditors as part of formal proceedings. Apart from the stigma that these proceedings carry, this plan procedure is rarely used as it only binds unsecured creditors, making it ineffective against shareholders or secured or preferential creditors. Outside of formal insolvency proceedings, there is no statutory route to bind dissenting creditors to a restructuring plan. The lack of an effective restructuring mechanism has meant that many Dutch companies have had to avail themselves of the Chapter 11 proceedings and the U.K. scheme of arrangement to restructure their debts.⁸

The new Dutch restructuring scheme combines elements from the U.K. scheme, such as the ability to implement a plan outside formal insolvency proceedings, with elements from Chapter 11, such as a cross-class cram down mechanism. The result is a fast and flexible procedure that is designed to avoid unnecessary court involvement.

For the purpose of the voting process, creditors with equal rights are placed in classes and a vote is then taken per class. If the plan is supported by a two-thirds majority in amount of the class in question, creditors voting against the plan may also be forced to cooperate. The main economic requirement for confirmation of a consensual plan is that *individual* creditors under the plan receive rights with a value that is not materially lower than the amount that they would expect to have received upon liquidation in bankruptcy (“best-interest-of-creditors-test”).

In addition, even in the event that the two-thirds majority required within a class is not achieved, a pre-insolvency private plan may be sanctioned by the court, resulting in a cross-class cram down of the respective class of dissenting capital providers. For a cram-down, the main economic requirements are inspired by the Chapter 11 procedure and the current version of the Dutch bill, which prescribes the absolute priority rule.

These criteria aim to ensure that creditors in a dissenting class receive their share of the reorganization value in accordance with their ranking in the capital structure. To protect senior creditors’ exit rights – and this is different compared to the US system – creditors in a dissenting class must also have the right under the plan to opt for a distribution in cash equal to their share in accordance with their ranking of the liquidation value (‘cash-out option’). Thus, unlike what is the case under the American system, under the proposed Dutch bill, creditors in a dissenting class cannot be forced to continue financing the business against their majority will at terms imposed by the court. If a senior class dissents, it must have the right to be “cashed-out.”

The proposed Dutch bill has the ability to transform the Dutch restructuring landscape for both domestic and foreign debtors. It will give debtors in the Netherlands an effective option to restructure their debts. The result is a modern and light-touch restructuring procedure with minimal court involvement, but which does include cross-class cram down and the necessary flanking measures.

The consultation version of the draft bill does not yet determine whether the contemplated Dutch scheme will or will not fall under the European Insolvency Regulation.⁹ There are advantages and disadvantages to both.

Inclusion of the Dutch Scheme in the European Insolvency Regulation	
Advantages	Disadvantages
<ul style="list-style-type: none"> Automatic recognition in other Member States (except Denmark) 	<ul style="list-style-type: none"> May only be used for debtors with their COMI in the Netherlands It would render a restructuring plan ineffective against creditors with security rights over assets located abroad and would render third party releases ineffective where the third party has its COMI in another Member State.¹⁰ This makes it difficult if not impossible to restructure cross-border groups.

Dutch Scheme Falls Outside of the European Insolvency Regulation	
Advantages	Disadvantages
<ul style="list-style-type: none"> It could – similar to the U.K. scheme of arrangement – also be applied to debtors, assets and third parties located or having their COMI outside the Netherlands.¹¹ 	<ul style="list-style-type: none"> It will not benefit from automatic recognition under the European Insolvency Regulation. As the Dutch scheme would in all likelihood also not fall within the scope of the Brussels I regulation (recast),¹² recognition of the plan would depend on the domestic private international law of each individual member state where the debtor has assets.

Because of various pros and cons, it could be preferable to have the instrument fall in- or outside-the-scope of the European Insolvency Regulation, depending on the situation. This is one of the reasons why the Dutch ministry of justice is currently contemplating a dual track system whereby the debtor has the ability to choose between a public or a confidential procedure. This choice directly influences whether or not the procedure falls under the scope of the European Insolvency Regulation, as the recast of the European Insolvency Regulation only

applies to public insolvency proceedings. The fact that the Dutch scheme seeks to offer great flexibility in cross-border situations, by giving the option to be used both within and outside the scope of the European Insolvency Regulation, adds to its effectiveness.

Conclusion

Following the formal adoption of the EU Restructuring Directive, Member States now have two years to implement it (plus an additional year if they encounter particular difficulties during implementation). In respect of the cross-class cram down provision, Member States have the possibility to choose between the U.S. style “absolute priority rule,” which was recently confirmed by the U.S. Supreme Court,¹⁴ and the European Relative Priority Rule. Although the European Relative Priority Rule aims to provide for more restructuring flexibility, it is different to the concept of “relative priority rule” as developed in U.S. literature and it may actually lead to forum shopping within the EU, which is contrary to the objective of the harmonization of European preventive restructuring frameworks.

The proposed Dutch bill as currently prepared provides for a cross-class cram down provision that is to a large extent based on the Chapter 11 procedure. In the current draft it thus includes the absolute priority rule and although it is generally expected that the absolute priority rule as explained above will also be included in the final version of the bill, this will become clear once the bill will be submitted to the Dutch parliament; it is currently expected that this will happen this summer. ■

1. <https://www.consilium.europa.eu/en/press/press-releases/2019/06/06/giving-entrepreneurs-a-second-chance-new-rules-on-business-insolvency-adopted/>
2. “Essential executory contracts” shall be understood to mean executory contracts which are necessary for the continuation of the day-to-day operations of the business, including contracts concerning supplies, the suspension of which would lead to the debtor’s activities coming to a standstill.
3. Under the EU Restructuring Directive it seems that the “best-interest-of-creditors test” also has a different meaning compared to Chapter 11 of the US Bankruptcy Code, namely “a test that is satisfied if no dissenting creditor would be worse off under a restructuring plan than such a creditor would be if the normal ranking of liquidation priorities under national law were applied, either in the event of liquidation, whether piecemeal or by sale as a going-concern, or in the event of the next-best-alternative scenario if the restructuring plan were not confirmed.”
4. Under the 2016 draft of the EU Restructuring Directive, the “absolute priority rule” was given the meaning that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan (<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0723&from=EN>). It was, thus, not yet explicitly indicated that “no class of affected parties can, under the restructuring plan, receive or keep more than the full amount of its claims or interests” (sometimes referred to as the “no more than 100% rule”), as is the case in the current EU Restructuring Directive (article 11(1)(d)).
5. See: R. Mokal and I. Tirado, ‘Has Newton has his day? Relativity and realism in European Restructuring’
6. Eurofenix 2018/19.
7. See: R. de Weijts, A. Jonkers and M. Malakotipour, “The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing ‘Relative Priority’ (RPR).”, Amsterdam Law School Research Paper No. 2019-10, Centre for the Study of European Contract Law Working Paper No. 2019-05, March 2019; Moritz Brinkmann, “Die relative

Vorrangregel aus Art. 11 (1) (c) der Insolvenzrichtlinie: nicht nur untauglich, sondern brandgefährlich!”, European Insolvency & Restructuring, TLE-009-2019, March 2019.

8. A. Mennens, “Puzzling Priorities: Harmonisation of European Preventive Restructuring Frameworks”, Oxford Law Blog, 25 March 2019.
9. Examples of Dutch companies turning to the scheme of arrangement include Magyar Telecom B.V. (Re Magyar Telecom BV (2013) EWHC 3800 (Ch.)), Van Gansewinkel Groep B.V. (Re Van Gansewinkel Groep BV [2015] EWHC 2151 (Ch) (Snowden J, 22 July 2015)) and Indah Kiat International Finance Company B.V. (Re Indah Kiat International Finance Company B.V. [2016] EWHC 246 (Ch)). Examples of Dutch companies using the Chapter 11 procedure include: Almatris B.V. (Re: Almatris BV et al., case number 10-12308-mg, in the U.S. Bankruptcy Court for the Southern District of New York), Versatel Telecom International N.V. (Re: Versatel Telecom International N.V., case number 02-13003 (RDD), in the U.S. Bankruptcy Court for the Southern District of New York) and Global Telesystems Europe B.V. (Re: Global Telesystems Europe B.V., case number 01-11280 (EIK) in the U.S. Bankruptcy Court for the District of Delaware).
10. Regulation (EU) 2015/848 of the European Parliament and of the Council of May 20, 2015 on insolvency proceedings (recast).
11. European Court of Justice December 15, 2011, ECLI:EU:C:2011:838, Case C-191/10 (*Rastelli Davide e C. Snc v Jean-Charles Hidoux*).
12. In this scenario, jurisdiction of the Dutch court will be determined on the basis of Article 3 DCCP, which stipulates that the Dutch court has jurisdiction if: (a) the applicant or, if there are more applicants, one of them or one of the interested parties mentioned in the request is domiciled or habitually resident in the Netherlands, or (b) the case is otherwise sufficiently connected with the legal sphere of the Netherlands.
13. Regulation (EU) 1215/2012 of the European Parliament and of the Council of December 12, 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast).
14. Article 1 of the European Insolvency Regulation (recast).
15. *Czyzewski v. Jevic Holding Corp.*, 137 Supreme Court 973 (2017).



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