Priority Rules Under the Directive (EU) 2019/1023 and the Shareholder-Creditor Agency Problem

- A comparative legal research

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1. Introduction

The relationship between stakeholders in corporate governance have a strong influence on company solvency — the fewer conflicts of interest they have, the more chances there are for stable and efficient company development. Agency theory defines any conflict between company stakeholders concerning corporate governance as an agency problem. Agency problems infringe good company governance, which potentially reduces the company income and invite financial difficulties. It is especially true with shareholder-creditor agency problem. On the one hand, shareholders as the owners of the company generally have the most power over its governance, especially in SMEs, which represent 99% of all the business in the EU. [1] On the other hand, creditors provide investments, which are essential for any business. Thus, any friction between those parties might be critical for the company. It becomes especially evident when the company is facing the risk of insolvency.

On the 16th of Jule 2019 the Directive (EU) 2019/1023 on preventive restructuring frameworks, on the discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency, and discharge of debt, and amending Directive (EU) 2017/1132 ("Directive") entered into force.[2]

One of the critical points in the Directive is the introduction of a restructuring framework with a possibility of enforcing a restructuring plan on a dissenting class of creditors (cross-class cramdown). It means that even if one of the classes of creditors does not vote for the restructuring plan, court might anyway enforce it. To protect the dissenting creditors, the Directive allows the Member States to choose which priority rule will be applied by the national courts when they are confirming the plan. The first (default) option is the Relative Priority Rule ("RPR"). It means that "dissenting voting classes are treated at least as favorably as any other class of the same rank, if the normal ranking of liquidation priorities under national law were applied, and more favorably than any junior class rule".[3] The second option provided by the Directive is the Absolute Priority Rule ("APR"). It means that "dissenting class is paid in full

[1] §17 of Directive (EU) 2019/1023 recitals
[2] EUR-Lex, [online], accessed 25 July 2019
[3] §55 of Directive (EU) 2019/1023 recitals

if a more junior class receives any distribution or keeps any interest under the restructuring plan."[4]

Priority rules seek to protect dissenting creditors in a case of cross-class cramdown. Such protection rules inevitably affect the agency problem between stakeholders of corporate governance. This paper, however, focuses on the APR and the RPR from the perspective of generally existing agency problem between shareholders and creditors.

Since the Member States have to implement the Directive in 2 years period, it is unclear how those rules will influence the shareholders-creditors agency problem in restructuring procedures in each jurisdiction. Moreover, it is interesting how these rules would fit the legal systems in terms of consistency with the current measures in place.

Drawing on this uncertainty, this paper aims to answer the following research question: "Which of the two alternative priority rules under the Directive (EU) 2019/1023 on preventive restructuring frameworks, on the discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency, and discharge of debt, and amending Directive (EU) 2017/1132 should be implemented into the existing legal systems of Germany and the UK?".

The UK is a country which is traditionally considered as a restructuring friendly jurisdiction with well-practiced and settled restructuring mechanisms such as the scheme of arrangement. However, surprisingly, so far, there is no cramdown procedure for dissenting classes of creditors. On the other hand, Germany was chosen as a country with no flexible out of court restructuring framework; the existing ones are available only in formal insolvency proceedings. However, since the reforms in 1999, Germany has adopted a statutory provision on cross-class cramdown similar to the US absolute priority rule.[5] In 2012 it has become possible to cramdown shareholders.[6] As shareholder-creditor problem is firmly linked to the amount of power shareholders have over company management, UK and Germany were chosen as countries with a different attitude towards shareholders primacy paradigm. The UK supports

4 Ibid

5 Sacha Lürken, *One year later: Germany's corporate insolvency law reform turns out success story*, Financier Worldwide Magazine, May 2013, [via www.financierworldwide.com], accessed 25 July 2019

6 Art 217 (2) (InsO, German Insolvency Code) (English translation by Dr. Eberhard Braun, [via www.insol-europe.org], accessed 25 July 2019

the shareholder-oriented model, whereas Germany does not provide that volume of rights in company decision making.

1.1 Thesis trajectory

This paper consists of six chapters. The first chapter is introduction. The second chapter will set out the basics of agency theory and the definition of the shareholder-creditor agency problem. This chapter will also disclose the roots of that problem, shareholders actions that cause it, and provide a brief overview of measures that have influence on this issue. In the third chapter, this paper will describe how each of the rules of priority works and what impact it has over the agency problem on examples of excessive risk-bearing and value expropriation. In the fourth chapter, this paper will explore existing measures in restructuring procedures of the UK and Germany form the position of agency theory. Also, a brief analysis of similarities and differences in restructuring regimes in the UK and Germany will be provided. This paper will also take into account the upcoming UK reform on restructuring. Upon completion of this analysis, Chapter 5 will discuss how APR, RPR, and current measures in place fit each other. Taking into account shareholder-creditor agency problem as a common denominator, this paper will consider which rule fits Germany and UK best.

1.2 Methodology

It is a comparative study of German, English and E uropean restructuring procedures rules, and its effects on the shareholder-creditor agency problem. A descriptive method is adopted for establishing the history and functions of the priority rules suggested in the Directive, as well as describing the current legal structures in both jurisdictions. The advantage of this method is that it is well-suited to the discovery of legal doctrines, examination of legal precedent and statutory interpretation.[7] In order to establish the balance of shareholder-creditor interests in existing restructuring procedures and investigate existing instruments that deal with creditor protection against shareholders corrupt practices, functional-institutional method will be used. It means that this paper will focus on the function of priority rules and restructuring procedures as instruments to influence shareholder-creditor agency problem.

[7] Paul Chynoweth, 'Legal Research', in Andrew Knight (ed.) *Advanced Research Methods in the Built Environment* (Wiley-Blackwell, 2008) p. 28, [via https://pdfs.semanticscholar.org], accessed 25 July 2019

Among all the business structures of Germany[8] and the UK[9], SMEs constitute more than 99% of the total population of enterprises. One of the critical characteristics of SMEs is the small number of shareholders and less active share trading than in public companies. It creates a close connection between shareholders and directors, combining their interests.[10] In such circumstances it is almost impossible to imagine directors acting independently from the shareholders. Therefore, this study is built on the hypothesis that the management is generally dependent on the shareholder's will and will not propose a restructuring plan contrary to the shareholder's interests.[11]

From the perspective of Kraakman's framework on the principal's interests protection[12], priority rules can be attributed to governance strategies, i.e., policies that limit the opportunism of agents by increasing the principal's control over the agent's behavior. To determine the outcome, this paper will, therefore, compare priority rules with the existing governance measures in restructuring. The criteria to answer the main question will be the consistency between current governance strategy measures in restructuring procedures and the introduced priority rules.

2. Agency theory. Shareholder-creditor agency problem

Agency theory in company law helps to understand the relationships between actors that influence company governance. While this theory has a substantial impact on governance relationships between the stakeholders of the corporation, namely shareholders and hired management, it also covers shareholder – creditor interactions. In theory, an agent should comply with the interests of the principal and do its best for the benefit of the latter. In relationships between shareholders and creditors, the former act as an agent and the latter as a principal. Creditors invest in a company and rely on shareholders acting in good faith to support creditor's investments. However, in practice, the interests of shareholders and creditors might be different. It creates a fertile ground for conflict. The agency problem is an apparent and

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8 fW Research, *Regional faces of Germany's SMEs: a state-by-state comparison,* KfW SME Atlas 2018, p.1, [via www.kfw.de], accessed 25 July 2019

9 Chris Rhodes, *Briefing paper, Number 06152, 12 December 2018,* House of commons Library, p.5, [via https://researchbriefings.files.parliament.uk], accessed 25 July 2019

10 Gregor Bachmann, Horst Eidenmüller, Andreas Engert, Holger Fleischer, Wolfgang Schön, *Regulating the Closed Corporation,* 2013, p.9

11 Nicolaes W.A. Tollenaar, *The European Commission's Proposal for a Directive on Preventive Restructuring Proceedings*, Insolvency Intelligence, number 5, 2017, p.73, [via https://papers.ssrn.com], accessed 25 July 2019

12 John Armour, Henry Hansmann, Reinier Kraakman, *Agency Problems, Legal Strategies, and Enforcement, Discussion Paper No. 644,* 2009, p.5, [via http://www.law.harvard.edu], accessed 25 July 2019

predictable contradiction between the interests of creditors and shareholders, which arises due to the lack of desire of shareholders to maximize the income on input invested by creditors. That problem inevitably corresponds to the level of shareholders control over company decision-making. The strong influence over company management facilitates the shareholders initiative to abusive behavior. According to theoretical assumptions, shareholders with limited rationality strive to increase their well-being at the expense of investors. This opportunism leads to an agency problem. The consequence is a decrease in value of the company and increase in transaction costs. Agency problems lead to the reduction of overall income, its efficiency, and in general vital capacity of the company. It results in excessive time and money-wasting, which is termed as the agency costs. In order to protect themselves from abusive behavior, creditors impose contractual covenants that secure their investments. However, such measures reduce the flexibility of the company, its ability to swiftly adapt to the everchanging business environment. The restrictions on corporate decision-making, as well as shareholders value-decreasing behavior, may discount the profitability of the company and run it into the risk of insolvency. In the vicinity of insolvency, such conflict is especially evident as a distressed company cannot fulfill the obligations, and limited assets must be divided between stakeholders. Both shareholders and creditors have the right to the company assets, and each of them wants to get as much as possible. This situation invites additional incentives for a shareholder to resort to unfair and harmful actions at the expense of the creditors.

2.1 Reasons for shareholder creditor agency problems

The agency problem between shareholders and creditors has two causes. The first one is a different risk perception of the parties. Limited liability of shareholders creates incentives for risky business, as in case of failure, their loss is limited to the value of shares. On the other hand, creditors want their investments back, and additional risk decreases the chances that the company will return the investments. The second one is the limited earnings; creditors only look for the interest rate, while shareholders profit is not limited and depends on the company value. The more profit the company can make, the more value shareholders can obtain.

2.2 Shareholder - creditor agency problems

R.H. Kraakman mentions two types of shareholder - creditor agent problems.[13] The first one is misrepresenting the value of company assets (*ex-ante*)[14]. The second one is corporate shielding that encourages shareholders to undertake beneficial actions at the expense of creditors (*ex-post*)[15]. The first problem arises at the stage where the creditor has not yet invested. The second type of problems arises where the investment is already being made. This paper will focus on *ex-post* problems, as it is what the parties have to deal with in restructuring procedures when the company is facing insolvency.

According to R.H. Kraakman, there are three forms of shareholders actions leading to the agency problems.[16] Creditors usually are entitled only to the fixed interest on their investment. Meanwhile, shareholders surplus depends on the share price. Limited liability of shareholders naturally inclines them to more aggressive and risky business conduct to increase the value of the shares. However, creditors will not benefit from additional risk on their investments, and their interest might be harmed from it — for example, conversion of the business from low risk to a highly risky. The shareholder will enjoy additional surplus over the fixed repayments to creditors. However, the risk of failure also increases. The second form is increasing in borrowing. A company borrows more and more debt, as a result, in case of default, old creditors will share the assets with the new ones, and the expected recovery rate will decrease.
The third form of action is when shareholders for their benefit withdraw company funds from the common pool of assets. It might be the case when shareholder, who has control over the company decision-making, transfer company assets to another firm under control. It increases shareholders wealth but leaves creditors with fewer chances to save investments.

2.3 Strategies to mitigate shareholder-creditor agency problems

In order to mitigate the agency costs that arise in the presence of shareholder-creditor conflict, different jurisdictions provide instruments that can be divided into two groups – governance strategies and regulatory strategies.[17] The first group of measures is intended to constrain the agent behavior by imposing direct rules and norms that intimidate shareholders adverse actions. The most prominent instruments of regulatory strategies are the doctrinal measures of piercing

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[13] R.H. Kraakman, *The Anatomy of Corporate law*, Kindle edition, 2017, p.110
[14] Ibid
[15] Ibid
[16] Ibid
[17] John Armour, Henry Hansmann, Reinier Kraakman, 2009, p.5

a corporate veil, shareholders subordination, capital maintenance, and shadow director doctrine. Measures related to governance strategies restrain shareholders by increasing the control powers of creditors. They include appointment rights, decision rights, and finally, measures that do not empower creditors but instead prevent the harmful incentives by transferring the volume of the rights in restructuring to the courts or insolvency practitioners. Under the Kraakman's strategies framework, priority rules may be attributed to the decision rights strategy.

However, the agency theory framework is a universal instrument and can be useful to determine the problems in any legal sphere where shareholders and creditors interests confront. Thus, existing restructuring procedures might be investigated from the position of governance strategies, more specifically, how power distribution influences the agency problem, how jurisdictions at stake strike that problem and what impact the APR and the RPR may have on that conflict.

3. The Effects of the APR and the RPR on the Shareholder–Creditor Agency Problem

In a situation where a company faces financial difficulties, insolvency regulation tools inevitably affect the balance of interests of the affected parties. The new Directive (EU) 2019/1023 has become such a tool potentially affecting the shareholder-creditor agency problem.[18]

The Directive allows Member States to choose which priority rule will be applied by the national courts when they are confirming the plan under the cross-class cramdown procedure. The first (default) option is the Relative Priority Rule. It means that "dissenting voting classes are treated at least as favorably as any other class of the same rank, if the normal ranking of liquidation priorities under national law were applied, and more favorably than any junior class rule".[19] The second option provided by the Directive is the Absolute Priority Rule. Which translates as "dissenting class is paid in full if a more junior class receives any distribution or keeps any interest under the restructuring plan".[20] One of the most controversial issues was the inclusion of the Relative Priority Rule in the text of the Directive. This rule excited the

18 Directive (EU) 2019/1023 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132

19 §55 of Directive (EU) 2019/1023 recitals

20 Ibid.

academic community of the European Union and found both its opponents and supporters.[21] The Directive invites EU member states to choose from the Absolute or Relative priority rules for inclusion in national legislation. This paper will try to examine both rules from the position of governance strategy and determine the effects they impose on shareholder-creditor agency problem.

3.1 The Absolute priority rule (APR)

In according to the text of the Directive: "In the case of a cross-class cramdown, Member States should ensure that dissenting classes of affected creditors are not unfairly prejudiced under the proposed plan and Member States should provide sufficient protection for such dissenting classes. Member States should be able to protect a dissenting class of affected creditors (…) by ensuring 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')."[22] In order to understand how the rule of absolute priority works, one can imagine a situation in which the debtor, who is in a pre-insolvency state, offers creditors for approval of a restructuring plan. In the event any of the classes of creditors disagree with the restructuring plan, the court will be able to approve the plan against the will of the dissenting class, provided that the plan in addition to other mandatory conditions, ensures payment in full to a senior class of creditors before any payments can be made to junior claims. Thus, the APR comes into play only in the process of plan adoption, and only if one of the classes of creditors rejected the restructuring plan.

The APR establishes the generally accepted procedure for settlements with creditors in insolvency and constitutes the cornerstone of insolvency regulation.[23] The APR establishes a hierarchy of rights in insolvency proceedings, commencing with secured creditors at the top and ending with equity holders.[24] The application of this rule in the restructuring procedure

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21 One of the most prominent supporters of the RPR is R. Mokal - Riz Mokal et al. *Best practices in european restructuring Contractualised Distress Resolution in the Shadow of the Law*, draft 2018, p. 44, [via https://www.ssrn.com] accessed 25 July 2019. The inclusion of the RPR is opposed by de Weijs, Roelf Jakob and Jonkers, Aart Lambertus and Malakotipour, Maryam, *The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)*, (March 11, 2019), [via https://www.ssrn.com], accessed 25 July 2019

22 §55 of EU Directive (EU) 2019/1023 recitals

23 Stephen J. Lubben, *The overstated absolute priority rule*, 2016, p. 603, [via https://www.ssrn.com], accessed 25 July 2019

24 Angela Snell, *The Absolute Priority rule is alive and well for Chapter 11 cases*, 2018, [via https://www.ssrn.com], accessed 25 July 2019

proposed by the Directive essentially means the following. If the creditors did not agree, the court can approve the restructuring plan and therefore force the non-agreeing class of creditors to its execution only if the claims of the higher class of creditors are met in full before the lower-class claims. Such an approach is consistent with the approach to the distribution of the company assets in case of liquidation. However, the APR is not as absolute as it seems at first glance. Under the Directive, Member States are also provided with some flexibility in applying the APR. First of all, Member States are free to decide what concept of "payment in full" would mean in terms of amount and time.[25] Moreover, the EU legislator took the US experience into account by allowing the Member States to derogate from strict priority when it is considered fair that shareholders keep some interest under the plan or junior creditors paid before senior ones. Of course, such derogations put additional pressure on the court, but in terms of creditors protection, it seems optimal. On the one hand, there is a default rule, protecting creditors from the shareholders' power misuse. However, on the other hand, in cases where deviation from the rule will be beneficial for the creditors, court may rearrange the order of priority in order to increase the overall payout.

Position of stakeholders under the APR

As shareholders in restructuring procedure constitute the lowest class of creditors, it puts them in the most unfavorable position, as they lose control over the firm, which represents the general idea that "equity wipes out first". On the one hand, it is the price that shareholders pay for limited liability. On the other hand, it might be the case where poor shareholders decisions caused the financial problems of the company, and there is no point to leave them equity and power over the in-debt firm. Anyway, the APR creates clear rules for creditors which can confidently predict the fate of their claim in a probable situation of a debtor's financial crisis and accordingly adopt more precise and effective business decisions. The APR gives creditors a strong position to shareholders, establishing firm statutory protection.

As it was stated in the first chapter, shareholder-creditor problem arises when there are incentives for shareholders to be engaged in actions that may hurt creditors. The APR successfully restrict such incentives at least in two potential conflict situations, by providing creditors with a substantial advantage in plan voting.

[25] §55 of Directive (EU) 2019/1023 recitals

Expropriating value

First of all, the APR prevents shareholders from unreasonable expropriating value in restructuring. As the most junior class, shareholders will never retain value in the company. If the company presents a plan, where shareholder remain some interest, such plan under the APR generally could not be enforced by the court if any class of creditors votes against it. The APR significantly decreases incentives for saving some part of equity at the expense of the creditors, because under the APR it appears to be pointless.

Excessive risk-bearing

Secondly, the APR mitigates the agency problem by setting the firm rules on assets distribution. The lowest rank in creditors hierarchy might decrease shareholders incentives for excessive risk-bearing. Shareholders know that in case of restructuring, they have minimal chances to keep control over the company. In that sense, the APR does not push forward one of the reasons for shareholder-agency problem, namely corporate shielding. However, In the United States, where the use of restructuring procedures has a long history, the absolute priority rule has gathered much criticism on being stiff while to reach the best results some flexibility is desirable. For example, the legal certainty that this rule is intended to give is often violated in practice by the actions of creditors in the race for priority inventing new tools to deviate from the default ranking.[26] Even courts sometimes disregard this rule.[27] It is possible that these alleged exceptions to the APR are based on sound policies, as they allow parties to speed up the proceedings, maximize property value. Where it is the only way to avoid liquidation and to overcome potential containment problems that arise if a class of creditors can actually veto any compromise which fails to comply with priorities. For example, first day motions allow the debtor to violate the priority rule and put employees in a more privileged position than secured creditors. Of course, such exceptions must be justified and cannot be applied spontaneously.[28]

[26] Mark J. Roe and Frederick Tung, *Breaking bankruptcy priority, How Rent-Seeking Upends the Creditors' Bargain*, Virginia Law Review, 2013, p. 1237, [via https://www.ssrn.com], accessed 25 July 2019

[27] In *Re Iridium Operating LLC*, 478 F.3d 452, 467 (2d Cir. 2007) Court held that "the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects with the priority rule if the parties to the settlement justify, and the reviewing court clearly articulates the reasons for approving, a settlement that deviates from the priority rule".

[28] 11 U.S.C. § 507(a)(4).

There is also a historical argument. The absolute priority rule was formed by the courts in railway reorganization cases - *Northern Pacific Railway v. Boyd, Kan. City Terminal Ry. Co. v. Cent. Union Trust Co. of NY*.[29] In these cases, the courts have taken a softer approach to absolute priority than some seek in a modern understanding of this rule.[30] In these cases, senior creditors got less than they would have if the APR would have been applied in its pure form. Absolute priority was probably achieved by the application of the "fairness and equitable" test to the restructuring plans. Such test easily allowed exceptions to the rules, for example, in the form of "new value." This exception is also contained in the Directive text.

Despite much criticism on the APR from US scholars, this rule was recently confirmed by the US Supreme Court.[31] The court manifestly expressed its position that the APR is still the cornerstone of the practice and theory of reorganization.[32] However, it should not be overlooked that the court has stated that concerning the structured dismissal and more specifically to the priority of the wage claims which is quite a sensitive matter. However, there are still a lot of exceptions possible. The US courts, for example, have approved "first-day" wage orders that allow payment of employees' prepetition wages, "critical vendor" orders.[33] Nevertheless, all those exceptions perfectly align with the exclusions under the Directive. The Directive has the provision that the Member States may derogate from the absolute rule and provide equity holders with the opportunity to preserve particular value in the distressed company if the court considers it fair.[34] The exclusive nature of such exception and court involvement gives no evidence that such exclusion under the APR may give shareholder incentives for excessive risk-bearing.

Shareholder involvement in the procedure

The APR also creates conditions for shareholder inactivity, which might be detrimental to creditors. The rule of absolute priority deprives shareholders of the initiative to file an insolvency petition on time. As Professor Bob Wessels points out in his reply to professor De Weijs et al., one of the Directive's main tasks is to create incentives and tools for early

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29 In Re *Northern Pacific Railway v. Boyd, Kan. City Terminal Ry. Co. v. Cent. Union Trust Co. of NY* 271 US 445, 454 (1926)

30 Walter J. Blum, *The New Directions for Priority Rights in Bankruptcy Reorganizations*, 67 Harvard Law Review, (1954), p. 1367, 1369, [via www.heinonline.org], accessed 25 July 2019

31 *Czyzewski v. Jevic Holding Corp., No. 15-649*

32 Ibid

33 MarkJ. Roe, Frederick Tung, 2013, p. 1254

34 § 56 of Directive (EU) 2019/1023 Recitals

prevention of insolvency.[35] Putting aside the equity and removal of the firm's management hardly creates an initiative for shareholders and managers to apply for restructuring.[36] The text of the Directive stipulates that the restructuring plan should provide for the shareholder to participate in saving the company by making a non-monetary contribution in the form of experience or tips. However, this provision is incompatible with the rationale of absolute priority. There must be some clear benefits for the shareholders to bear additional risks of non-monetary contribution. Also, for small companies, experience, acquaintance, and market knowledge of shareholders and management is often the main asset of a company. Without it, a company is unlikely to survive and, accordingly, restructuring would not make sense at all. The APR disincentivize shareholders from saving the company. The later on company applies for restructuring the lower return rates will be. Thus, creditors will potentially bear the losses, which might have been prevented had shareholders applied for restructuring at the first signs of upcoming financial difficulties.

3.2 The Relative Priority Rule (RPR)

Position of stakeholders under the RPR

The Relative Priority Rule means that «dissenting voting classes are treated at least as favorably as any other class of the same rank, if the normal ranking of liquidation priorities under national law were applied, and more favorably than any junior class».[37] In practice, this means that the court may compel the dissenting class of creditors to the restructuring plan if their claims are treated more favorably than the claims of junior creditors. It appears to be a significant deviation from the existing insolvency procedure.

At the moment of the appearance in 2016, the Draft Directive did not comprise such an option as the RPR. Meanwhile, in 2018, everything has changed dramatically. Now, the provisions on the Relative Priority Rule appeared in Article 11 of the Draft Directive, as well as in paragraph 55 of Recitals. Moreover, it acquired a default status. The Directive gave the following explanations: "The cross-class cramdown mechanism was new to a number of Member States and raised some concerns. Two aspects, in particular, were problematic for a considerable

[35] Bob Wessels, *A reply to professor De Weijs et al*, Bob Wessels Blog, 22 March 2019, [via www.bobwessels.nl], accessed 25 July 2019
[36] Ibid
[37] §55 of Directive (EU) 2019/1023 Recitals

number of Member States: the new for many Member States concept of cross-class cramdown and the APR.[38]

The legislator has granted the Member States, at their request, greater flexibility in the application of the cramdown procedure by introducing the RPR rule; however, this flexibility has its effects on agency problem.

Shareholder involvement in the procedure

The Relative Priority Rule serves as a way to combat hold-out incentives. The hold-out problem arises when a creditor abuses its position and blocks the adoption of a potentially prospective plan, thereby achieving the most favorable conditions for itself. Concerning the shareholder-creditor agency problem, this has the following effects. The negotiating position of the creditor in relation to the shareholder becomes weaker, which creates a fertile ground for the shareholder to preserve part of the value. On the other hand, this makes it more likely that shareholders would participate in the procedure. As mentioned above, in some cases, for SME, such participation might be critical.[39] The RPR might facilitate shareholders involvement in the management of the company during the restructuring, which corresponds to the trend that we can see in the EU Capital Market promotion after the banking crisis of 2007–2009. The Shareholders Rights Directive (2017/828 of 17/05/2017) or Takeover Rights Directive (2004/25/EC of 21/04/2004) are two notable examples. The legislator prioritizes the creation of incentives for shareholders in long-term investments, by protecting their interests and giving them broader rights and at the same time increasing the transparency of business management tools. In my opinion, the inclusion of the RPR in the text of the Directive as a tool to increase the participation of shareholders in the distressed company is consistent with the abovementioned trend established in the EU.[40]

The action of the RPR on creating an initiative for shareholders to participate in saving the company has a positive effect on the agency problem. An earlier appeal to the restructuring procedure increases the chances for the complete satisfaction of creditors' claims.

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[38] The Draft version of Directive (EU) 2019/1023 (October 2018), pp.5-6

[39] Stanghellini, Lorenzo and Mokal, Riz and Paulus, Christoph G. and Tirado, Ignacio, September 20, 2018, p. 44

[40] European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the regions: Action Plan on Building a Capital Markets Union, COM(2015) 468 final, 30 September 2015. This finding was confirmed by the Five-Presidents'-Report on "Completing Europe's Economic and Monetary Union" which listed insolvency laws among the most important issues preventing the integration of capital markets and therefore to be addressed as a priority: European Commission, Completing Europe's Economic and Monetary Union, a report by Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz.

If we take a broader look at the RPR, we can apply the incentive alignment hypothesis (dual-holders hypothesis) to this situation. According to it, the presence of shareholders, which simultaneously hold some debt in the company promotes converging of interests of shareholders and creditors, thereby reducing an agency problem.[41] This hypothesis is close to the RPR rationales.

Meanwhile, the same positive trait introduces several adverse effects aggravating the agency problem and disrupting the balance of interests of the parties.

Expropriating of the value and excessive risk-bearing

Possibility for shareholders to retain their participation in the company's capital at the cost of trade creditors creates initiatives for more risky company behavior and increases debt in the economy.[42] Any senior creditor under the RPR should be treated more favorably than the junior creditor. However, it is not clear what should be considered as "more favorably". As R.J. de Weijs, A.L. Jonkers and M. Malakotipour pointed out in their article, such term invites value decreasing uncertainty.[43] Such uncertainty creates a precondition for agency problems, specifically value expropriating. The "best-interest-of-creditors" test is not always a solution to that problem, because it may lead to undesirable results if the returns from the liquidation of the business are significantly lower than its going concern value under restructuring.[44] In this case, if the restructuring plan adheres to the going concern value, then the Relative Priority Rule does not protect the dissenting creditors and allows shareholders to take away the whole going-concern surplus. The creators of the Directive's text understood this, so they suggested the new "best-interest-of-creditors" test – Member States implement the next-best-alternative scenario.[45] However, it is not clear which scenario should be applied and how the court is going to evaluate whether a particular scenario is a next-best or not.

Restructuring plan introduction

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[41] Wei Jiang, Kai Li, Pei Shao, *When Shareholders Are Creditors: Effects of the Simultaneous Holding of Equity and Debt by Non-commercial Banking Institutions*, The Review of Financial Studies, Volume 23, Issue 10, October 2010, p. 3623, [via https://www.ssrn.com], accessed 25 July 2019

[42] de Weijs, Roelf Jakob, Jonkers, Aart Lambertus and Malakotipour, Maryam, p.2

[43] Ibid, p. 18

[44] Paragraph 52 of the Directive Recitals reads as follows: "Satisfying 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 either in the case of liquidation, whether piecemeal liquidation or sale of the business as a going concern.

[45] §49 of Directive (EU) 2019/1023 Recitals

Another aspect that has a great impact on the shareholder-creditor balance of interests is that restructuring plan in Germany and UK is generally submitted by the debtor or with its consent.[46] So, in small companies where management is in full control of shareholders, it is unlikely that a proposed plan would not promote shareholders interest as far as it is possible. The RPR allows it. It follows the main rationales behind the Directive to engage owners and promote the internal market. Creditor's protection is a residual objective. It is evident from the §§1, 2 of the Directive Recitals.[47] These paragraphs mention seven objectives: continue the business, prevent job losses, loss of know-how, loss of skills, maximize total value for owners and economy as a whole, and creditors. Strictly, only one out of seven of them is about creditors. So, it is clear why the RPR was made default rule under Directive: it better suits the Commission's objectives. However, it provides significantly less protection for creditors.

The rule of relative priority is not *a priori* destructive, but it does invite many disruptions to the shareholder-creditor balance of interests. The RPR confronts the Member States with a difficult choice. It creates an initiative for the shareholder to participate in the procedure, which may increase the return rates and rescue of the company. On the other hand, it attracts many negative consequences. The RPR infringes the control powers of creditors. Thus, shareholder as an agent acquires more initiatives to act in his interest, neglecting the interests of the creditors.

4. Existing Restructuring Procedures in Germany and the UK from the Position of Governance Strategies

Restructuring procedures establish a balance of interests between creditors and shareholders. From the standpoint of fighting agency problems, it is possible to consider how the existing restructuring procedures affect the balance of interests through appointment rights, decision rights, and trusteeship measures.

4.1 Overview of Restructuring in Germany

46 §218(1) InsO, Part 26, Sec 895 (1)-(2) Companies Act 2006, Part 1, §1, Insolvency Act 1986

47 "…Preventive restructuring frameworks should, above all, enable debtors to restructure effectively at an early stage and to avoid insolvency, thus limiting the unnecessary liquidation of viable enterprises. Those frameworks should help to prevent job losses and the loss of know-how and skills, and maximise the total value to creditors — in comparison to what they would receive in the event of the liquidation of the enterprise's assets or in the event of the next-best-alternative scenario in the absence of a plan — as well as to owners and the economy as a whole."

There is no statutory preventive restructuring procedure in Germany, such as the English scheme of arrangement, whose flexibility and generous jurisdictional assumptions made it attractive within the EU. German law allows for the possibility of restructuring out of insolvency only for bondholders, but this procedure has very narrow application and cannot be used to solve the whole range of problems that need to be solved by the parties in restructuring. In Germany, restructuring is considered as one of the insolvency procedures, and not an independent and out of insolvency action. It is an alternative way to resolve an open insolvency case. According to Article 1 of InsO: «The purpose of insolvency proceedings is the collective satisfaction of the creditors through the realisation of the debtors assets and distribution of the proceeds or through agreement on an alternative arrangement in an insolvency plan, particularly in order to maintain the enterprise».[48] As can be seen from the very definition of an insolvency procedure, the legislator sets the main task to maximize the satisfaction of creditors' claims. Thus, other aims such as preserving jobs, preserving the business of the debtor seem to be residual.[49] Nevertheless, according to "Reorganization proceedings index" which is the part of the Doing Business studies 2019 conducted by the World Bank, Germany gets ahead of the UK.[50] The index ranges from 0 to 3 — higher values indicating greater compliance with internationally accepted practices. The index comprises of three components: whether the plan is voted by affected/unaffected creditors, whether creditors divide into classes, whether there is a "best-interest-of-creditors" test in place. Germany was granted 3 points, whereas the UK only 1.[51] It is surprising, taking into account that the UK is considered to be a very popular jurisdiction for insolvency tourism.

4.2 Governance Measures in the Insolvenzplan

The primary tool for restructuring is Insolvenzplan. The plan itself can be prepared by the debtor or an administrator (preliminary administrator).[52] Until 2012, the ability to apply debt-to-equity required the consent of 75 percent of shareholders. Therefore, decisions on such matters were in the exclusive competence of the shareholders. As pointed out by Annika Wolf, this situation led to the fact that, for example, debt-to-equity transformation in Insolvenzplan

48 Art 1 InsO
49 Christian Bärenz and Anne Bach, *The Restructuring Review*, 2017, p. 150
50 Doing Business Research by The World Bank, [via https://www.doingbusiness.org], accessed 25 July 2019
51 Ibid.
52 Art 217 InsO

was unlikely to occur.[53] After the reform of 2012, it became possible to include shareholders in Insolvenzplan and consequently to overcome their disagreement on capital restructuring with the help of cross-class cramdown.[54] The plan is aimed at the fullest satisfaction of the claims of creditors; this can be achieved both by measures to save debtor and by measures to sell it and distribute the proceeds among the creditors.

Appointment rights

Together with the initiation of restructuring proceedings, the court appoints a special administrator, who supervises the debtor.[55] Moreover, even in the case of self-administration, the court still appoints a special trustee to the debtor, who controls company transactions and funds.[56] In contrast to the UK, in order to maintain control over the business (debtor-in-possession procedure), the debtor must obtain the consent of the creditors, which in practice might be rather tricky. However, unlike the UK, in a preliminary insolvency procedure, creditors can form a committee that approves legal acts of particular importance[57] and can submit to the court the candidacy of an insolvency practitioner.[58] The court should consider the proposed candidate and has the right to refuse its approval only by submitting a motivated decision. The selection of an insolvency practitioner is one of the most important features in insolvency proceedings. Before the reform of 2012, no one could appoint a practitioner other than the court. «Previously, creditors had to view the proceedings much like the weather: they had to take things as they come.»[59] Another important characteristic, which takes German restructuring closer to liquidation proceedings is that shareholders lose their formal control over the management of the company.[60]

Decision rights

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53 Annika Wolf, *Promoting an Effective Rescue Culture with Debt-Equity-Swaps*, 2015, p. 123
54 Art 225 (3) InsO. Any provision that is admissible under company law may be made in the plan
55 Art 56 InsO
56 Art 275 (1) InsO
57 Art 160 InsO
58 Art 22(a) InsO
59 Gerret Höher, *ESUG: German for "Modernising Bankruptcy Law*" 2012, Eurofenix 2012, p.18 [via https://www.insol-europe.org], accessed 25 July 2019
60 Art 276 (a) InsO

The application for insolvency can be filed by a debtor (a person related to a debtor[61]) or a creditor.[62] The possibility and/or obligation to file for insolvency is subject to the following conditions: illiquidity, overindebtedness, and imminent illiquidity. The application goes to the court without reference to a specific procedure. In the framework of the preliminary proceedings, the court determines whether the debtor has enough assets and whether there are grounds for insolvency. This procedure is widespread. For example, in Russia, the courts adhere to the same pattern.[63] However, it is often criticized as ineffective.[64] It delays the insolvency procedure and thus makes it less likely that creditors' claims will be satisfied.

The restructuring plan might be submitted by the debtor or insolvency administrator[65] and consists of several parts. As stated in Art 219 InsO: "The insolvency plan consists of the descriptive part (Darstellender Teil) and the constructive part (Gestaltender Teil). The attachments should accompany it.[66]" The declaration part of the plan is intended to reflect financial information of the debtor and set of measures to achieve the goal of the plan (liquidation, reorganization). The constructive part must reflect the effects that the plan will have on the parties.

The court schedules a meeting for the parties affected by the plan. During the meeting the parties must discuss the reorganisation plan and, if possible, vote for it. [67]

The restructuring plan divides creditors into classes. After the 2012 reform, holders of interest should be defined in a separate class.[68]

The plan is recognized as approved when more than half of the creditors in each group voted for it and to whom more than half of the claims belong (the rule of double majority)[69]. The plan should contain a description of the conditions under which similar insolvency-related economic

[61] Art 15 InsO
[62] Art 16 InsO
[63] Ilya Kokorin, *Bankruptcy In Russia: Basic Framework, Recent Trends And Tips For Foreign Creditors,* 2017 [via http://www.mondaq.com] accessed 25 July 2019
[64] Ksanaev A.B., *The evaluation of effectiveness of supervision procedure in insolvency (Оценка эффективности ведения процедуры наблюдения в банкротстве)* Network science journal, 2018, [via https://cyberleninka.ru], accessed 25 July 2019
[65] Art 218 (1) InsO
[66] Art 219 InsO
[67] Art 235 InsO
[68] Art 222 InsO
[69] Art 244 InsO

interests have formed a particular group. In the absence of such explanations, the court, according to section 231 (1) InsO, will reject the plan.[70]

In case the plan did not receive the sufficient number of votes German law establishes the so-called prohibition of obstruction (Obstruktionsverbot) rule.[71] The court has the right to approve the plan contrary to the dissenting class of creditors, subject to several safeguards. The first safeguard is the no-worse off test. The dissenting class should not be put in a position worse than if the debtor was liquidated under ordinary insolvency procedure. Secondly, the majority of the classes support the plan. Thirdly, members of this class are involved to a reasonable extent in economic value on the basis of the plan. It means that none of the creditors will receive a payoff exceeding initial claim, and none of the lower creditors, shareholders will receive anything in violation of hierarchy of creditors classes (similar to the US APR).[72] Finally, none of the creditors of the same level will receive more than it would have received without a plan. Concerning the dissenting class of shareholders, the law contains only two requirements; no creditor receives economic value exceeding the full amount of its claim, none of the shareholders of the same level receive more than it would have received without a plan. It is important to note here that in order to apply cramdown, all conditions of 245 (1) must be fulfilled at the same time, which has been confirmed by jurisprudence.[73]

As can be seen, the existing German restructuring procedure adheres to the rule of absolute priority. It is not surprising, since the current insolvency law, which introduced the absolute priority rule, was based on the provisions of US Chapter 11.[74] Prior to that moment there was no reorganization procedure as such in Germany[75] and all the power in the procedure belonged to the insolvency practitioner.[76] It is worth noting that Chapter 11 of the United States in 1999 served not only as an inspiration for the German legislator but as a reference.[77] German courts, when applying and interpreting an absolute priority rule, did refer to the practice of the US Supreme Court as set forth[78], for example, by LG Traunstein, в Resolution of 27.08.1999, AZ

[70] Decision of the *AG Cologne from 06.04.2016, Az .: 74 IN 45/15*
[71] Art 245 (1) InsO
[72] Title 11 U.S.C. 1129(b)(1)
[73] *District Court Cologne*, 73 IN 173/15, 14/11/2017
[74] *LG Traunstein*, Resolution of 27.08.1999, AZ 4 T 2966/99
[75] Presentation of the EU Commission's Proposal for a Directive on a Preventive Restructuring Procedure By Dr. Utz Brömmekamp (Darstellung des Richtlinienvorschlages der EU-Kommission zu einem präventiven Restrukturierungsverfahren Von Dr. Utz Brömmekamp), 2017, [via www.buchalik-broemmekamp.de], accessed 25 July 2019
[76] One year later: Germany’s corporate insolvency law reform turns out success story, Financier Worldwide Magazine, 2013, [via www.financierworldwide.com], accessed 25 July 2019
[77] *LG Traunstein* (n48)
[78] Ibid.

4 T 2966/99: "…In the absence of decisions by German courts and in view of the comparability of the norms, which the legislator points out in its legislative documents, the core statements of this decision [The US Supreme Court issued a resolution on 03.05.1999 in its Bank of America National Trust and Savings Association decision against 203 North LaSalle Street Partnership (cf. ZInsO 99, 373)] can also apply to German law."[79] Interestingly, despite the significant influence of American law, in 1999 the German legislator gave shareholders an advantage without depriving them of their exclusive right to resolve the fate of the company's capital during restructuring (corporate neutrality).[80] Meanwhile, after the reform of 2012, shareholders have eventually lost that privilege for the benefit of the creditors.

Trusteeship measures

Creditors interests in the Insolvenzplan procedure enjoy a significant level of protection from shareholders' abusive actions. The procedure itself is an insolvency procedure and is carried out under judicial control. Judicial intervention mitigates friction between shareholders and creditors as the court oversees the restructuring. Besides, Insolvenzplan is only available in the presence of financial difficulties listed in the InsO which reduces the incentives of the controlling shareholder to reduce the debt burden on the business to the detriment of creditors by excessive use of the procedure. The other trusteeship feature is that company management appointment is only valid with the supervisor's permission.[81] Thus, supervisor intervention significantly limits the shareholder's control over company decision-making even in the case of debtor-in-possession.

Conclusion

The strength of the shareholder-creditor agency problem depends to a large extent on the degree of shareholders control over the decision-making in the company.[82] Germany fights agency problem in restructuring by giving the creditors extensive powers to control the procedure and

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[79] Mangels Entscheidungen deutscher Gerichte und vor dem Hintergrund der Vergleichbarkeit der Normen, auf die auch der Gesetzgeber in seinen Gesetzesmaterialien hinweist, können die Kernaussagen dieser Entscheidung [The US Supreme Court issued a resolution on 03.05.1999 in its Bank of America National Trust and Savings Association decision against 203 North LaSalle Street Partnership (cf. ZInsO 99, 373)] auch für das deutsche Recht Geltung haben."

[80] Alexander Frauer *Limits of interference with shareholder rights in insolvency plan proceedings*, p. 67, [via www.peterlang.com], accessed 25 July 2019

[81] Art 276 (a) InsO

[82] R.H. Kraakman, p.112

activities of the debtor. It also deploys quite excessive use of trusteeship strategy by transferring control over the debtor to the court or insolvency practitioner and dismissing shareholders influence.[83] Empowering creditors with considerable power is a continuation of the policy set out in Article 1 of InsO. Creditors have substantial leverage over the procedure and actual control over the debtor. This level of control and creditors involvement in the company's governance in restructuring significantly reduces shareholders' initiatives for opportunistic behavior. However, at the same time, it reduces the initiative of shareholders to apply for a debt restructuring on time.

4.3 Overview of Restructuring in the United Kingdom

English law offers a vast choice of reorganization procedures: Company Voluntary Arrangement (CVA), Scheme of Arrangement (SOA), and administration.[84] Administration involves the most significant judicial control, and it is essentially an insolvency procedure. The other two are pre-insolvency proceedings. In the scheme of arrangement, the influence of the court consists of two meetings - one on the procedure introduction, the other on the adopted plan sanctioning. CVA does not involve the participation of the court. The court intervenes in the procedure only if any of the creditors consider the plan unfair and challenge it. CVA is the most common existing debtor-in-possession option currently used by companies looking to restructuring. In 2014 there were 563 CVAs, of which 388 failed, equating to a failure rate of 60%.[85] In the first quarter of 2019, there were 93 CVAs, which is 43.1% higher than in Q4 2018.[86] The administration is often used in conjunction with CVA or SOA, combining the advantages of these procedures. On the one hand, this allows creditors and stakeholders to negotiate on restructuring options. On the other hand, it gives the statutory possibility to introduce a moratorium, which is not available in the Scheme of Arrangement and is very limited in the CVA.

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83 Art 276(a) InsO

84 Part 26, Companies Act 2006, Part 1, Part 2 of Insolvency Act 1986

85 A review of the corporate insolvency framework A consultation on options for reform, The insolvency service, 2016 < https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/525523/A_Review_of_the_Corporate_Insolvency_Framework.pdf >, accessed 25 July 2019

86 Company insolvency statistics, Q1 January to March 2019, The insolvency service UK, 30 April 2019, [via https://assets.publishing.service.gov.uk], accessed 25 July 2019

English law generally does not yet implement the institution of cross-class cramdown.[87] Therefore, all classes of creditors should vote for the plan to approve it. This paper draws upon the Scheme of Arrangement and CVA as the main restructuring tools in the UK.

4.4 Governance Measures in the Company Voluntary Arrangement

CVA is a procedure for the arrangement of unsecured creditors and the company on debt restructuring and the preservation of the company under sec 1 - 7 of Insolvency Act 1986.[88] As mentioned above, the approval of the court is not required for performing CVA. Also, no signs of insolvency or the likelihood of insolvency are required.

Appointment rights

As a general rule, directors of the company should propose the restructuring arrangement. Also, the directors have the right to choose the person who will control the execution of the arrangement and will control all procedural issues regarding the organization of the CVA procedure (nominee). If the company is in administration, then the liquidator or administrator exercise such rights.[89]

Decision rights

CVA voting requires "... three-quarters or more (in value) of those responding [creditors] vote in favor of it."[90] Secured creditors do not participate in the voting. In contrast to the scheme, there is no rule on double majority to accept the arrangement. Also, after creditors approval, a simple majority of the 'company's shareholders should vote for CVA. However, this rule does not endow shareholders with a meaningful bargaining position. If the shareholders do not approve the CVA, it will still be accepted. Meanwhile, the advantage of this procedure for shareholders is that despite their limited voting rights, creditors cannot decide on equity without the separate approval of the respective majority of shareholders, which preserve a corporate shielding.

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87 However, pre-pack administration in conjunction with SOA gives such opportunity in so-called "transfer scheme".
88 Part 1, §1 (1) Insolvency Act 1986
89 Part 1, §1, Insolvency Act 1986
90 Part 15, §8, rule 15.34 Insolvency (England and Wales) Rules 2016

The proposal approved by creditors does not need court sanction. However, dissenting creditors and shareholders may file a claim if they consider approved arrangement as violating their rights (unfairly prejudices the rights of creditors) or the vote was held in violation of the procedure (material irregularity).[91]

The practice of using CVA in the UK shows that this procedure is especially popular among street vendors as a tool to reduce rent burden. CVA does not provide a tool that would force the majority to take into account the interests of creditors with small claims. It might be quite a problem for certain types of unsecured creditors. It constitutes a big concern, especially for landlords due to the evaluation of the future rent payments in CVA. The future payments evaluation for voting is up to the chair: « …in relation to a proposed CVA or IVA, a debt of an unliquidated or unascertained amount is to be valued at £1 for voting unless the convener or chair or an appointed person decides to put a higher value on it».[92] This circumstance has a potential effect on shareholder-creditor agency problem. If the interests of shareholders coincide with the interests of major creditors, it gives way to abusive behavior towards creditors with future payment claims, like, for example, landlords. Landlords due to the type of their claims, do not enjoy significant power in CVA and can be quickly overruled by the majority of the creditors. Since CVA is available without any signs of insolvency, the debtor might apply for it even if the company is solvent. With the help of the major creditors, CVA turns into rent fees reduction and landlords abuse instrument rather than business rehabilitation. The recent example of such opportunistic usage of CVA is *Arcadia Group Ltd. Restructuring.*[93]

Trusteeship measures

CVA is an out of court procedure. Thus, the court involves only in case of plan challenging. Moreover, CVA does not require company's management to resign. To balance such relaxation on the side of the debtor, CVA involves a supervisor appointment (nominee).

Until the CVA is submitted to the creditors for voting, nominee should approve the arrangement. Nominee reflects approval in a special report and sends it to the court.[94] The company must provide a nominee with all the necessary information to conclude a CVA. If

[91] Part 1, § 6, Insolvency Act 1986
[92] Part 14, §8, rule 15.31 (2)(3) The Insolvency (England and Wales) Rules 2016
[93] Ashley Armstrong, Tim Wallace, *Follow CVA tactic has led to closure of 1,000 shops*, The Telegraph, 17.06.2019, [via https://www.telegraph.co.uk], accessed 25 July 2019
[94] Part 2, §3, rule 2.9 Insolvency (England and Wales) Rules 2016

this information is not enough, the nominee has the right to apply to the court for its recovery. Nevertheless, nominee powers are limited. The authority of the nominee is restricted to evaluating the plan and gathering a limited volume of information. It prevents creditors from obtaining comprehensive information about the debtor's activities. Moreover, a trustee is unable to file a claim against the directors or shareholders in case fraudulent transactions were disclosed.

Conclusion

Even though shareholders have voting rights even if the equity is not affected under the plan, their vote can barely influence the arrangement adoption. Moreover, thanks to the lack of cross-class cramdown, shareholders do not have an opportunity to enforce the proposed plan against the majority of the creditors.
However, shareholder still has a significant level of control over the company in CVA. Management stays in place. Equity cannot be rearranged without shareholders' approval. The lack of court supervision over the procedure is compensated with nominee appointment. Nevertheless, nominee powers are minimal and do not constitute a real limitation on the corporate powers of the shareholders. CVA leaves company and shareholders in a referenced position, giving opportunities to use it in an abusive way.

4.5 Governance Measures in the Scheme of Arrangement

There is much in common between the CVA and scheme of arrangement. Both procedures pursue restoring of the debtor's solvency. Both imply the preparation of a specific document - a plan providing a set of measures on the debtor. The debtor retains control over the business, the approximate duration of the procedure is also the same. Meanwhile, there are significant differences.
First, the scheme of arrangement applies to secured and preferred creditors, which makes it more universal. Secondly, voting on the scheme of arrangement is held in classes. It makes the adoption of the plan more demanding. In case of disagreement of shareholders as a class, the court will not sanction the plan. Thirdly, the more liberal jurisdictional requirements cause significant popularity of the scheme abroad.[95] It attracts companies from all over Europe.

[95] Part 26, Sec 895 (2) Companies Act 2006

Fourth, the scheme involves the participation of the court, which of course spells out the procedure, but gives creditors some kind of guarantee that the procedure will be followed. Fifth, the fact that the scheme regulation is a part of the Companies Act 2006 makes its perception probably less terrifying.[96]

Appointment rights

Scheme of arrangement is a procedure of agreement between a company, its creditors, and its members. Unlike other procedures, the scheme of arrangement is not governed by the law and insolvency rules, but by Companies Act 2006. Perhaps this fact alone makes this procedure more attractive for the debtor or creditors as it distances this procedure from the terrifying word "insolvency". Similar to the CVA, this procedure can be claimed in the absence of insolvency signs.

According to statutory provisions, SOA is "a compromise".[97] As stated in the decision of the *NFU Development Trust Ltd* case: "Section 206(2) of the Act is dealing with what is described as a "compromise or arrangement between a company and its creditors or a company and its members."[98] The word "compromise" implies some element of accommodation on each side. It is not apt to describe total surrender. A claimant who abandons his claim is not compromising it.

Similarly, I argue that the word "arrangement" in this section implies some element of give and take. Confiscation is not my idea of an arrangement. A member whose rights are expropriated without any compensating advantage is not, in my view, having his rights rearranged in any legitimate sense of that expression. This position is promising for shareholders as the court held that, total unreasonable deprivation of the equity is not fair.[99]

The scheme can be proposed by the directors of the company, liquidator or administrator, or creditors and shareholders.[100] Although this procedure entitles creditors to such opportunity,

96 Bob Wessels, *Scheme of arrangement: a viable European rescue strategy?*, 2010, Bob Wessels blog [via https://bobwessels.nl] accessed 25 July 2019

97 Part 26, Sec 895 (1) Companies Act 2006

98 In *Re NFU Development Trust Ltd* [1972] 1 WLR 1548 p 1555C–F

99 In *Re Alabama, New Orleans, Texas and Pacific Junction Railway Co*. [1891] 1 Ch. 213:"… Now, I have no doubt at all that it would be improper for the court to allow an arrangement to be forced on any class of creditors, if the arrangement cannot reasonably be supposed by sensible business people to be for the benefit of that class as such, otherwise the sanction of the court would be a sanction to what would be a scheme of confiscation…"

100 Part 26, Sec 896 (2) Companies Act 2006

the debtor has a right of veto. It is not enshrined in the law but derives from the definition of this procedure as a “compromise” and is evidenced by jurisprudence.[101]

Decision rights

The scheme, unlike CVA, is binding on secured creditors. The plan should define the circle of persons affected by the scheme. In contrast to CVA, a scheme of arrangement divides creditors into classes, in case their rights differ significantly or according to the scheme they receive different rights. To approve the plan, it is necessary that the majority of the number of creditors in each class whose claims amount to more than 75 percent voted for the scheme.[102] Shareholders also vote if the scheme involves operations with equity. The court can only sanction the scheme in the event the majority of shareholders approve it. The court does not have the statutory power to apply a cross-class cramdown and sanction the scheme if any of the classes voted against its approval. Voting in classes along with a high voting threshold is a severe prerequisite to negotiations between creditors and shareholders. That brings this procedure closer to the RPR rationales, as it gives flexibility and thus final result depends to more extent on negotiations of the parties.

Incentive measures

The debtor retains control over the firm in SOA. However, the court is involved in this procedure more than in the CVA. Two hearings must be held. During the first hearing, creditors may express objections to the composition of the classes, or the methods of holding the meetings.[103] Meanwhile, at the first meeting, the court will not hear objections regarding the fairness and soundness of the plan. For these purposes, there is a second hearing at which the court considers the plan prior approved by the creditors.[104]
There is no trustee in scheme proceedings. Therefore, such control seems to be reasonable. When considering a plan, the court may, on its initiative, inspect it, without objection by the parties if it deems it necessary. In evaluating the scheme, the court will verify the integrity and validity of the scheme by adhering to the test outlined in *Re TDG plc [2009]*:

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101 In *Re Savoy Hotel Ltd.* [1981] Ch 351
102 Part 26, Sec 899 (1) Companies Act 2006
103 Part 26, Sec 896 Companies Act 2006
104 Part 26, Sec 899 Companies Act 2006

• The scheme complies with statute provisions

• Those who attended the meeting fairly represented a class of creditors or shareholders, and the statutory majority is acting *bona fide* and not coercing the minority in order to promote interests adverse to those of the class they purport to represent

• An intelligent and honest person, a member of the class concerned and acting in respect of his interest, might reasonably approve the scheme

• There must be no blot on the scheme[105]

The test seems to be quite extensive. Nevertheless, courts are quite reluctant to exercise such right and go against the majority correctly voted for the scheme, until something is seriously wrong.[106]

Conclusion

The UK strikes a shareholder-creditor balance in SOA with the help of the following measures. On the one hand, shareholders involvement in voting gives them a strong bargaining position. Creditors cannot easily impose the loss on shareholders. It may favorably affect the initiative for timely and fair restructuring application. The image of the scheme as a compromise plays in favor of shareholders - the most junior class of creditors.

On the other hand, 75% voting threshold decreases the shareholder's incentives to present a creditor-unfriendly scheme (or intimidate one particular class of creditors) as that class could easily reject it. Moreover, judicial control set in *Re TDG plc* also prevents power abuse and dishonest behavior of shareholders.[107] The lack of cross-class cramdown in English restructuring procedures puts it closer to the pre-insolvency (voluntary) rationales since the disagreement of the class of creditors or shareholders cannot be overruled by the court. It protects creditors from the shareholders' obstructive behavior, but also advocate shareholders

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[105] In *Re TDG plc* [2009] 1 BCLC 445

[106] In *Re Telewest Communications plc (No 1) [*2004] BCC 342, *Re APP China Group, Ltd.* [2003] no. 381, "The court's role, then, on the hearing of a sanction petition (and indeed, in directing the summoning of the scheme meeting), is more akin to that of a football referee, than to a football player. It is not for a referee in a match where a goal is validly scored to disallow the goal because, if he had been the goalkeeper, he would have prevented a goal from being scored, or, because he supports the team against which the goal was scored. Equally, it is not for the court to decline to sanction a scheme because it would have found it unpalatable as a scheme creditor and would have voted against it. If the statutory requirements have been met, and the guiding principles set out in the case law have been adhered to, it is not open to the court to decline to sanction the scheme on what may be called 'merits' grounds."

[107] In *Re TDG plc* [2009] (n79)

interests. Perhaps, this feature, together with relaxed jurisdictional requirements, might be the reason for the insolvency tourism in UK, in particular, by companies from Germany.

Upcoming UK restructuring reform

As it was mentioned above, Member States have two years to implement the Directive. However, UK will probably be leaving the EU by that time and have no legal obligation to do so. Nevertheless, since 2016, the UK government has been discussing a reform to introduce the cross-class cramdown. Therefore, the choice of priority rule is relevant for the UK even in the case of exit from the EU.

In response to numerous comments on the imperfection of the existing business rescue procedures, the UK government proposed a new restructuring procedure[108] which allows cross-class cramdown.[109] Despite the criticism on absolute priority rule expressed by UNCITRAL and The European Law Institute[110], the UK government prefer the APR: "…Where a cross-class cramdown is to be applied, a requirement is needed to safeguard creditor interests that respect and applies the ordinary order of priority in liquidation and administration…"[111] It seems that this reform was inspired by the early draft of the EU Directive that originally proposed only the APR. The state's proposal gives grounds to believe which option the UK is inclined to adopt. However, it gives no evidence which rule better fits existing measures striking shareholder-creditor balance of interests.

Nevertheless, the UK is currently in the final stages of the Brexit negotiations. It is thus not clear when (if at all) this proposal will be debated in Parliament.

5. Comparing priority rules with existing governance measures in restructuring procedures

Existing governance measures in restructuring procedures in Germany and the UK influence the agency problem in different ways and thus establish a different balance of shareholder-creditor interests. The same happens with the APR and the RPR, which have various impact on agency problem. However, the ultimate objective of both measures is the same, that is to

108 Insolvency and corporate governance, UK Government response, 26.08.2018
109 Ibid, par. 5.123
110 Ibid, par.5.160
111 Ibid, par 5.163

preserve the value of the debtor and minimize potential conflicts between a shareholder and a creditor. The APR and the RPR both aim to achieve the same goals but in different ways. The APR is more consistent with the procedures that follow pro-insolvency approach. Meanwhile, the RPR promotes pre-insolvency (voluntary) rationales. In accordance with the chosen approach (pro-insolvency or non-insolvency), the balance of interests is also changing.

5.1 The UK

From the position of governance strategies in the restructuring procedures in the UK, creditors enjoy less level of control over shareholders behavior` than in Germany. The UK resorts to trusteeship measures significantly less then Germany does. The court involvement in procedures is lower in UK than it is in Germany. In terms of decision rights, CVA does not provide protection to creditors other than the size of their claims and possibility to challenge the plan. The SOA is perceived by the courts as a compromise between the parties. This to some extent equates the negotiating positions of shareholders and creditors. English law provides shareholders with significant control on the distribution of equity in restructuring. In the UK practically, it is impossible to distribute equity without the approval of the necessary majority of shareholders. Appointment right enhance shareholders position - plans in both procedures are presented by the debtor or with its consent (unless the debtor shows the signs of insolvency). It is unlikely that company directors, who are often dependent on shareholders[112], will present a plan without taking into account or contrary to the interests of shareholders.[113] Besides, as noted by N. Tollenaar, even in the event of a cross-class cramdown, it will not significantly affect the possibility of the removal of shareholders from the capital against their will if the debtor will still have the right to initiate the procedure.[114]

Taking into account the upcoming reform, [115] one may argue, that the lack of cross-class cramdown constitutes the strong defense against the shareholders abusive behavior because

112 These shareholder-director relations might be different in big firms. According to Reinier Kraakman (The Anatomy of Corporate Law, 2017, p.112) the management of large companies or widely held companies is less dependent on shareholders. Managers of such companies are more interested in maintaining their reputation than shareholders risks. D.G. Baird supports this position: “But in modern reorganizations, shareholders hold little power. In the vast majority of cases, they are going to be wiped out. As soon as a firm is in financial distress, the managers pay more attention to the creditors who will control the firm going forward” D.G. Baird, Priority matters: absolute priority, relative priority, and the costs of bankruptcy, University of Pennsylvania Law Review, 2017, p.801, [via https://www.ssrn.com], accessed 25 July 2019

113 Nicolaes Tollenaar, 2017, p. 79

114 Nicolaes Tollenaar, Pre-Insolvency Proceedings: A Normative Foundation and Framework, 2019, par. 7.97

115 Insolvency and corporate governance, UK Government response, 26.08.2018, par. 5.163

shareholders don't have an opportunity to cramdown an unfavorable plan. Therefore, in terms of agency problem and creditor protection, the APR would be the preferable choice as being the closest to the current measures in place.

However, the lack of cross-class cramdown might also bring the UK restructuring closer to the democratic and thus non-insolvency paradigm.[116] As the current restructuring procedures are available for the solvent firms, introducing the APR, which generally follows insolvency logic, would be unreasonable. As long as the company does not meet the criteria of insolvency, the use of bankrupt logic will lead to a breach of the set shareholder-creditor balance of interests.

English law is known as merchant law. In contrast to German, English law is not so paternalistic and gives more freedom to business. The existing restructuring measures handle the agency problem by less invasive methods then Germany does. The UK is less inclined to exercise strict protection frameworks. It provides the tools facilitating independent negotiation with the focus on the individual rights rather than public interest, so the parties reach the compromise on protection of their interest.[117] The high voting thresholds contribute to it. Of course, such measures on the on the hand expose creditor to higher level of risks. Although on the other hand it mitigates the agency problem ex ante, before the restructuring even takes place. According to the well-known rule, timely recourse to insolvency instruments increases the chances of saving the company and improves the return rates. Current UK regulation gives shareholders incentives for timely restructuring application. The RPR promotes the same idea, that is why it is very well aligned with existing approach in the UK.
From the agency problem position, the RPR seems to be more consistent with the way the legislator and the courts in the UK handle the agency problem now.

5.2 Germany

From the position of governance strategies, creditors in the restructuring procedures in Germany enjoy more powers over the shareholders than in the UK. It is not a surprise because restructuring could be applied only if there are signs of insolvency. Thus, the shareholder-creditor balance is adjusted accordingly.

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[116] Nicolaes Tollenaar, 2019, par. 4.04
[117] Siems, Mathias, *Comparative Law (Law in Context),* Cambridge University Press. Kindle Edition, p. 75

In its recent statement, filed to the Permanent Representatives Committee on 21 May 2019, Germany expressed its position on the new Directive.[118] It states that its current version does not provide adequate safeguards against abuse and economically inefficient restructuring attempts. As a result, the proposed Directive does not offer the required minimum level of creditor protection. However, it is interesting that Germany considers lacking safeguards as a factor that may decrease the rates of return in insolvency. This statement makes evident that even when Germany expresses its concerns about restructuring, it is still focused on substantial insolvency proceedings. Therefore, it can be said that Germany holds on to the pro-insolvency paradigm. Meanwhile, the RPR creates the preconditions for negotiations between the parties, it equalizes the rights of the negotiators. Such equalization is given by the price of reduction of creditors protection from destructive behavior of shareholders. If Germany declares the protection of creditors as its priority, the APR seems to be the most appropriate model.

Moreover, as jurisprudence shows, German courts confirm the compatibility of the German and American approach to cramdown. In this regard, the recent decision of the US Supreme Court in the case of *Czyzewski v. Jevic Holding Corp*, which confirmed the Absolute Priority Rule in the US, makes it even less likely that Germany will opt out for the Relative Priority Rule. Thus, Germany has an established harmonious approach to fight the agency problem in restructuring. This approach follows substantial insolvency rationale – presumption that managers and shareholders failed and bring the company to the crisis. If so, there is no reason to leave the company in their hands. Decision rights measures such as creditor committee and the prohibition of obstruction significantly limit the powers of shareholders. Germany is also actively using the trusteeship methods for the benefit of the creditors. In the case of self-administration, the court appoints a trustee to supervise the debtor. And that trustee has significantly more powers then his or her UK colleague.

Germany handles the conflicts of interests by taking away the powers of the shareholders and transfer it to the creditors. Decision, appointment and trusteeship strategies in Germany are all aimed to fight agency problem by suppressing shareholders rights in restructuring. Such power distribution between shareholders and creditors is also evident from the other doctrinal

[118] Council of the European Union, Interinstitutional File: 2016/0359 (COD), 9170/2/19 REV 2 ADD 1, 21 May 2019

(standards) strategies[119] like shareholders loans subordination[120] or piercing the corporate veil doctrine.[121] For example, shareholder loans in Germany are the subject to strict, almost automatic subordination[122]. The existing exception does not give grounds to believe that the German legislator perceives the creation of initiatives for shareholders for an early appeal to the court as a solution to the agency problem. If it is so, the RPR will contradict the current German regime. If Germany were to adopt the rule, it would not work as intended, because the abovementioned measures and doctrines would nullify the incentive effect of the RPR.

German law is known for its professorial and conceptual style.[123] It has been shaped more by scientific writings and doctrines than by judicial practice. The same can be said about the existing measures in restructuring. They can be characterized as very clear and precise. In its turn, the uncertainty that the RPR invites by offering the "more favorably" test does not correspond to the existing framework in terms of consistency and accuracy and thus may impose a disruptive effect in the agency problem regulation.

Nevertheless, such an unfavorable treatment of shareholders does not mean that Germany is not following the objectives of promoting business activities. In fact, there are some evidences that Germany is making steps towards making business more accessible and attractive for entrepreneurs.[124] However, in this endeavor, Germany base itself upon the pillar of creditor protection.

6. Conclusion

119 R.H. Kraakman, p.127

120 Shareholders loans are almost automatically subordinated in Germany, meanwhile this instrument doesn't apply in the UK. See for an overview Ulrich Huber, Mathias Habersack "Special rules for shareholder loans: Which consequences would arise for shareholder loans id the system of legal capital should be abolished?", Legal Capital in Europe, 2011, p.308 - 317

121 German provisions on parent liability in groups of companies (Konzernerecht) are the most elaborate and characterized as protective of subsidiary's creditors. See R.H. Kraakman, p.134

122 Art 39 of InsO

123 Siems, Mathias, p. 75

124 Law for the Modernisation of the German Liability Company Law and the Prevention of Misuse (MoMiG; Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen) introduced in 2008 a new legal structure (UG) with relaxation on minimal capital requirements. Also, German Supreme Court abandoned the practice of "piercing the corporate veil" in relation to cases of "destructive intervention" in its Trihotel (II ZR. 3/04) decision.

The rules proposed by the Directive are intended to protect the dissenting class of creditors in the case of cross-class cramdown. The agency theory would consider these rules as measures that influence the shareholder-creditor agency problem. Both rules can either aggravate the agency problem or mitigate it. Which rule to implement can be influenced by its consistency with existing measures in restructuring procedures balancing the shareholder-creditor interests.

In this thesis, it was argued that the Relative Priority Rule follows the non-insolvency paradigm. As a strategy tool in shareholder-creditor agency relationships, it is more an incentive measure, than a decision instrument. The RPR creates an initiative for shareholders to participate in saving the company. An earlier resort to the restructuring procedure increases the chances for the complete satisfaction of creditors' claims. Thus, the more money the company retains for the creditors, the higher the chances of overcoming the crisis and the less likely conflict will arise.
Meanwhile, the same positive trait invites incentives to expropriate the value or conduct excessively risky business at the expense of the creditors. To some extent, RPR promotes equality of the parties, leaving more room for negotiation and flexible solutions. Such an approach aligns well with the current measures deployed by the UK in restructuring procedures. The English approach towards balancing the interests between shareholders and creditors might be encapsulated by the dictum of Lord Halsbury L.C. in *Salomon v A & Salomon Co Ltd*: "a creditor who will not take the trouble to use the means which the statute provides for enabling him to protect himself must bear the consequences of his own negligence."[125] English law does not perceive creditors as victims of a debtor's financial crisis, but rather as an equivalent party that shares the risk of company insolvency alongside the shareholder. The Relative Priority Rule grants flexibility, which better fits the English approach towards striking the balance of shareholder-creditor interests.

The Absolute Priority Rule is a strict and precise rule. It represents the cornerstone of insolvency. It fights the agency problem with the pure insolvency method and deprives shareholders of any opportunity to retain any control in the plan adoption. The APR rationales are well aligned with the way Germany strikes the agency problem in restructuring framework. In Insolvenzplan proceedings, creditors acquire significant control over the debtor. Germany is much more concerned on expropriation of value by shareholders than the UK does. It relies

[125] *Salomon v A Salomon & Co Ltd* [1897] AC 22

on a decision, appointment rights strategies, and trusteeship measures to suppress shareholders' power and prevent any possibility of them getting away with abusive behavior. The APR, like the existing measures in German system, do not create incentives for one to apply for restructuring in a timely fashion. Empowering creditors with considerable power is a continuation of the policy set out in Article 1 of InsO. Creditors have substantial leverage over the procedure and actual control over the debtor. This level of control and creditor involvement in the company's governance in restructuring significantly reduces shareholders' initiatives for opportunistic behavior. According to the choice Germany made in the past, the APR seems to be a logical and reasonable option to consider.

Of course, the priority rules are not the only measures to influence the agency problem. They probably will not be able to fundamentally change the balance of interests between shareholders and creditors, even if they contradict the layered restructuring framework. However, if such measures are not in line with the current approach towards the agency problem, this may lead to an increase in agency costs and a decrease in the effectiveness of the restructuring measures proposed in the Directive. Nevertheless, to a large extent, the final choice will strongly depend on the objectives of the particular Member State and its concerns about the agency problem.

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