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Involving Secured Creditors in Restructuring Proceedings

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1 Introduction

This Chapter offers a description of the theoretical debate about the protection of security rights and the extent of the preferential treatment they will enjoy in restructuring proceedings. The main purpose is to analyse why secured creditors should be compulsorily involved in the restructuring proceedings and provide good reasons for it. In this respect, this Chapter presents the main reasons for restricting or limiting pre-insolvency entitlements of secured creditors in order to meet the objective of restructuring proceedings and the limitations that should be imposed on them. These reasons are linked to the need to minimize the negative impact of procedural and substantive privileges granted to creditors by secured debt on reorganisation in order to achieve insolvency goals, specifically to maximize the value of the distressed company. For that purpose, this Chapter is divided in four sections. After a brief introduction (section 1), the Chapter defines the analytical framework and the problems that secured creditors may pose in insolvency proceedings, in general, and in restructuring proceedings, in particular, i.e. in the negotiations of a restructuring plan. Likewise, it presents the reasons which justify limiting their pre-insolvency entitlements (section 2). The Chapter then describes the nature and extent of the limits imposed by the positive law, taking as a reference the approaches followed in the US (Chapter 11 of the US Bankruptcy Code) and in Europe (the Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 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, or ‘Directive’), but making punctual references to other approaches in comparative law as well (section 3). In particular, it focuses the attention on two main issues, that is, whether and under what conditions secured creditors may be affected by the stay, and whether these creditors can be ‘dragged along’ by the restructuring plan, i.e. whether the plan can be crammed down upon secured creditors. This chapter finishes by outlining some concluding remarks (section 4).

1.1 Issue

The interplay between secured transactions law and insolvency law, in particular, the legal treatment of secured creditors in insolvency, has been thoroughly discussed in recent years,

mostly because of the expansion of secured transactions.¹ Most jurisdictions recognize the possibility of creating security rights over the debtor's assets to mitigate the insolvency risk. These security interests may fall individually upon movable and immovable property, tangible or intangible, or even collectively upon a pool of assets (the so-called floating charges). Furthermore, they may be based on a contractual arrangement or have a statutory basis (so-called statutory lien). If they are permitted under general civil and commercial law, and have been validly created and perfected in accordance with that law, those creditors will enjoy a preferential treatment in insolvency proceedings.

The extent of this preferential treatment is, however, disputed. This dispute is inextricably linked to a broader debate about the sense of the priority granted to security rights.² Policy discussions have revolved around whether and to what extent procedural and substantive privileges of secured creditors should be reduced or limited in order to achieve insolvency goals, specifically to maximize the value of the distressed company. Basically, two theoretical approaches have been suggested. On the one hand, the desirability of secured creditors' protection since it will lead to a hierarchical priority waterfall that may constitute an effective way to overcome limitations in judicial institutions to maximize the value of the debtor's estate. Given the power of secured creditors to appropriate the value of the insolvent company in the first place until they are fully repaid, they will be in the best position to determine how to put a debtor's estate to its best use. On the other hand, it has been argued that secured creditors' privileges and control may exacerbate the risks of rent seeking and negative externalities. This second approach seeks to explain the perception that secured lending imposes undue costs and risks on unsecured creditors.³

In principle, the preferential treatment of secured claims in insolvency proceedings should correspond to the scope of the liens under civil or commercial law without exceeding their limits.⁴ As long as pre-insolvency rights cannot be fully protected in insolvency proceedings, the treatment of secured claims in these proceedings cannot be a mere replication of their pre-insolvency rights. Nevertheless, it should reflect the relative standing existing among the different stakeholders, namely, the *relative value* of pre-insolvency entitlements.⁵ As long as

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¹ See, with further references, John Armour, Audrey Wen-hsin Hsu, and Adrian Walters, 'The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK' (2012) 8(1) *Review of Law & Economics* 101; for an extensive and critical analysis, see the seminal works of Lucian Bebchuk and Jesse M Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105(4) *Yale L J* 857; 'The Uneasy Case for the Priority of Secured Creditors in Bankruptcy: Further Thoughts and a reply to Critics' (1997) 82 *Cornell L Rev* 1279.

² D D'Onfro, 'Limited Liability Property' (2019) 39 *Cardozo Law Rev* 1365, 1365 & 1372: 'While it is easy to explain why lenders, and sometimes even borrowers, like secured credit, it is far more difficult to explain why secured credit should enjoy the priority rights that makes it so attractive. As Lynn LoPucki puts it 'security is an agreement between A and B that C take nothing''. However "[...] there are reasons to believe that secured debt is a net positive for the economy.'

³ For further details on the debate, see Melissa B Jacoby and Edward J Janger, 'Tracing Equity: Realizing and Allocating Value in Chapter 11' (2018) 96 *Texas L Rev* 673, 677-678.

⁴ Edward J Janger, 'The Logic and Limits of Liens' (2015) 2015(2) *University of Ill L Rev* 589, 592, 595 & 611.

⁵ See Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (first published 1986, Beard Books 2001) 20, 28-29.

the debtor and creditors use securities to adjust *ex ante* the risk of claims and reduce the costs of capital, insolvency law must recognize at least the *relative value* of these claims. This relative value will be used as a pattern to distribute value in insolvency proceedings.⁶ Diversion from pre-insolvency entitlements may be anticipated by creditors and reflected in the cost of capital. An increase in the cost of capital may affect in the future the chances for developing and financing valuable projects.⁷

1.2 Purpose of the Chapter

This contribution offers a description of that theoretical debate and analyses the main reasons for restricting or limiting pre-insolvency entitlements of secured creditors in order to meet the objective of insolvency law, in particular in restructuring proceedings. Our main purpose is to analyze why and to what extent secured creditors should be compulsory involved in restructuring proceedings.

2 Policy Considerations: the Case for Involving Secured Creditors in the Restructuring Process

Dispersed creditors, secured and unsecured, may give rise to collective action problems in the context of restructuring proceedings. They may use their rights opportunistically to exhaust part of the ongoing concern surplus and therefore jeopardize the main objective of those proceedings, i.e. to reorganize a distressed but viable firm when its restructuring value exceeds its liquidation value and therefore maximizes the value of the estate. In this context, secured creditors may be more interested in foreclosing the collateral and getting paid immediately rather than waiting for restructuring and obtain payment against the proceeds of it. For the same reason, they may be more interested in fire sales which grants them promptly the full value of their claim rather than in reorganizing the firm, even if it frustrates other options which will be more beneficial for unsecured claims. Furthermore, they may be more interested in maximizing the value of the collateral than in maximizing the value of the firm as a whole, the latter of which will basically benefit unsecured creditors. Additionally, the debtor's decision to grant a security interest to a creditor may provide incentives to secured creditors and shareholders to act opportunistically at the expense of non-adjusting creditors. This section analyses these problems. After summarizing the main objective of restructuring proceedings and the basic content of secured creditors' pre-insolvency entitlements and its rationale, it briefly describes the collective action problem and the opportunistic behavior risks which manifest when the debtor becomes insolvent.

⁶ *Ibid.*, 20-33.

⁷ *Ibid.*, 60-61.

2.1 Restructuring Proceedings

2.1.1 General objective of restructuring proceedings

In general terms, insolvency law should ensure the maximization of the value of the distress debtor and the distribution of such value in accordance with pre-insolvency rights.⁸ As regards restructuring proceedings, this means a twofold objective: (i) facilitating the restructuring of the debtor when it is economically viable, i.e. when there is a going concern surplus; and (ii) protecting creditors' pre-insolvency entitlements by maximizing such going concern surplus and allocating it in accordance with those entitlements. The first aspect is mainly related to the left side of the balance-sheet, the latter to the right side, i.e. the capital structure.

2.1.2 The sole owner hypothesis

In theory, the maximization of the value of the distress debtor determines the option for restructuring or liquidation. As noted, insolvency law must seek value maximization, i.e. putting the firm's assets to their best use.⁹ Either it must promote restructuring proceedings when the restructuring value is superior to the liquidation value, i.e. preventing that viable firms fall into liquidation proceedings exhausting the going concern surplus;¹⁰ or vice versa, it must promote the liquidation of non-viable firms.¹¹ The option for either restructuring or liquidation is usually answered by (i) estimating the future income that the assets would generate if they are kept together (but restructured), discounting that to the present value, and (ii) comparing it to the amount the asset would generate if they were liquidated in insolvency.

This option between restructuring or liquidation would not be a problem if all the assets belonged to the same person (a 'sole owner'). This sole owner will assume the positive and negative consequences (benefits and losses) of his or her decision and therefore has the right incentives to take the alternative that maximizes the value of those assets. In practice, however, when a firm approaches insolvency, disperse stakeholders (creditors and equity holders) may have rights over those assets. This gives rise to a 'common pool' or 'collective action' problem. Each stakeholder may have an incentive to claim and enforce his or her pre-insolvency rights individually, and this may lead to an disorderly piecemeal liquidation of the debtor's estate even if, in collective terms, restructuring is a preferable option, i.e. even if a *sole owner of the assets would decide to continue with the business*. To tackle this problem, insolvency law imposes certain restrictions or limits on the pre-insolvency rights granted by general civil and

⁸ Jackson (n 5) 27-33. See recently and with further references, Jacoby & Janger (n 3) 682.

⁹ See Douglas G Baird, Anthony Casey, and Randal C Picker, 'The Bankruptcy Partition' (2018) University of Chicago Coase-Sandor Institute for Law & Economics Research Paper, n° 848, 8-9 (Bankruptcy Law should focus on maximizing the value of the estate).

¹⁰ See and with further references, Eric A Posner and Kevin A Kordana, 'A Positive Theory of Chapter 11' (1999) 74 New York Univ L Rev 161, 164-167; Kenneth M Ayotte and David A Skeel, 'Bankruptcy Law as a Liquidity Provider' (2013) 80 U Chi L Rev 1558, 1563-1567.

¹¹ As stated in the Directive, recital 3: 'Non-viable businesses with no prospect of survival should be liquidated as quickly as possible.'

commercial rules in order to coordinate all stakeholders and require them to reach the solution that maximize the value of those assets. This is the solution that the sole owner would have adopted. Insolvency law should therefore be designed to require stakeholders to act collectively, as a ‘sole owner’, since this would permit options for a solution that maximizes the value of the assets. Furthermore, this solution would be consistent with the hypothetical bargain creditors would strike among themselves had they had the opportunity to do so.¹²

To achieve such an objective, insolvency law replaces individual races to the court to enforce contractual rights by a mandatory stay and structured bargaining.¹³ The strict preservation of pre-insolvency rights in insolvency proceedings may impose on stakeholders a collective disadvantage which may exceed any benefit of fully recognizing these rights. Insolvency law thus interferes with pre-insolvency rights insofar as when doing so preserves the value of the estate for the collective good of the stakeholders.¹⁴ Nevertheless, as mentioned, the treatment of secured claims in insolvency proceedings should reflect the relative standing existing among the different stakeholders, i.e. *relative value* of pre-insolvency entitlements.¹⁵ As regards secured creditors, the key policy issue is, thus, whether and to what extent the restructuring proceedings should interfere or limit secured creditors’ rights under general civil and commercial law.

2.2 Secured Creditors: Pre-insolvency Entitlements and its Rationale

To understand the problems raised by secured creditors in insolvency it may be worth recalling why security rights exist and are protected by most legal systems. This section briefly summarizes the rationale of security rights.

2.2.1 Secured, unsecured, and equity

In legal and financial terms, the sources of capital in a firm may be classified in three broad categories: secured creditors, unsecured creditors, and equity. Each layer, in turn, may contain many subdivisions.¹⁶ These sources of money are reflected in the priority waterfall. The proceeds of a firm must be allocated in accordance with the position assumed by each stakeholder in the capital structure of the firm. All stakeholders have some rights against the assets but hierarchically arranged.

¹² See Thomas H Jackson, ‘Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain’ (1982) 91 Yale L J 857; Jackson (n 5) 22-24.

¹³ Kenneth Ayotte, ‘On the Mandatory Stay of Secured Creditors in Bankruptcy’ (2017) <https://ssrn.com/abstract=3060748> accessed 2 January 2020, 4.

¹⁴ Jackson (n 5) 28.

¹⁵ *Ibid.*, 28-29.

¹⁶ D’Onfro (n 2) 9.

2.2.2 Secured creditors: substantive and procedural privileges

In particular, as regards secured creditors, under general civil and commercial law they enjoy both procedural and substantive privileges. They have the right to enforce the collateral and to be satisfied with the proceeds prior to other creditors. In this sense, the security interest entitles the lender to liquidate the encumbered assets to satisfy its claim thereby giving it a distribution priority over unsecured claims up to the value of the collateral. Unsecured creditors have claims against the value of the firm and thus lack property rights in any particular asset of the debtor. Therefore they are only entitled to the residual unencumbered assets of the firm.¹⁷

2.2.3 Consequences: cost of capital

The debtor's decision to grant a security interest is supposed to be reflected in the firm's capital contribution and results in a hierarchical priority allocation in the capital structure of an entity.¹⁸ Scholarship has explained that secured financing may have positive effects, since it addresses *information problems* inherent to business finance and therefore reduces the costs of misbehavior by the borrower.¹⁹ This information rationale falls into two categories: static and dynamic.²⁰

The *static aspect* explains that priority can be used to exploit the comparative advantages of creditors in screening and monitoring the debtor, and enforcing debt claims upon default against the debtor's assets. If the junior creditor has superior information that allows it to screen, monitor or enforce its claim at a lower cost than the senior creditor, then the junior creditor could bear the risk of default more cheaply than the senior creditor. Furthermore, the debtor may assign to each creditor priority only in those assets in which that creditor enjoys a comparative screening and monitoring advantages.²¹ As a consequence, the aggregate cost of capital would be reduced by the different priorities.

The *dynamic aspect* focuses on the temporal element: the debtor may reduce its cost of capital by allocating priority over time by means of secured lending. Giving the first creditor

¹⁷ Jacoby & Janger (n 3) 689-690. Note that secured creditors have recourse against the debtor for any deficiency in the value of the collateral and they shares ratably with unsecured creditors in the value of unencumbered assets, i.e. they enjoy a prior claim to one asset pool and a pro rata claim to remaining debtor assets. According to some scholars, on the one hand, this imposes negative consequences on non-adjusting creditors and redistributes value, and on the other hand, it destroys social wealth, as long as it increases the cost of credit for unsecured financing (adjusting creditors) and discourages efficient monitoring. Therefore, it is proposed to subordinate secured creditors deficiency claims to unsecured creditors. See R Squire, 'The Case for Symmetry in Creditors' Rights' (2014) 118(5) Yale L J 806, 846-851. For a critical view, see Barry E Adler and George G Triantis, 'Debt Priority and Options in Bankruptcy: A Policy Intervention' (2017) 91(3) Amer Bankr L J 563, 571-575, where they underline the negative effect of this solution on enforcement incentives.

¹⁸ See, recently, 'Study of the Reform of Chapter 11' (American Bankruptcy Institute 2014) (ABI Report) 214 and n 781, with many references; or Adler & Triantis (n 17) 565-572.

¹⁹ Bebchuk & Fried 'Uneasy Case' (n 1) 873. Recently, see Adler & Triantis (n 17) 565-566, with further references.

²⁰ Adler & Triantis (n 17) 566.

²¹ *Ibid.*, with further references.

priority –early-in-time priority- means that the later creditor will be subordinated to the previous and consequently more careful in providing funds. Therefore secured lending will prevent borrowing to invest in high-risk and unprofitable projects in an attempt to achieve a reversal of fortune, and thus reduce overinvestment incentives. Note that in these cases the second lender may only be willing to finance unprofitable projects if it enjoys priority over the initial lender (late-in-time priority). Such a priority offers the opportunity to externalize some of the negative consequences of the project into the previous lenders. Moreover, it may contribute to finance other distributive actions, i.e. declaring dividends or making other payments to shareholders; granting benefits to managers. So, early-in-time priority, by means of secured lending, may also play a significant role in reducing agency cost of corporate governance.²²

2.3 Secured Creditors and Insolvency

Alongside the positive aspects, secured financing may also have negative aspects, which manifest when the debtor becomes insolvent. Legal scholarship has pointed out three main problems raised by secured creditors in insolvency: (a) negative externalities and *ex ante* incentives; (b) race to individual enforcement and risk of piecemeal liquidation; and (c) opportunism vis à vis unsecured creditors. The first two problems are common to any insolvency proceedings, while the last one is specific to restructuring proceedings.

2.3.1 Negative externalities and *ex ante* incentives

Secured finance may be used to shift risk from adjusting to non-adjusting creditors. That is, secured financing may be used by sophisticated (adjusting) creditors and shareholders to *externalize costs to non-adjusting creditors*.²³ A security interest gives a priority to a creditor at the expense of other creditors, subordinating them without their consent. This may be used to transfer value from non-adjusting creditors to secured creditors and shareholders, and therefore it gives the two parties an incentive to adopt inefficient arrangements to accomplish that result (overinvestment). The debtor and its shareholders will be willing to grant the creditor a priority right on part of the estate in exchange for the capital required to develop a highly risky project which will probably fail, but could be highly profitable if it succeeded, i.e. a negative value project. At the same time, secured creditors will not care about the negative value of the project as long as its claim will be fully backed by the collateral. If the project succeeds, the debtor and his shareholders will reap all the benefits after paying the existing claims. However, if things go wrong and the project fails, the losses will be suffered by unsecured creditors. To the extent that secured creditors are fully backed by the collateral, they

²² *Ibid.*, 566-570.

²³ Non-adjusting creditors may be defined as those that do not adjust the terms of their loans to reflect the risk they assume and, in this context, in particular, the effects that the creation of security interests may have on their claims, i.e. that they will be subordinated. Typically, non-adjusting creditors are tort creditors, public creditors, employees, or trade creditors; see, Bebchuk & Fried 'Uneasy Case' (n 1) 864-865.

will not experience any loss. Certainly, shareholders will also suffer the losses, but only up to the limit of their investment as a consequence of limited liability. Thus, the negative consequences of their decisions over their personal estate are mitigated, especially when they hold a diversified portfolio of investments. As a result, shareholders will be more prone to develop risky projects, even if they may increase the likelihood of insolvency of the firm, to the extent that they can capture the upside and externalize the downside on non-adjusting creditors. In this respect, they can transfer value from non-adjusting creditors to themselves.²⁴

In these cases, the debtor's benefit could well be outweighed by the nonconsensual creditors' loss. That is why it has been argued that an absolute protection of secured creditors in bankruptcy may be inefficient or at least some form of protection for nonconsensual creditors may be needed.²⁵ As has been explained, since non-adjusting creditors do not reflect the risk in the terms of their claim:

[...]the borrower is able to 'sell' the non-adjusting creditors' share of bankruptcy value to the secured lender in exchange for a lower interest rate, without paying any additional interest to the non-adjusting creditors. As we explained in *The Uneasy Case*, the ability to sell non-adjusting creditors' share of bankruptcy value (whether those non-adjusting creditors are large banks, small trade suppliers, or tort creditors) creates a 'subsidy' for the use of security interests and can cause a borrower, under full priority, to incorporate a security interest into its loan arrangements even though the security interest is value-wasting.²⁶

Furthermore, secured debt protected by a rule of full priority may reduce the incentive of the secured creditors to 'monitor' the debtor: since their claims are protected till the value of the collateral, they do not have incentive to prevent the debtor from engaging in value-wasting investments.²⁷ This additionally combines with the fact that non-adjusting creditors do not have the ability to monitor the debtor.

To address this problem, in relation to tort claims, scholars propose to accord them a *statutory priority*, i.e., a super-priority, which grants preference over secured claims.²⁸ This case raises a particular issue, because secured debt may also have a negative impact on the level of deterrence: to the extent that, in the event of insolvency, losses will be suffered by tort claims, the debtor has no incentives to develop activities that will reduce the risk of accidents.²⁹ The super-priority granted to tort claimants will be anticipated by the affected creditors and reflected in the extra cost that the debtor will have to pay for obtaining secured financing. The increase in the cost of credit will dissuade the debtor from developing highly risky projects and reduce overinvestment. At the same time, the super-priority will push the debtor to invest in limiting

²⁴ See Bebchuk & Fried 'Uneasy Case' (n 1) 874; Douglas G Baird, 'Importance of Priority' (1997) 82 Cornell L Rev 1420, 1429.

²⁵ See Bebchuk & Fried 'Uneasy Case' (n 1).

²⁶ Bebchuk & Fried 'Further Thoughts' (n 1) 18. For a numerical example, see L LoPucki, 'The Death of Liability' (1996-1997) Yale L J 1, 41-42.

²⁷ Bebchuk & Fried 'Further Thoughts' (n 1) 38-39; Adler & Triantis (n 17) 570 '...a debtor who does not pay for the higher risk borne by nonconsensual creditors also does not internalize the full cost of the capital it uses and will tend to overinvest in risky endeavors.'

²⁸ See Douglas G Baird, 'Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy' (2016) 156 U Pa L Rev 785 considering the value of statutory preferences. See, also, Adler & Triantis (n 17) 570.

²⁹ Jackson (n 12) 902-903.

the risk of accidents to avoid higher increases in the cost of credit. Moreover, it will provide incentives to secured creditors to monitor debtor's activities to prevent the occurrence of tort liabilities, which will negatively affect *ex post* their position. Thus, granting a super-priority to tort claims will contribute both to internalize the negative consequences of the decision to invest in highly-risky projects and to foster deterrence. Note that even if non-adjusting creditors have a statutory preference, as long as the priority does not affect secured creditors (super-priority), the result remains unchanged: shareholders will still have the incentive to invest in highly risky projects, secured creditors will not have any incentive to refuse credit to finance them and tort claims 'will be paid with their own money', as long as there is not money to pay all the claims. As a result, the debtor will not have incentives to reduce the risk of accidents of his activities.

In order to minimize the risk of forum shopping, the super-priority should be granted in and outside insolvency. Otherwise, creditors would have incentives to file for bankruptcy in order to benefit from the preference granted under insolvency law.³⁰

However, to some academics, *the net benefits of granting tort claims a statutory priority are dubious*. The solution may be both over- and under-inclusive. On the one hand, tort claims represent only a small fraction of the claims of the firm, and on the other hand, when tort claims are massive, granting them a super-priority and giving secured creditors incentives to monitor the debtor's activities will transfer value to other creditors who could have also monitored them.³¹ In addition, super-priority undermines secured lending benefits and, therefore has a negative impact on financing. In this regard, first, secured credit will be discouraged for firms developing hazardous activities, even when the projects to be finance have net positive value and there is no overinvestment.³² Second, it negatively affects the incentives for creditors to monitor debtor's assets in order to avoid assets depletion.³³ Third, debtors will look for substitutes, which will not be affected by super-priority, but are more expensive or more disruptive, i.e. placing major assets in subsidiaries.³⁴ Fourth, the increase in the cost of credit will be experienced not by the debtor who caused the damages, but by any future debtor who may develop hazardous activities, irrespective of whether they have incurred any liability or will incur it. In so doing, careless debtors will externalize part of the costs of their hazardous activities in terms of increases of the cost of credit over careful debtors. Moreover, it is far from clear that secured creditors will have the appropriate skills to monitor a debtor's activities.³⁵ In such a case, they will be forced to buy these services in the market. However, when monitoring becomes expensive, secured creditors will prefer to charge an extra price for granting financing, to monitor debtors' activities. Hence, as long as negative externalities can be minimized with other tools such as mandatory insurance, funds, directors liability, etc., granting a statutory

³⁰ Jackson (n 5) 21, 25-27. Recently, see Baird, Casey & Picker (n 9) 9 & fn 18.

³¹ Baird (n 24) 1430-1431.

³² Squire (n 17) 864.

³³ *Ibid.*, 864.

³⁴ In a similar vein, with regard to the stay, see Ayotte (n 13) 24.

³⁵ Henry Hansmann and Reinier Kraakman, 'Toward Unlimited Shareholders Liability for Corporate Torts' (1991) 100(7) Yale L J 1879, 1901-1902 & fn 66.

preference to tort claims will not be the best option to internalize the negative consequences of secured debt and to foster deterrence.³⁶ In the same vein, the subordination of a secured creditor's deficiency claim has been proposed as a more efficient solution.³⁷

The externalization of cost to non-adjusting creditors may be exacerbated by a *strategic use of security rights and company law*. The combination of these two legal tools permits a distribution of the debtor's assets among different subsidiaries (*asset partitioning*), and the creation of security rights and guarantees over these subsidiaries. Subsidiaries are useful, and in some ways necessary, to separate different businesses and risks. The separation of legal entities allows creditors to focus their monitoring efforts in a particular pool of assets and permits them a better adjustment of the return to the risk associated with the business they are financing.³⁸ Moreover, the subsequent asset partitioning creates a preference for a subsidiary's creditors against parents company's creditors over a separate pool of assets (subsidiary's estate).³⁹ As a result, the cost of credit is reduced. In addition, it allows the creation of bundles of contracts that can be more easily transferred as a unit and therefore helps the owner to obtain liquidity.⁴⁰

When the separation of assets entails a separation of standalone businesses, the insolvency of a company of the group should not be affected by the viability of other companies: the assets of a separate entity will not be essential to the insolvent entity and, therefore, its restructuring will not be jeopardized. This is, however, not the case when it is a business (a firm in economic terms) with assets placed in separate legal entities. In such a case, asset partitioning may also be used by adjusting (secured) creditors to circumvent or avoid any limit imposed by insolvency law (e.g., automatic stay).⁴¹

Example

A typical structure includes a parent company (HoldCo) and several subsidiaries. The intermediate subsidiaries only hold the relevant assets (PropCo), and the operating subsidiary (OpCo) enters into agreements with the PropCos to rent the assets or obtain services from them, and naturally pays for those assets and services. This implies that the OpCo owes much of its revenue to other companies of the group (HoldCo and PropCo). The money flows up the corporate structure as it comes in. The non-adjusting creditors (employees, public authorities, tort victims or suppliers) are mostly located at the level of the OpCo, whereas the secured creditors have guarantee against the different companies and security rights over the assets and the equity at the different level of the group. If the group collapses, the OpCo falls into insolvency with all the liabilities, and probably no assets, whereas the secured creditors, who are not affected by the insolvency of the OpCo, may enforce their guarantees and security rights. They may also have the possibility to foreclose the security rights over the equity at different levels and become the

³⁶ Baird (24) 1429-1430.

³⁷ Squire (17) 865-866.

³⁸ Hansmann & Kraakmann (n 35) 399-403.

³⁹ *Ibid.*, 393-394.

⁴⁰ Kenneth Ayotte and Henry Hansmann, 'Legal Entities as Transferable Bundles of Contracts' (2013) 111(5) Mich L Rev 715, 722-728.

⁴¹ See Ayotte (n 13) 2. See, also, with further references, but giving a justification of the withdrawal rights that asset partitioning entails, Douglas G Baird and Anthony J Casey, 'No Exit? Withdrawal Rights and the Law of Corporate Reorganisations' (2013) 113(1) Columbia L Rev 1, 6-20. However, they point out that withdrawal rights will only be efficient as long as they are granted to one or to very few creditors.

owners of all or different parts of the business and thus owners of the going concern. Since insolvency law is usually based on an entity by entity approach, secured creditors may easily avoid any automatic stay or being forced into the negotiation of a restructuring process by using the legal tools that enable asset partitioning within the same business. That is, the combination of security rights and company law may allow secured creditors to opt-out of insolvency.⁴²

Furthermore, in a *cross-border setting*, the debtor-adjusting creditors' coalition may benefit from legal differences and the lack of cooperation between states to extend further their benefits at the expense of non-adjusting creditors.

In the example, the enforcement of the guarantees and the security rights would be even easier if they are located in a jurisdiction different from the OpCo's jurisdiction, where restructuring proceedings are opened. The so-called double LuxCo structure is a refined option of the strategic combination between security-rights law, company law and regulatory competition.⁴³

2.3.2 Race to individual enforcement and risk of piecemeal liquidation

The second problem is common to all creditors, but, in theory, collective action problems associated with a run to enforcement may be exacerbated in the case of secured creditors.

Secured creditors usually have a *procedural privilege to individual enforcement* under general civil and commercial law. Therefore, for each individual secured creditor, it may be easier to run and grab the assets without taking into account the rest of the secured and unsecured creditors. Furthermore, it is very common nowadays that when a firm approaches insolvency all assets are encumbered. There is a tendency in general civil law to facilitate secured transactions and this has provoked firms to use any valuable asset to obtain financing as a means to evade insolvency. Thus, when the firm approaches insolvency almost all of its assets are usually encumbered.⁴⁴ This reduces the cost of finance *ex ante* but may increase the cost of restructuring *ex post*, since this may provoke a disorderly piecemeal liquidation of the assets.

In many cases, however, that problem is more theoretical than practical. Secured creditors are sophisticated stakeholders that design their financing scheme in a way that prevents collective action problems. Although there may be exceptions, in general, *secured creditors coordinate among themselves ex ante, by inter-creditors arrangements* or equivalent

⁴² Baird & Casey (n 41) 5-6.

⁴³ In this regard, see Sophie Vermeille, 'The Legal System and the Development of Alternative Methods of Financing to Bank Credit; Or How French Law has Failed to Adapt to the Evolution of the Economy and Finance' (2012) 2 *Revue Trimestrielle de Droit Financier* 1, 24.

⁴⁴ Insolvency law may, nevertheless, put limits to the assets that could be encumbered. This is particularly important in the case of floating lien collateral. Typically, after-acquired property inside bankruptcy, i.e. post-petition acquired property, cannot be encumbered in most legal systems; see Jacoby & Janger (n 3) 702. The collateral is usually fixed at the petition date (and its value, subject to adequate protection, upon disposition).

mechanisms, and therefore ensure a coordinated enforcement.⁴⁵ That is, hold-out strategies among secured creditors are usually excluded by contractual mechanisms. Furthermore, secured creditors usually take security over the holding company (and over various operative subsidiaries) so that they may have control, by enforcing such a collateral, over the restructuring (or the liquidation) proceedings. This ‘single point of enforcement’ is an effective way to overcome the race to the courthouse to dismember the debtor. This is also why institutions such as the floating charge has been justified as a means to give control to the secured lender(s), who in turn may solve the collective action problems *ex post* and maximize the value of the debtor.⁴⁶ The weight of this argument is examined in the following section.

In addition, in most jurisdictions, as we will explain below as regards the Directive and Chapter 11, *insolvency law imposes a stay on the enforcement of secured claims that may destroy value*. The stay contributes by making creditors act as a sole owner. Certainly, the stay can be understood as an interference with the procedural rights of secured creditors, as long as it affects the full value of its non-bankruptcy rights and limits their procedural privileges. However, this interference should be considered justified as long as the collective benefit for all stakeholders, in terms of increase of the value of the estate, exceeds the costs imposed on the secured creditors affected by the limitation.⁴⁷ This is, in particular, the case when collateral presents synergies with the rest of the assets of the firm. When this is not the case, because the collateral does not present any synergy or can be easily replaced, i.e. accounts receivable, or cash collateral, this interference may not be justified.⁴⁸

However, secured creditors should obtain compensation for their contribution to the creation of the going-concern surplus, in particular where a stay has been imposed on the enforcement of their claims. This compensation for the time value of money offsets the delay suffered by secured creditors under the stay in the enforcement of their rights and grants full protection of their substantive rights. Moreover, it imposes the cost of the decision to reorganize the firm on unsecured creditors and shareholders, who benefit from a delayed going-concern sale or any other form of reorganization that maximizes the value of the estate. As a result, it provides junior classes with the appropriate incentives to avoid strategies that may harm secured creditors’ interest and expropriate value, i.e. wait and see whether the estate value increases over the time at the expenses of secured creditors. It contributes, thus, to adopt the appropriate decision about how to deploy the debtor’s asset.⁴⁹

⁴⁵ In this regard, see Edward R Morrison; ‘Rules of Thumb for Intercreditor Agreements’ (2015) 2015(2) U Ill L Rev 721, 722-723.

⁴⁶ See Armour, Hsu, & Walters (n 1) 3-4, with further references; for another view, see Jacoby & Janger (n 3) 682-683 Melissa B Jacoby and Edward J Janger, ‘Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy’ (2015) 123 Yale L J 862, 920-925, and Janger (n 4) 600, claiming that a secured creditor with a blanket lien on debtor’s assets it is not entitled to all the enterprise value.

⁴⁷ Jackson (n 5) 182. See also, Douglas G Baird and Thomas H Jackson, ‘Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy’ (1984) 51(1) U Chi L Rev 97,

⁴⁸ Ayotte (n 13) 23-25.

⁴⁹ Jackson (n 5) 189. Recently, see Ayotte (n 13) 23-25: ‘Under current law, secured creditors do not receive compensation for the lost time value of money due to the delay inherent in reorganization. A change to the

2.3.3 Opportunism *vis à vis* unsecured creditors

Creditors do not have a monolithic interest. Secured and unsecured creditors have different interests, which come into conflict in insolvency. This conflict can destroy value and hence frustrate the purpose of insolvency proceedings, namely to maximize the value of debtor's estate. This conflict has become particularly severe in restructuring proceedings. On the one hand, when the value of the collateral exceeds the value of the claim and the debt is over-secured, creditors will prefer to quickly sell the collateral and obtain the full value of its claims to take part in the restructuring process. This may affect negatively the chances of restructuring of insolvent companies.⁵⁰ Moreover, secured creditors will be willing to accept the face value of the claim in a *fire sale* even though unsecured creditors would have obtained more value in the near future.⁵¹ On the other hand, secured creditors can control restructuring proceedings and will try to *appropriate part of the going-concern surplus* even if it exceeds the value of their claims.

(i) Fire sale

Even if secured creditors are coordinated, i.e. they act as a 'sole secured creditor', it has been argued that there is still an *ex post* risk of opportunistic behavior. Secured creditors may have an incentive to prefer liquidation to restructuring even if there is a going concern surplus. If secured creditors are fully - or almost fully – collateralized, they may have incentives to close down and prematurely liquidate viable firms or to carry out a quick (fire) sale in cases where a delayed going-concern sale or reorganization may prove the better choice for creditors collectively. In other words, they do not have any incentive to maximize value where the debtor's assets are worth more than the nominal value of the secured debt.⁵² The reason is easy to understand: as long as the value of their claims is fully covered by the collateral, they do not benefit from the going-concern surplus. This risk increases in cases of groups of companies when the creditor has recourse to other companies of the group, e.g. by means of upstream, downstream or cross-stream guarantees. The creditor may be willing to fire-sale a company of the group if it has recourse to other companies. To the extent that this process and its dynamics ruins the opportunity to maximize the value of the estate, shareholders and unsecured creditors might view them as grossly unfair and feel that their interests have been ignored.⁵³

Bankruptcy Code that eliminate this dilution of secured credit would result in less temptation to create withdrawal rights, and less breakdown in bargain as a result.'

⁵⁰ Kenneth M Ayotte and Edward R Morrison, 'Creditor Control and Conflict in Chapter 11' (2009) 1(2) J Legal Analysis 511, 532, 538.

⁵¹ *Ibid.*, 512-514, 526 & 538-539.

⁵² See, Baird & Jackson (n 47) 106; Ayotte & Morrison (n 50) 514, 528; Charles J Tabb, 'Credit Bidding, Security, and the Obsolescence of Chapter 11' (2013) 2013(1) U Illinois L Rev 103, with further references; however, Armour, Hus, & Walters (n 1); Adler & Triantis (n 17).

⁵³ Rolef J de Weijs and Bob Wessels, 'Proposed Recommendations for the Reform of Chapter 11 US Bankruptcy Code' (draft of article published in *Ondernemingsrecht* 2015/37) <http://bobwessels.nl/site/assets/files/1804/wessels-de-weijs-abi-proposed-recommendations-for-the-reform-of-chapter-11.pdf> accessed 2 January 2020, 29.

Furthermore, in many jurisdictions, the experience shows that *secured creditors usually control the restructuring process*. As pointed out above, in most restructuring proceedings almost all of the debtor's assets are encumbered, i.e. subject to security interests of particular stakeholders. This is the result of a recent tendency at a global level. Under the auspices of international organizations, a growing number of jurisdictions have embarked on legal reforms to facilitate the expansion of credit through the recognition of proprietary entitlements (security rights), including upon the whole business of the debtor (floating charges).⁵⁴ This tendency in civil and commercial law has facilitated the explosion in secured lending and with it an explosion in companies entering restructuring with few unencumbered assets.⁵⁵ It has been said that the scope of the secured lenders property rights began to resemble the scope of the equity holders' rights.⁵⁶ This allows secured creditor to control the restructuring process in the pre-petition and in the post-petition period. When almost all the assets are encumbered, it usually is not possible to obtain DIP financing other than from the pre-petition secured creditors.⁵⁷ Furthermore, most of the time, secured creditors control the timing of restructuring proceedings filings, which actually work as liquidity providers, i.e. granting priority to DIP financiers, or nullifying negative covenants and freeing assets.⁵⁸ In addition, super-priority granted by administrative expenses contributes to reinforce this control, as long as creditors benefiting from that priority can demand immediate repayment in cash.⁵⁹ Thus, if secured creditors are not legally forced to cooperate with other stakeholders, there may be the risk that they frustrate the restructuring proceeding (*supra*) or that they try to capture a larger part of the going concern for themselves and so denying junior creditors any increase in firm value.⁶⁰

(ii) The allocation of the going concern surplus

This latter circumstance has provoked an academic dispute about *who is entitled to the going concern surplus*. In principle, secured creditors do not have any priority above and beyond the

⁵⁴ See, for a recent summary, Giuliano G Castellano and Marek Dubovec, 'Global Regulatory Standards and Secured Transactions Law Reforms: At the Crossroad Between Access to Credit and Financial Stability' (2018) 41(3) Fordham Int'l L J 531, 541-548.

⁵⁵ Tabb (n 52) 2 ('For at least the past decade, the reality is that senior secured creditors often have liens on all the firm's assets and exercise virtually total control over the debtor's access to cash, and thus call the shots – before and during bankruptcy- in corporate restructuring') and p. 32; Charles J Tabb 'The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy' (2015) 2015(2) U Illinois L Rev 765, 768. See also Ayotte & Morrison (n 50) 523; Ayotte & Skeel (n 10) 1562; or Douglas G Baird and Robert K Rasmussen, 'The End of Bankruptcy' (2002) 55(3) Stan L Rev 751; David A Skeel, 'Creditors' Ball: The 'New' New Corporate Governance in Chapter 11' (2003) 152(2) U Pa L Rev 917; Ralph Brubaker, 'Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11' (2012) 32(7) Bankruptcy Law Letter 1, 15, and Stephan Madaus and Bob Wessels, 'Rescue of Business in Insolvency Law' (2018) 27(2) IIR 255. See, however, Jay Lawrence Westbrook, 'Secured Creditor Control and Bankruptcy Sales: An Empirical View' (2015) 2015(2) U Ill L Rev 831.

⁵⁶ D' Onfro (n 2) 1372-1374.

⁵⁷ Tabb (n 52) 32. It has even been said that Chapter 11 has become in many instances a convenient mechanism for the secured creditors to realise upon their collateral.

⁵⁸ Ayotte & Morrison (n 50) 523-524, and Ayotte & Skeel (n 10) 1590-1592.

⁵⁹ Ayotte & Morrison (n 50) 525. See also, John Armour, Gerard Hertig, and Hideki Kanda, 'Transactions with Creditors' in Reinier Kraakman, et al (eds), *The Anatomy of Corporate Law. A Comparative and Functional Approach* (3rd edn, OUP 2017) 109, 138.

⁶⁰ E.g., de Weijts & Wessels (n 53) 23; Tabb (n 55) 768-770 (including a numerical example); Adrian J Walters, 'Statutory Erosion of Secured Creditor's Rights: Some Insight from the United Kingdom' (2015) 2015(2) U Ill L Rev 543, 561-562; ABI Final Report and Recommendations, 217. See, also, Douglas G Baird, 'Bankruptcy Quiet Revolution' (2017) 91(4) Amer Bankr L J 593, 603-608.

value of their collateral. The secure claim is worth what the value of the collateral is worth, and this value defines the amount of the creditor's secured claim: the baseline thus is the value that the secured creditor would have received had it pursued its individual enforcement remedies. The consequence of this idea in restructuring proceedings is however disputed. A relevant group of academics consider that secured creditors that are not paid in full do not have any priority over the going concern surplus, i.e. the additional value created by the restructuring of the firm (to the extent that this surplus is not attributable to appreciation of the value of the encumbered assets themselves).⁶¹ In other words, a secured creditor, even if it has perfected a security right over all of the debtor's assets, is entitled to receive the liquidation value of its collateral in individual enforcement proceedings, and not to capture all the reorganization surplus from its collateral, which is created by the reorganization process itself.

Example.

Company X files a restructuring proceeding, Secured Creditor Y has perfected a security interests in all of the Company X's assets, including tangible and intangible assets. At the time of the petition, Company X owes Secured Creditor Y € 100, and owes Unsecured Creditor Z € 50. Company's X value as a going concern is € 80 while a piecemeal liquidation value is € 50. Thus, the going concern surplus is € 30, due to the synergy of all Company X's tangible and intangible assets. This surplus is obtained by means of the restructuring proceedings. The key question is whether Secured Creditor Y is entitled to obtain the € 80.

The argument can be summarized as follows. Restructuring proceedings are supposedly designed to preserve or create value vis à vis liquidation proceedings, i.e. preserving going concern value where it exists, while respecting pre-insolvency distributional priority. As regards the distribution of this added value, restructuring law should distinguish between the preserved value inherent in the firm encumbered assets and value that does not. The latter does not belong to the secured creditors but is left to be allocated via negotiations through the plan confirmation process among all stakeholders (unsecured creditors and equity holders). The added value has two components. First, the 'non-individual enforcement premium'; the secured creditors may benefit since individual foreclosure is costly. This excess is value created by the insolvency framework and belongs to the whole body of creditors. Secondly, the going concern premium when the operating business is worth more than the sum of its parts. The ability that insolvency law offers to capitalize on asset synergies, reorganize, sell off business units or sell the whole enterprise, that is, to aggregation and coordination, is the going concern surplus.⁶²

⁶¹ See Jacoby & Janger (n 3) 706 & fn 47. In general, 'a secured creditor only has the right to the cash he could raise upon the sale of the property, not to any value deriving from its continued used' (though the latter may be partially incorporated in the former), see Baird & Jackson (n 48) 113-116; Brubaker (n 55) 15; Janger (n 4) 602: 'To the extent that this bankruptcy-created value exceeds what would have been obtainable under nonbankruptcy law, it is not by any means clear that the surplus is owned by the secured creditor.'

⁶² Jacoby & Janger (n 3) 707; Janger (n 4) 606 (individual enforcement proceedings under state law 'are generally far more cumbersome...' and 'preclude assembling the property in value maximizing packages').

Secured creditors' pre-insolvency right is limited to the value of the collateral in a piecemeal or individual liquidation. The premium vis à vis a piecemeal fire-sale belongs to the whole body of creditors, and not only to secured creditors. In other words, secured creditors have an asset-based claim, but not a going-concern value claim.⁶³

These views have been *partially* endorsed by the American Bar Association in its Study to the Reform of Chapter 11 of 2014:

[...]the Commissioners recognized the competing interests at stake and that the extreme position on either the pro-senior creditor or the pro-residual stakeholder side was not in the best interests of chapter 11 or the bankruptcy system. They strived to reach an appropriate balancing of these interests to the greatest extent possible. That balancing provides for valuing a senior creditor's collateral at (i) foreclosure value (as defined in these principles) for purposes of adequate protection, and (ii) reorganization value (as defined in these principles) for purposes of distributions in the case.⁶⁴ The Commissioners believed that this balance would enhance a debtor's ability to obtain much-needed liquidity early in the case while allowing the senior creditor to benefit from the reorganized debtor's continued use of collateral in the ongoing business by receiving the value of its collateral on an enterprise or going concern basis later in the case. They also found that it comported with the mandate of section 506(a) that '[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property.

The definition of reorganization value in these principles is designed to capture the total enterprise value of the firm, including value generated through the chapter 11 case. Subject to the principles regarding redemption option value described below and the courts' powers under sections 506(c) and 552(b), as described in Section VI.C.3, Section 506(c) and Charges Against Collateral and Section VI.C.4, Section 552(b) and Equities of the Case, the principles further provide that a senior creditor should be entitled to receive the reorganization value of its collateral under a chapter 11 plan or in a section 363x sale.⁶⁵

According to this proposal, a secured creditor is entitled to receive the reorganization value of its collateral under a chapter 11 plan, but 'subject to the redemption option value', which reflects the possibility that the debtor's going concern assets might increase in three years following restructuring. This redemption option value, calculated under the Black Scholes option price valuation or other generally accepted model, should be allocated to the class of junior creditors just below the senior creditor benefiting from the plan. And it should be paid in cash, debt, warrants or other consideration, on the effective date of the plan.⁶⁶

The secured creditor does not need to be given cash at the time of the petition in order to be given the full value of its nonbankruptcy rights. As long as the package of rights the secured creditor is given is worth the liquidation value of the collateral –can be sold by the secured creditor for that

⁶³ Janger (n 4) 603 and Jacoby & Janger (n 3) 690.

⁶⁴ In this paragraph, adequate protection in part seeks to balance the prepetition rights of secured creditors with the rehabilitative purposes of restructuring proceedings. Under Chapter 11, If a debtor seeks to use cash collateral or prime a prepetition secured creditors' interests as part of a post-petition financing arrangement (i.e., in priming a secured claim with a DIP loan), or if the secured creditor requests relief from the automatic stay that is denied, s 361 of the Bankruptcy Code requires the debtor to provide the secured creditor with adequate protection of its interest in property (ABI Report (n 18) 69). 'Foreclosure value' means the net value the secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the encumbered asset outside insolvency.

⁶⁵ ABI Report (n 18) 215.

⁶⁶ *Ibid.*, 207-211.

amount at the time of the petition- it has received the value of its rights under nonbankruptcy law.⁶⁷

Legal scholars have proposed other (more radical) variations of the so-called ‘relative priority rule’ in order to limit somehow the protection that secured creditor enjoy in a insolvency scenario. For example, treating a fixed fraction of every secured claim as an unsecured claim (10%) or an adjustable priority rule according to which claims of non-adjusting creditors would not be subordinated to secured claims to which they were non-adjusting.⁶⁸ Other approaches have focused on establishing a legal cap on the extent to which debtors could create security interests in their assets, a cushion that should remain available for unsecured (or at least nonconsensual) creditors: i.e., that a carve out of 20-25% of the value of the debtor’s assets should be preserved for non-adjusting creditors; imposing secured lenders some ownership-based liability.⁶⁹

Conversely, another group of academics concludes otherwise.⁷⁰ They point out that, at the same time that secured creditors may try to maximize their return at the expense of other stakeholders, unsecured creditors and shareholders often pull the process in the opposite direction. A group that would get nothing by an immediate liquidation will resist it even if the liquidation is a preferable option for the whole body of creditors, both secured and unsecured, acting as a sole owner. Furthermore, the moral hazard risk becomes especially intense in insolvency and the risk of overinvestment particularly acute.⁷¹ Thus, the opportunism risks run in both directions. The critics of the relative priority rule approach accept that under-secured creditors with a lien on all of the debtor’s assets should pay administrative expenses, since the restructuring proceedings are run for their benefit. They also accept that there are also reasons to justify that they partially return to non-adjusting creditors. But they do not see any convincing reason to surcharge secured creditors in favor of unsecured creditors when a secured claim is not paid in full. For them, there are no entirely persuasive arguments to undermine the debtor’s ability to grant a lien in a going-concern surplus.⁷²

⁶⁷ Jackson (n 5) 186.

⁶⁸ Bebchuk & Fried ‘Further Thoughts’ (n 1) 4; considering also other alternatives see Jacoby & Janger (n 3) 717-721; for a reference to the 10% fund for distribution among unsecured creditors, see also Walters (n 60) 553 n 65.

⁶⁹ See the references in Adler & Triantis (n 17) 571. See also D’Onfro (n 2) 1421-1423.

⁷⁰ See, with further references, Barry E Adler, ‘Priority in Going-Concern Surplus’ (2015) 3 U Ill L Rev 811; Adler & Triantis (n 17) footnote 33, 579: ‘...this conclusion is a non-sequitur. Although the bankruptcy process may be an indispensable element in the preservation of going-concern value, this observation merely begs the question of to whom such value should belong... the secured creditors’ entitlement to going concern surplus has a contractual basis that may well reflect an efficient ex ante priority allocation;’ ‘this broad [going concern] value pledge is perfectly consistent with the efficiency enhancing objective to discourage overinvestment’.

⁷¹ Adler & Triantis (n 17) 579-580.

⁷² Adler (n 70) 814.

3 Positive Law: How to Involve Secured Creditors in Restructuring Proceedings

In this section we will offer a brief description of how positive law has tried to strike a balance between those two relatively conflicting policies, taking the Directive and US Chapter 11 as references. In particular, we will focus on two main issues: (a) whether and under what conditions secured creditors may be affected by the stay; (b) whether they can be ‘dragged along’ by a restructuring plan, i.e. whether a plan can be crammed down upon secured creditors. As will be explained, restructuring frameworks, in general, protect the value of the secured creditors’ claims, but limit their rights to determine *how and when* they realize their collateral.⁷³ The final goal is twofold: to ensure that a secured creditor is not able to thwart a debtor’s restructuring that works to the benefit of all creditors (hold-out strategies) but, at the same time, to prevent giving ordinary creditors value at the expense of secured creditors that they could not enjoy outside bankruptcy (expropriation strategies).

3.1 Stay

Both the Directive and the US Chapter 11 extends the scope of the stay to both secured and unsecured creditors. During the stay period, secured creditors are stayed from exercising the pre-insolvency foreclosing rights. The stay may be particularly relevant when the assets encumbered are firm-specific, i.e. they are not easily replaceable so that the firm’s value may be seriously affected by the withdrawal of the asset.⁷⁴ If secured creditors could foreclose immediately on the debtor’s assets, it would crater the debtor’s rehabilitation at the outset.

3.1.1 Directive

The Directive establishes a moratorium or stay of individual enforcement actions to allow negotiations to take place and to fend off hold-out creditors, or simply to prevent collective action problems (article 6 (1)). During this period, the debtor is under no obligation to open insolvency proceedings, and the stay also prevents creditors from requesting the opening of such proceedings (article 7 (1) and (2)).⁷⁵ The stay may be ordered in respect of all types of creditors, including *secured creditors*, and may be general, covering all creditors, or limited, covering one or more individual creditors or categories of creditors, that have been informed of the negotiations in accordance with national law (article 6 (2) to (3)). However, they may be excluded when their enforcement is not likely to jeopardise the restructuring of the business, or the stay would unfairly prejudice them (article 6 (4)).

The Directive envisages *certain general safeguards*. Concerns that creditors might be negatively affected by the stay are addressed by provisions on the *duration of the stay*, the

⁷³ Tabb (n 52) 7.

⁷⁴ Ayotte (n 13) 3.

⁷⁵ However, Member States may derogate from these provisions when the debtor is unable to pay its debts as they fall due (art 7 (3)).

conditions for its renewal and the *conditions for lifting the stay*. In principle, the stay should be granted for a period of no more than four months (article 6 (6)). The Directive, however, allows Member States to decide that in complex restructurings, extensions of this period may be granted by the judicial or administrative authority, providing there is evidence that negotiations on the restructuring plan are progressing; that creditors are not unfairly prejudiced, or insolvency proceedings that could end in liquidation have not yet been opened (article 6 (7)). If further extensions are granted, the judicial or administrative authority should be satisfied that there is a strong likelihood that a restructuring plan will be adopted. Furthermore, creditors should have the right to challenge the stay once it has been granted by a judicial or administrative authority. This is the case when the stay is no longer necessary with a view to facilitating the adoption of a restructuring plan, for example because it is clear that there is a lack of support for the restructuring from a majority of creditors as required by national law (article 6 (9) (a)). But also when so provided by national law, if creditors would be unfairly prejudice by the stay (article 6 (9) (c)), or stay would give rise to the insolvency of a creditor (article 6 (9) (d)). Under these circumstances, creditors should be able to ask that the stay be lifted. Where a judicial or administrative authority does not take a decision on the extension of a stay of enforcement before it lapses, the stay should cease to have effects on the day the stay period expires. The total period of the stay should be limited to twelve months (article 6 (8)).

The Directive does not envisage specific measures of protection addressed to secured creditors, but general safeguards. To ensure that the creditors do not suffer detriment, the stay should not be granted or, if granted, should not be prolonged or should be lifted when creditors are unfairly prejudiced by the stay of enforcement (article 6 (9) (c)). Some criteria to apply the test of ‘unfairly prejudiced’ are provided for in Recital 36 and 37:

[...] In establishing whether there is unfair prejudice to creditors, judicial or administrative authorities may take into account whether the stay would preserve the overall value of the estate, whether the debtor acts in bad faith or with the intention of causing prejudice or generally acts against the legitimate expectations of the general body of creditors.

[...] A single creditor or a class of creditors would be unfairly prejudiced by the stay if for example their claims would be made substantially worse-off as a result of the stay than if the stay was not granted, or if the creditor is put more at a disadvantage than other creditors in a similar position.

Only the last sentence may provide some comfort to secured creditors. A secured creditor may claim that the value of the encumbered asset is or will substantially diminish during the stay and this could make its secured claim ‘substantially worse-off as a result of the stay than if the stay was not granted’.⁷⁶ The inclusion of the adverb ‘substantially’, however, raises the threshold, and may make it difficult in practice to obtain a lifting of the stay. In contrast, the

⁷⁶ See Directive, Recital 37.

Directive does not cover provisions on compensation or guarantees for creditors of which the collateral is likely to decrease in value during the stay.⁷⁷

3.1.2 US Chapter 11

The regulation of the stay in the US Chapter 11 is more detailed, in particular with regard to secured creditors. According to 11 USC 362 (a) (4), a secured creditor is automatically stayed from exercising its non-bankruptcy foreclosure rights. The stay may last until the proceedings are closed.

But, unlike the Directive, it envisages certain safeguards addressed to secured creditors. Under Chapter 11, secured creditors have a specific remedy: a right to adequate protection and the power to lift the stay if adequate protection is not provided (11 USC 362 (d) (1)). That is, secured creditors can demand that the stay be lifted unless their interests in the debtor's encumbered assets are adequately protected. Adequate protection entails protecting the secured creditor from a decrease in the value of the collateral during the stay period, but in principle it does not seem to be entitled to compensation for the loss of the time value.⁷⁸

3.2 Cram-down

Both the Directive and the U.S. Chapter 11 envisage the possibility of extending a restructuring plan to secured creditors as well. However, both contain safeguards to protect their pre-insolvency rights, and in particular the value of their secured claims. In broad terms, secured creditors may be impaired but the value of the collateral must not be affected, i.e. they may receive an instrument with different terms and conditions but with the same present value and secured by the same or equivalent collateral.

3.2.1 Directive

According to the Directive, a restructuring plan can become binding on dissenting parties within the same class (*'intra-class cram down'*) if certain conditions are met, in particular if (i) a majority in value (*'claims or interest'*) has voted in favor of the plan (Article 9 (6) and article 10 (2) (a))⁷⁹, (ii) creditors with sufficient commonality of interest in the same class are treated equally, and in a manner proportionate to their claim (article 10 (2)(b)), (iii) notification of the restructuring plan has been given in accordance with national law to all affected parties (article 10 (2)(c); and (iv), the plan complies with the best interest of creditor test (article 10 (2)(d)). The decision by classes may be justified by a simple idea: when a qualified majority of the creditors who are impaired looks at the plan and votes for it, they likely believe that the benefits of the plan compensates for the cost they are suffering. Furthermore, it prevents hold-out

⁷⁷ *ibid.*

⁷⁸ See (n 49). See also, Tabb (n 52) 7. However, see Baird & Jackson (n 47) 99, with further references (a compensation to secured creditors for the loss of the time value may prevent dilatory strategies by junior creditors and shareholders).

⁷⁹ In addition, Member States may require a double majority, that is, a majority in the number of affected parties in each class. In any event, majorities shall not be higher than 75% of the amount of claims or interests or of the number of affected parties (art 9 (6)).

strategies by a minority of creditors. The compliance with the best interest of creditor test prevents expropriations by the majority: it requires that no dissenting creditor be worse off under the plan than they would be in the event of liquidation (either piecemeal or by sale as a going concern), or in the next-best-alternative scenario if the normal ranking of liquidation priorities under national law were applied.⁸⁰ As regards the formation of classes, the Directive ensures that rights which are substantially similar are grouped in order to be treated equitably in the plan.⁸¹ Accordingly, it requires that *‘as a minimum, secured and unsecured claims shall be treated in separate classes’* (article 9 (4)). In practice, however, secured creditors whose claims benefit from different collateral should vote in different classes.⁸²

Furthermore, once the plan has been approved by a minimum of voting classes (article 11(1)(b)), the Directive also envisages the possibility that the plan becomes binding upon one or more dissenting classes (*‘cross-class cram-down’*) if certain conditions are fulfilled. In addition to the conditions mentioned above, the plan can be ‘crammed down’ if 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 no class of affected parties can, under the restructuring plan, receive or keep more than the full amount of its claims or interests (article 11(1)(c)(d)). Alternatively, Member States could 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’) (article 11(2)).⁸³ With regard to secured creditors, that means that they may be ‘crammed down’ under such conditions. Member States have discretion in implementing the concept of ‘payment in full’, as long as the principal of the claim and the value of the collateral are protected.⁸⁴ The Directive does not however contain any further indication about the application of the absolute priority rule as regards to secured claims.

3.2.2 Chapter 11

U.S. Chapter 11 also establishes the possibility to cram down secured creditors, but contains a more detailed regulation of the application of the absolute priority rule in this case. In particular, clarifying two key issues in this context: valuation and timing, i.e. *how* collateral’s value is to be determined and *when* it is to be determined. The rules are spelled out in USC

⁸⁰ Directive, art 2 (1) (6).

⁸¹ Directive, Recital 44.

⁸² This is not explicitly stated in the text, but derives from the fact that when the encumbered assets are separated, it is difficult to argue that all secured creditors have a substantially similar interest, see K Klee, ‘All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code’ (1979) 53 Am Bankr L J 133, 150; Baird & Jackson (n 47) 106; Tabb (n 52) 8. An exception occurs when claims of secured by a lien of the same rank (e.g. a bond secured by a single mortgage).

⁸³ Directive, Recital 55.

⁸⁴ Directive, Recital 55.

section 1129 (b) (2) (A). This section lists three alternative circumstances under which a plan can be extended to secured creditors. Summarily: ⁸⁵

(i) First, *the debtor or a transferee retain the collateral, with the secured creditor retaining a lien on that collateral*, and receiving payments under the plan with a present value equal to the amount of the allowed secured claim. In this case, if the debtor seeks to cram down the secured creditor by cashing it out with the judiciary appraised price, the secured creditor may make use of paragraph 1111 (b) (2) election. In an under-secured claim, the creditor thus has a choice: It can elect to have the debt treated as completely secured — the so-called § 1111(b) election — or it can allow the claim to be bifurcated into unsecured and secured portions. Under 1111 (b) (2) election, the secured creditor may elect to have its entire claim treated as secured, but it must give up its unsecured claim. Thus, if the creditor believes that market prices are rising rapidly, the 1111 (b) (2) election can prevent the debtor from stripping off the unsecured portion of the debt. Then if the property value goes up, but the reorganization is unsuccessful and the property is liquidated, the election preserves the full value of the claim rather than the value of the collateral on the effective date of the plan.⁸⁶ The real importance of this election is to protect a secured claim against the risk that the debtor will cram it down at a low value determined by the court.

(ii) Second, that *the collateral is sold free and clear* (with the secured creditor having the right to a credit bid), *and with the secured creditor's lien attaching to the proceeds of the sale* and with this lien being dealt with under the first (supra (i)) or the third option (infra (iii)). In principle, the right to a credit bid allows the secured creditor to protect the liquidation value of its collateral, but this realization value would be limited to the encumbered piece of collateral. The problem that credit bidding raises in practice is that it may be used by the secured creditor to capture all of the debtor's reorganization surplus to the detrimental of junior classes.⁸⁷

(iii) Or third, that *the secured creditor realizes the 'indubitable equivalent' of its secured claim*, which may include surrender of the collateral to the secured creditor or substitution of replacement collateral. In this third case, secured creditors are forced to give up their collateral and to take something else provided they receive the 'indubitable equivalent'.

Note that each alternative corresponds to the three general means by which the collateral may be realized in the restructuring proceedings: the debtor keeps the collateral, the collateral is sold, or the collateral is delivered to the secured creditor.

⁸⁵ For a detailed explanation of those three options, and their consequences, Tabb (n 52) 9-39; also Klee (n 82) 150-162; Brian P Hanley, 'Preserving the Secured Creditor's Bargain in Chapter 11 Cramdown Scenarios' (2014) 8(2) Brooklyn J Corp Fin & Comm L 494; with many details Charles D Booth, 'The Cramdown on Secured Creditors: An Impetus towards Settlement' (1986) 60(1) Amer Bankr L J 69, 87.

⁸⁶ Note, however, that the payments made to the secured creditor need only have a present value as of the plan's effective date equal to the collateral appraised value, in 'present value' money. Thus, if the debtor does not default, but instead completes payments under the plan, the fact that the secured creditor had a lien securing the full principle amount is irrelevant; see Tabb (n 52) 17; with a numerical example, Klee (n 82) 158-159.

⁸⁷ On the issue of credit bidding and the loan-to-own phenomenon, Brubaker (n 55); Tabb (n 52) with further references; ABI Report (n 18) 146-148.

Thus, both in the Directive and in the US Chapter 11, secured creditors can be temporally deprived of the right to individual foreclosure, and they cannot veto a restructuring plan, but not be deprived of the assurance that the value of the encumbered asset will be devoted to the payment of their secured claims. They enjoy a full protection of their rights measured by the value of their collateral. The key question, however, is when and how to determine such value, since for secured creditors value and timing are of the essence. In fact, the main policy discussion revolves around whether, and under what conditions, the debtor may pick the time when it wants to either redeem or sell the collateral, and whether it may redeem or sell without competition from the secured creditor, at a price set by the court or at auction. Note that, if the debtor has control of these circumstances, he may pick a time when the market may be temporally depressed, and at a price fixed by an expert and confirmed by the bankruptcy court, and redeem the asset, without the secured creditor having the chance to submit a bid if credit-bidding were not allowed.⁸⁸ The possibility of credit-bidding reduces the risk of opportunistic behavior by the debtor, as long as it allows secured creditors to cash out the collateral for more value (i.e., bidding for the asset with the full value of their credit and waiting to sell the asset later under better conditions, where they can recover at least the value of their credit or even obtain more value).⁸⁹

3.3 DIP financing and secured creditors (post-commencement privilege) (s 352(d) US Code)

In the proximity of insolvency, an absolute protection of earlier creditors may deter the financing of even profitable projects ('debt overhang'). Since new creditors may be junior to senior creditor, the former may not be willing to finance a profitable project when there is a serious risk that if the company eventually falls into insolvency proceedings they would recover nothing. This is particularly the case when the old creditor's priority covers all or almost all debtor's assets. In the bad state (i.e., bankruptcy), the (old) senior creditor's priority may absorb the new creditor's investment, whereas in the good state the profitability of the project may not be sufficient to compensate the new creditor's risk.⁹⁰ In such a case, new creditor's priority would be necessary to exploit profitable projects. This is the rationale behind the Debtor-In-Possession financing priority, in particular, considering that transaction costs and hold-out strategies may impede a timely contractual solution to the debt-overhang problem.⁹¹ In this regard, as we have seen, restructuring proceedings work as liquidity providers, as long as they reduce the cost of financing the plan .

A confirmed restructuring plan addresses the overhang problem by a compulsory reduction of the amount of the pre-commencement claims (cramdown). However, prior to or during the negotiation of the plan, there usually are urgent needs of finance that must be address before the plan is confirmed. Otherwise the going concern value may disappear while the plan is being negotiated. Thus, in many jurisdictions the courts may authorise debtor-in-possession finance that takes priority over unsecured creditors. The question is whether it should also take priority over secured creditors if need be.

⁸⁸ For an example, see Tabb (n 52) 20.

⁸⁹ *Ibid.*, 20-21.

⁹⁰ Adler & Triantis (n 17) 7 with a numerical example.

⁹¹ *Ibid.*, 8.

The Directive does not go that far. It only obliges Member State to rank in subsequent insolvency procedures new and interim finance senior to other creditors that would have equal or superior claims (article 17 (4)). U.S. Chapter 11 goes further and permits the court to authorize debtor-in-possession financing that takes priority even over secured creditors.⁹² According to 11 USC § 364 (d), the court may authorise the obtaining of credit secured by a senior or equal lien on property of the estate that is subject to a lien if (a) the trustee is unable to obtain such credit otherwise; and (b) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.⁹³

4 Concluding Remarks

As we have seen, there are good reasons to involve secured creditors in restructuring plans and force them to cooperate with other stakeholders, in particular in a scenario where secured lending has dramatically increased over the years. Solutions like staying the enforcement of secured claims when the collateral is necessary for restructuring the company or extending the plan to dissenting secured creditors may contribute to reduce the opportunism of these creditors that may thwart the adoption of an efficient plan (hold-out strategies). However, in order to avoid any form of expropriation, their involvement in restructuring plans should not redistribute value *ex post* for the benefit of other stakeholders. Redistributive solutions will not only disregard the relative value of those claims, but may also exacerbate creditors' interest for finding close substitutes with which to 'bypass' the restrictions imposed to secured claims. Different proposals have been made to overcome non-justified transfers of value (e.g., secured creditors are forced to share value with junior classes when the value of their claims has not been fully covered), or non-justified restrictions of secured creditors' individual rights (e.g., secured creditors are forced to finance the distressed debtor). Nevertheless, it still remains open to the debate to what extent secured creditors can invoke their priority to appropriate the going concern surplus created by the reorganization.

⁹² See also, Madaus & Wessels (n 55) 218, with references to Belgium Law.

⁹³ On the concept of 'adequate protection' in this context, Adler & Triantis (n 17) 9.