European Insolvency and Restructuring Journal
Academic Article
EIRJ-2022-7
eirjournal.com

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European Insolvency and Restructuring Journal

Strategic behaviours and priority rules in debt restructuring

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Abstract

The paper analyses the correlation between the various categories of strategic behaviours that may be adopted by the parties involved in a debt restructuring and the three types of priority rules that might apply: the so called "absolute priority rule" and "relative priority rule" and a rule that can be named "no priority rule". More specifically, the article offers an overview of the literature concerning the opportunistic behaviours in a debt restructuring and reports a lack of categorisation and agreement on the meaning of the terms used to label such behaviours, revealing how this negatively affects the discussion on priority rules. Therefore, the paper aims at filling such gap, by presenting a systematic analysis of four categories of strategic behaviour: "holdout", "holdup", "free-riding" and "rent-seeking". On the basis of such categorisation, the paper proceeds with an analysis of the ways in which each category of opportunistic behaviour is affected by the application of each of the "absolute priority rule", the "relative priority rule" and the "no priority rule".

1. Introduction

Over the last decades, the literature concerning the absolute priority rule ("APR") and the relative priority rule ("RPR"), and the superiority of one over the other, has been prolific. The recent approval of the so-called "European Preventive Restructuring Directive" (the "Restructuring Directive"), which elected the RPR as the rule of choice, although allowing Member States to adopt the APR,[1] has ignited the debate. Similarly, the recent introduction of the new UK restructuring tool – the so-called "restructuring plan procedure" – which allows cross-class cram-down without imposing any priority rule,[2] has inspired further thoughts. The literature regarding the priority rules has often taken into consideration the opportunistic behaviours the application of each rule allows or prevents. In particular, deviations from the APR, as well as the introduction of the RPR, have been analysed in relation to certain forms of strategic behaviours, which have been labelled, as the case may be, "holdout", "holdup", "free-riding" or "rent-seeking". However, while in some instances different labels are utilised as synonyms to identify the same substantial problem, in some other cases the same label is attached to issues that ought to be distinguished.

As this paper will argue, each of the above-mentioned labels refers to a specific concept, and therefore a specific type of behaviour, and ought to be characterised and assessed separately. Such behaviours, moreover, are differently affected by each of the APR, the RPR and a rule of "no priority" ("NPR"), hence the analysis of such rules should take into consideration and balance all the effects of same on the various forms of strategic behaviours. However, this paper does not engage in a discussion on what the most appropriate priority rule is, but aims at setting

[1] European Parliament and Council Directive (EU) 2019/1023 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/EU (Directive on restructuring and insolvency) [2019] OJ L 172 (Restructuring Directive), recitals 55-57, art 11.

[2] UK Companies Act 2006 (CA 2006), pt 26A, ss 901F and 901G.

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a common ground on which such discussion could take place. Indeed, setting a clear and accurate foundation of definitions and categories is pivotal to ensure that all contributors fully understand each other, thus encouraging a more efficient discussion on the substance. In turn, providing an exhaustive and detailed set of definitions and categories requires an exhaustive, thorough and systematic analysis of the various forms of (strategic) behaviours that may occur in a debt restructuring, and of the ways each priority rule helps (or fails) to address them. This paper proposes to engage in such systematic analysis, which – to the author's best knowledge – has never been offered in the context of insolvency law.

As a preliminary remark, it must be specified that the analysis offered through this article is limited to the opportunistic behaviours engaged in the context of a debt restructuring procedure aimed at rescuing the company or the business as a going concern,[3] as opposed to those procedures aimed at piecemeal liquidation. The former types of debt restructuring have become more and more frequent over the last decades, particularly in those countries embracing a rescue culture. This trend is expected to grow in the wake of the crisis originated by the Covid-19 pandemic, which has affected numerous otherwise viable companies that deserve to be rescued. Moreover, although the analysis is not limited to one or more specific jurisdictions, some references will be made to both the new UK restructuring plan procedure and the U.S. Chapter 11, as well as to specific provisions of the new Restructuring Directive. The paper proceeds as follows: Section 2 offers an overview of the literature addressing the opportunistic behaviours in debt restructuring, revealing an inconsistent use of terms and a lack of clear and uniform definitions; Section 3 presents a systematic analysis of four categories of opportunistic behaviour, namely holdout, holdup, free-riding and rent-seeking; Section 4 analyses in turn three different priority rules – the APR, the RPR and the NPR – and illustrates how they affect each of the four categories of opportunistic behaviours analysed in Section 3. Section 5 concludes.

2. The state of the art

Numerous studies in the field of economics have shown that the decision-making process of economic agents is imbued with both other-regarding behaviour and strategic considerations.[4] In particular, in the so-called ultimatum game – ie the game in which an agent gets to decide how to divide a certain sum of money between herself and another agent and the latter can decide whether to accept such division or to reject it so that both parties get nothing – the participants' behaviour is influenced by both altruism and strategy. Other-regarding attitudes could be associated with the concept of fairness, as it has been demonstrated that the agent's willingness to share a surplus is partly influenced by equity-driven considerations typically linked to the opponent having earned or somehow deserving to be remunerated for certain abilities or efforts.[5] At the same time, strategic considerations stem from the concern that the opponent might reject the offer, thus preventing both agents from being

[3] S Madaus, 'Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restructuring Law' (2018) 19(3) European Business Organization Law Review 615. For a distinction between "business rescue" and "corporate rescue", see S Frisby, 'Of rights and rescue: a curious confluence?' (2020) 20(1) Journal of Corporate Law Studies 39, 52.

[4] D Kahneman, JL Knetsch and RH Thaler, 'Fairness and the Assumptions of Economics' (1986) 59(4) The Journal of Business 286-292; BJ Ruffle, 'More is Better, But Fair is Fair: Tipping in Dictator and Ultimatum Games' (1998) (23) Games and Economic Behavior 249, 250.

[5] The notion of "fairness" falls outside the scope of this paper. For a wider analysis of such concept in the framework of the English restructuring tools see S Paterson, 'Debt Restructuring and Notions of Fairness' (2017) 80(4) The Modern Law Review.

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better off.[6] It goes without saying that a debt restructuring procedure is extremely more complicated than an ultimatum game for manifold reasons, including the variety of agents engaged and the diversity of their interests, the complexity of the procedure itself and the number of substantial rules that apply; moreover, any offer – before being rejected or accepted – may lead to a lengthy negotiation that might be detrimental for many of the parties involved. Hence the decision-making process engaged in by the parties involved in a restructuring – and, particularly, the opportunistic stances of some of them, on which this paper focuses – take various forms and names.

The most common term used when discussing opportunistic behaviours in debt restructuring is "holdout". This word has been used originally in the context of out-of-court bond workouts, to indicate the behaviour of bondholders denying their consent to the restructuring of the bond terms in the hope that the sacrifice borne by the consenting bondholders be sufficient for the company to emerge from distress and repay the dissentients the full amount of their claims.[7] Hence, in this context, the "holdouts" are those who "sit back" and wait, exploiting the sacrifice of their fellow bondholders, and the term is often used as a synonym for "free-rider".[8] By contrast, in the context of in-court restructuring procedures, authors have used the label "holdout" in relation to both the debtor and the creditor. Particularly in SMEs and in the context of those proceedings aimed at rescuing the company as a going concern, the management of the company in distress finds itself holding the whip hand, as it is often the only subject able to navigate the firm through the restructuring of its indebtedness. The managers' expertise and thorough knowledge of the company, indeed, means they are essential not only for the interim period (ie the one between filing and sanction) but also for the entire duration of the restructuring phase, which may last years. Consequently, they are in the position to impose their conditions (ie a high remuneration for their service or a return on their shares, where they are also shareholders) by the mere threat of leaving

[6] According to certain authors, in a setting of stylised legal bargaining (such as civil litigation), strategic considerations outweigh fairness-driven attitudes (see P Pecorino and MV Boening, 'Fairness in an Embedded Ultimatum Game' (2010) 53(2) The Journal of Law and Economics 285, 286).

[7] MJ Roe, 'The Voting Prohibition in Bond Workouts' (1987) 97(2) Yale Law Journal 232, 236ff; R Gertner and D Scharfstein, 'A Theory of Workouts and the Effects of Reorganization Law' (1991) 46(4) The Journal of Finance1189, 1191; J Helwege, 'How Long Do Junk Bonds Spend in Default?' (1999) 54(1) The Journal of Finance341, 348-349; S Ghosal and M Miller, 'Writing-Down Debt with Heterogeneous Creditors: Lock Laws and Late Swaps' (2015) 6(2) Journal of Globalization and Development 239, 244ff; LS Peterson, 'Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers' (1993) 103(2) Yale Law Journal 505, 513ff; H Eidenmüller and K van Zwieten, 'Restructuring the European Business Enterprise: the European Commission's Recommendation on a New Approach to Business Failure and Insolvency' (2015) 16(4) European Business Organization Law Review 625, 631; H Eidenmüller, 'Trading in times of crisis: formal insolvency proceedings, workouts and the incentives for shareholders/managers' (2006) 7(1) European Business Organization Law Review 239, 244; K Daniels and GG Ramirez, 'Debt Restructurings, Holdouts, and Exit Consents' (2007) 3(1) Journal of Financial Stability 1, 4; P Asquith, R Gertner and D Scharfstein, 'Anatomy of Financial Distress: An Examination of Junk-Bond Issuers' (1994) 109(3) The Quarterly Journal of Economics 625, 641-642; JC Lipson, 'Governance In The Breach: Controlling Creditor Opportunism' (2011) 84(5) Southern California Law Review 1035, 1055; A Krohn, 'Rethinking Priority: the Dawn of the Relative Priority Rule and the New "Best Interests of Creditors" Test in the European Union' (2021) 30(1) International Insolvency Review 75, 77).

[8] Eidenmüller (n 7) 244; Asquith, Gertner and Scharfstein (n 7) 641-642; WW Bratton and AJ Levitin, 'The New Bond Workouts' (2018) 166(7) University of Pennsylvania Law Review 1597, 1607-1608; J Armour and S Deakin, 'Norms in Private Insolvency: The London Approach to the Resolution of Financial Distress' (2001) 1(pt 1) Journal of Corporate Law Studies 21, 25-26.

the firm; such behaviour is often labelled with the term “holdout”. Turning to the position of the creditors, “holdout” has been used to indicate those creditors who have a blocking position (ie claims that exceed the majority threshold required to veto a restructuring plan) and decide to preventatively deny their consent in order to force the debtor and the other creditors to grant them full recovery or, at least, a higher recovery than the one originally proposed.[9] In this latter meaning, then, “holdout” is used to indicate a ransom threat, under which a positive vote allowing the restructuring plan to succeed is offered in exchange for a higher and “disproportionate” recovery,[10] or a negative vote is threatened in order to be granted full recovery.[11] Such behaviour may be prevented by the existence of a (cross-class) cram-down clause, under which the restructuring plan can be imposed on (classes of) dissentients, subject to certain conditions being met. However, in this context certain proponents of the RPR have claimed that, even when cram-down applies, the APR may still be conducive to holdouts, and therefore the RPR is preferable.[12] Some other authors, instead, have used the term “holdout” with a broader meaning, to indicate either the mere withholding of consent (without any ransom threat), or the simple delaying of the restructuring procedure, claiming that the only way to address this latter issue is to prevent any early determination of class composition, valuation etc., which may invite costly and lengthy litigation.[13]

Another label, which is relatively common in literature, is “holdup”. This term is sometimes used as a synonym for “holdout”, with the narrower meaning described above.[14] In a recent paper, Professor Casey defined holdup behaviour in terms of a threat exercised by one party, aimed at extracting value from the counterparty, through the exploitation of *ex ante* contract incompleteness and firm-specific investments made by the latter.[15] Such threat may,

[9] See Brown and Skeel, who also use the terms “veto game” and “veto power” (DT Brown, ‘Claimholder Incentive Conflicts in Reorganization: The Role of Bankruptcy Law’ (1989) 2(1) Review of Financial Studies 109; DA Skeel, ‘Distorted Choice in Corporate Bankruptcy’ (2020) 130(2) The Yale Law Journal 366); J Seymour and SL Schwarcz, ‘Corporate Restructuring under Relative and Absolute Priority Default Rules: A Comparative Assessment’ (2021) (1) University of Illinois Law Review 1, 30; RJ de Weijs, AL Jonkers and M Malakotipour, ‘The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing “Relative Priority” (RPR)’ [2019] Amsterdam Law School Legal Studies Research Paper No. 2019-10 <https://ssrn.com/abstract=3350375> accessed 19 April 2021, 6; RJ de Weijs, ‘Too big to fail as a game of chicken with the state: what insolvency law theory has to say about TBTF and vice versa’ (2013) 14(2) European Business Organization Law Review 201, 210ff; Madaus (n 3) 635-636; G Ballerini, ‘The Priorities Dilemma in the EU Restructuring Directive: Absolute or Relative Priority Rule?’ (SSRN 21 July 2020) <https://ssrn.com/abstract=3661191> accessed 24 April 2021, 19ff.

[10] Skeel (n 9) 375.

[11] Stanghellini and others, *Best Practices in European Restructuring - Contractualised Distress Resolution in the Shadow of the Law*, (Wolters Kluwer - CEDAM 2018) 46.

[12] ibid; R Mokal and I Tirado, ‘Has Newton had his day? Relativity and realism in European restructuring’ [2019] Butterworths Journal of International Banking and Financial Law 233, 235.

[13] NWA Tollenaar, *Pre-Insolvency Proceedings: a normative foundation and framework* (1st edn OUP 2019) 190; Tollenaar uses it to indicate the position of the debtor who has the exclusive right to propose a plan, leading to protracted negotiations and thus undue delay (NWA Tollenaar, ‘The European Commission’s Proposal for a Directive on Preventive Restructuring Proceedings’ (2017) 30(5) Insolvency Intelligence 65, 73).

[14] AJ Casey, ‘The Creditors’ Bargain and Option-Preservation Priority in Chapter 11’ (2011) 78(3) The University of Chicago Law Review 759, 789 and 796; Lipson (n 7) 1057; Ballerini (n 9) distinguishes the two labels but ends up using them interchangeably; Krohn (n 7) 87; Armour and Deakin (n 8) 26, 42.

[15] AJ Casey, ‘Chapter 11’s Renegotiation Framework and the Purpose of Corporate Bankruptcy’ (2020) 120(7) Columbia Law Review 1709, 1715ff.

according to Professor Casey, assume various forms: from the debtor's threat of filing for bankruptcy in order to reduce a senior creditor's claim, to a creditor's threat to deny a positive vote which is necessary for the company's rescue or an essential supplier's threat to terminate an essential executory contract for a pre-petition breach, demanding a higher price for post-petition continuation.[16] In Casey's paper, "holdup" and "holdout" are used interchangeably to indicate the same type of "ransom" behaviour, and it is claimed that the main role of a priority rule is to prevent it.[17] By contrast, other authors have used the term "holdup" more broadly, to indicate a delaying tactic, through the lengthening of the time spent in bankruptcy "*in order to negotiate for a portion of the claims of the reorganised firm*".[18] In this latter sense, "holdup" encompasses all delaying behaviours that creditors or shareholders may engage in, which may not explicitly consist in threats, but may indirectly threaten the successful outcome of a deal. For instance, it has been claimed that the mere prospect of valuation fights, even when they are not opportunistically pursued but reflect a sincere disagreement on the valuation proposed under the plan, encourage the plan proponents to offer a (higher) return to the opposing creditors, in order to avoid litigation.[19] In this context, deviations from the priority rules are considered necessary to prevent such delays, with a view to avoiding further bankruptcy expenses and facilitate the restructuring.[20]

A further term often used in literature is "rent-seeking", which generally refers to the so-called "priority jumps" that certain creditors are able to engage in, for a variety of reasons, ranging from a privileged status resulting from lobbying to the fact that their cooperation is necessary for the rescue of the business or the company.[21] More specifically, rent-seeking has been defined as the behaviour of those creditors who "*contest existing distribution rules and seek categorical changes to improve their private bankruptcy return*".[22] Within this strand of literature, the label is attached, *inter alia*, to the so-called "critical vendors" – who are deemed to exploit the fact that their continued relationship with the debtor is necessary for the business to be rescued as a going concern – in order to "*jump the queue*" and be paid in full before any other creditor, regardless of their unsecured status.[23] Thus, according to this literature, rent-seeking is a form of ransom behaviour, aimed at extracting value from other creditors. Certain authors, indeed, have argued that when suppliers, employees and other counterparties, "*acting as prepetition creditors, are undermining the collective proceeding and the judge has an ability to do something about it*", then the opportunistic behaviours should be countered.[24] From this statement, it seems correct to infer that, in these authors' opinion, if these creditors demand the payment of pre-petition claims in return for maintaining their relationship with the debtor, they are in fact acting opportunistically. By contrast, other authors have used the term in a rather different way,

[16] ibid 1756ff, 1766.

[17] ibid 1709.

[18] DN Layish, 'A Monitoring Role for Deviations from Absolute Priority in Bankruptcy Resolution' (2003) 12(5) Financial Markets, Institutions & Instruments 377, 380 (note 7); although not expressly defined, this seems to be the meaning ascribed to holdup by LoPucki and Whitford (LM LoPucki and WC Whitford, 'Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1990) 139(1) University of Pennsylvania Law Review 125, 184).

[19] ibid 130, 144ff.

[20] Layish (n 18) 380.

[21] DG Baird, AJ Casey and RC Picker, 'The Bankruptcy Partition' (2018) 166(7) University of Pennsylvania Law Review 1675, 1692ff.

[22] MJ Roe and F Tung, 'Breaking bankruptcy priority: How rent-seeking upends the creditors' bargain' (2013) 99(6) Virginia Law Review 1235, 1237.

[23] Skeel underscores that the critical vendor "privilege" also violates the equality of creditors having the same priority (DA Skeel, 'The Empty Idea Of "Equality Of Creditors"' (2018) 166(3) University of Pennsylvania Law Review 699, 717-18).

[24] Baird, Casey and Picker (n 21) 1709.

more specifically to indicate the behaviour of those parties who strategically bribe the management to either precipitate or delay a formal bankruptcy filing.[25]

Lastly, as for the term "free-riding", this is used merely as a synonym for "holdout" and/or "holdup" – in the various and often incongruous meanings described above – without a separate definition and assessment of what the label may and should encompass within a debt restructuring.

The framework depicted above appears (*rectius*, is) particularly confusing, mainly for three reasons: first, terms tend to be utilised with a more or less broad and nuanced meaning; secondly, often a single label is used to identify completely different issues or different labels are employed to refer to the same concept; thirdly, definitions are hardly ever provided. The following Section proposes to clarify the picture, providing a clear categorisation and a systematic assessment of the different types of opportunistic behaviour.

3. Categories of strategic behaviour

Based on the literature review offered above, this article will focus on four categories of opportunistic behaviour, labelled with the four terms most commonly found in literature: holdout, free-riding, rent-seeking, holdup. Such terms will be analysed in turn, in said specific order.

3.1 Holdout

The holdout problem has been defined as the situation in which two or more parties could create value by cooperating, but one or more of them try to obtain a greater share of such value to the detriment of the other(s); if all parties holdout, the deal cannot be concluded and therefore no value can be created.[26] In an in-court restructuring procedure, rescue can be typically achieved only if a certain percentage of impaired creditors and classes vote in favour of the proposed plan.[27] Non-impaired creditors are typically excluded from the vote and the relevant majorities that are necessary for the plan to be confirmed.[28] In this context, a creditor can find herself in a variety of situations: she can be wholly in-the-money, ie entitled to fully recover her claim in liquidation or in the relevant alternative;[29] she can be partly in-the-money, ie able to recover part of her claim in the relevant alternative; or she can be wholly out-of-the-money in the relevant alternative.

In the first situation, where the creditor is fully in-the-money, the choice between liquidation and rescue is indifferent to her, as in both circumstances she would be entitled to recover the full amount of her claim;[30] therefore, either she would be excluded from the vote because the plan envisages her full repayment, or she would be entitled to vote against the plan, in case this plan envisaged the writing down of her debt or any form of impairment of her rights. In this latter scenario, her refusal to vote in favour of the plan would not be opportunistic, because the plan would not be convenient to her, as

[25] P Aghion, O Hart and J Moore, 'The Economics of Bankruptcy Reform', Journal of Law, Economics and Organization (1992) 8(3) 523, 540 (note 41).

[26] Ballerini (n 9) 23 (note 117); de Weijs (n 9) 210ff.

[27] See, for example, US Bankruptcy Code 1978, ch 11 (Chapter 11) ss 1126 and 1129; CA 2006, ss 901C, 901F and 901G; Restructuring Directive, art 9 and 11.

[28] See, for example, Chapter 11, s 1126(f); CA 2006, s 901C(4).

[29] This would assume, for secured creditors, that she is oversecured, ie that the value of the collateral securing her claim is at least equal to the value of the claim (MB Jacoby and EJ Janger, 'Tracing Equity: Realizing and Allocating Value in Chapter 11' (2018) 96(4) Texas Law Review 673, 688-89).

[30] Armour and Deakin (n 8) 45; as underscored by Tollenaar, this depends on whether under the plan she would receive cash or non-cash instruments for the full value of the claim, because in the latter case her position could be considered materially worse (Tollenaar, 'The European Commission's Proposal' (n 13) 75-76).

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opposed to a piecemeal liquidation under which she would recover her claim in full.

In the situation of a partly in-the-money creditor, instead, assuming that such creditor would get a certain (diminished) recovery in liquidation and a higher recovery in a rescue scenario, rescue does indeed represent a surplus; in this case, and assuming that the favourable vote of the creditor or the class is required in order to obtain the plan's confirmation, a holdout behaviour may assume two forms: the creditor may either deny her positive vote outright or threaten to vote against the plan or to object to it unless she is offered a higher recovery thereunder. In the first case, the other parties may decide to pay the holdout in full in order to exclude her from the vote (assuming that, under applicable law, non-impaired creditors are in fact excluded from voting). In the second scenario, instead, the other parties may decide to offer the holdout the required higher recovery in order to secure her favourable vote. In both instances, the holdout creditor is – either indirectly or directly – extracting a ransom payment because the denial of the positive vote, far from being justified by the lack of convenience of the proposed plan, is aimed at appropriating a disproportionate share of the rescue surplus, thus transferring value from the other creditors to the holdout.

In the third situation, ie of the wholly out-of-the-money creditor, the analysis depends on whether, under applicable law, such creditor is entitled to vote or is excluded from it (or a negative vote is assumed at law, as under U.S. Chapter 11)[31]; in the event she had the right to vote and the plan envisaged a recovery for her, the same considerations offered for the second situation apply.

In addition to the above, some authors subsume under the "holdout" category also the position of the shareholders-managers of the debtor and of the so-called essential counterparties who threaten to deny their collaboration to extort a slice of the pie. However, the opportunism of such participants differs from those of the holdout creditors described above, because the bargaining strength that they are able to leverage originates from a contractual relationship with the debtor. Hence, for classification purposes, this paper proposes that their position be subsumed under another category, which will be analysed under Section 3.4 below.

In light of the above, and consistently with the definition given by some authors,[32] in an in-court restructuring procedure the holdout behaviour can be defined as the opportunistic behaviour of a creditor who, albeit being aware of the fact that the proposed restructuring plan would be convenient both for herself and for the other voting creditors, denies her collaboration by threatening to vote against such plan in order to receive a disproportionate and unfair recovery (ie either get full repayment of her pre-filing claim or a higher recovery under the plan).[33] This latter type of opportunistic behaviour is often attributed, *inter alia*, to the so-called "vulture funds" or "distressed debt investors", who purchase a blocking position of claims from various creditors and holdout in the hope of getting a disproportionate share of the surplus value.[34] The easiest way to overcome holdouts is the cram-down mechanism, which

[31] Chapter 11, s 1126(g); Tollenaar stresses how creditors should be considered out-of-the-money only with reference to their position under the plan, not under the relevant alternative, otherwise more senior creditors would be entitled to appropriate surplus value that belongs to those excluded from the vote (Tollenaar, *Pre-Insolvency Proceedings* (n 13) 234-36).

[32] Seymour and Schwarcz (n 9) 30.

[33] Ballerini (n 9) 5 (note 19); Krohn (n 7) 77; Madaus (n 3) 625.

[34] Seymour and Schwarcz (n 9) 30; Skeel (n 9) 375, 397; C Howard and B Hedger, *Restructuring Law and Practice* (2nd edn, LexisNexis 2014) para 6.11; Madaus (n 3) 635-636; DG Baird and RK Rasmussen, 'Antibankruptcy' (2010) 119(4) Yale Law Journal 648, 669-71; DA Skeel and G Triantis, 'Bankruptcy's Uneasy Shift to a Contract Paradigm' (2018) 166(7) University of Pennsylvania Law Review 1777, 1800-01.

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allows the imposition of the plan on dissentients. However, as will be illustrated in Section 4, certain priority rules favour holdout behaviours even when cram-down applies.

3.2 Free-rider

According to the Oxford English Dictionary, free-riding is the form of opportunistic behaviour engaged by those who benefit from a resource without contributing to its creation or maintenance.[35] Although the effect of free-riding is the same as the holdout – ie damaging the (other) creditors – the two differs in the form of the opportunism: while the holdout engages in an active opportunism through a proper threat, the free rider remains passive by merely benefitting from the resource, without actively extracting it. In order to identify, in the context of an in-court restructuring procedure, what behaviour amounts to free-riding, it might be useful to analyse the same three situations distinguished under the previous Sub-section: creditor wholly in-the-money, creditor partly in-the-money and creditor wholly out-of-the-money in the relevant alternative.

In the first case, it is not possible to categorise the creditor as "free-rider". Indeed, a creditor who would get full recovery in the relevant alternative and gets full recovery under a rescue plan is not free-riding in the sense of obtaining a benefit at the expense of others, simply because the choice between liquidation and rescue is, economically speaking, indifferent to her. By the same token, if such creditor was offered a lower recovery under the restructuring plan and denied her favourable vote, thus obtaining full recovery under the plan, she would not be free-riding, because she would not be benefitting from a resource to which she is not entitled. In other words, in such cases the prerequisite of the "benefit" is missing, hence they fall out of the free-riding category.

In the second (and third, depending on applicable law) situation(s), it could be argued, at first, that the creditor would be both free-riding and holding out. Indeed, assuming that the creditor who is partly out-of-the-money would get a certain (diminished) recovery in liquidation and a higher recovery in a rescue scenario, rescue does indeed represent a surplus; in this case, if she subjected her favourable vote, which would increase the overall value of the estate, to the receipt of a higher recovery than her "fair share" (however fair is intended, also considering how the pre-bankruptcy entitlement and the entitlement to the rescue surplus are defined)[36], she would be effectively seeking to get a bigger slice of the increased pie.[37] However, in light of the fact that in such event the creditor would be in fact exercising a proper ransom, the circumstance should not be subsumed in the category of free-riding, which instead is characterised by a passive approach.

Conversely, it is possible to find other circumstances that, in the context of an in-court restructuring, could be categorised under the label "free-riding". A first example is the situation in which the debtor and some creditors devise a restructuring plan envisaging the full repayment of certain other creditors because they realise that including some minor creditors in the negotiations would be too much costly and lengthy, for instance when these minor creditors have very small claims but are also extremely

[35] Oxford English Dictionary: "*To (seek to) benefit in some way from the effort, sacrifice, financial outlay, etc., of others without making a similar contribution*".

[36] Jacoby and Janger (n 29) 730-33; Jacoby and Janger consider as senior creditors' pre-bankruptcy entitlement only the liquidation value of the collateral (MB Jacoby and EJ Janger, 'Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy' (2014) 123(4) Yale Law Journal 862, 920-922, 925). Contra BE Adler and GG Triantis, 'Debt priority and options in bankruptcy: policy intervention' (2017) 91(3) American Bankruptcy Law Journal 563, 580-81 and BE Adler, 'Priority in Going-Concern Surplus' (2015) 2015(2) University of Illinois Law Review 811, 816.

[37] Stanghellini and others (n 11) 46; Krohn (n 7) 77.

numerous,[38] or when it is particularly difficult to reach them. In such instances, these minor creditors obtain a benefit (ie full repayment) which is not the outcome of their active opportunism or threat (hence of a holdout behaviour), but the consequence of an opportunity cost assessment by the other parties.

In light of the above, the free-rider category encompasses those situations in which the creditor benefits at the expense of others, without engaging in an active ransom threat, as in the example given in the previous paragraph. When, by contrast, the creditor is able to free-ride on the other creditors' shoulders as a consequence of a ransom threat, the behaviour will be subsumed only under the label "holdout".

3.3 Rent-seeking

The term "rent-seeking" has been originally conceived, in the context of public policy, to indicate the "*use of resources to obtain* […] *special privileges in which the injury to other people arguably is greater than the gain to the people who obtain rents*".[39] Nowadays, the term is commonly defined as "*the fact or process of seeking to gain larger profits by manipulating public policy or economic conditions*".[40] Drawing upon these definitions, the term could be used, in the context of a debt restructuring, to indicate the behaviour of those creditors who aim at increasing their share of distributions, not only without increasing the overall value of the estate, but also by creating deadweight losses. This category of opportunistic behaviour can be distinguished both from the category of "holdout" and from the category of "free-riding". Both free-riding and holdout, indeed, assume an increase in value of the common resource and a benefit for the opportunistic creditor, either due to an active ransom threat on the part of the latter (as in the case of holdout) or due to the existence of certain contingencies or the application of specific priority rules (as in the case of free-riding). Conversely, in a rent-seeking strategy the opportunistic creditor does not benefit from an increase in the overall value of the common resource, but from a transfer of value from the other participants.

A first example of a rent-seeking behaviour is the litigation initiated by creditors that are classified, from the debtor, as out-of-the-money in the relevant alternative and therefore are either prevented from voting or deemed to be objecting to the plan.[41] These creditors may threaten to litigate the valuation on the basis of which the plan is devised, considering them out-of-the-money, and to offer an alternative valuation, which would allow to consider them (partly) in-the-money and therefore would necessitate their positive vote;[42] or they may simply try to delay an accurate valuation hoping that "*things turn out better than expected*", allowing them to receive some distribution.[43] Alternatively, rent-seeking creditors may threaten to challenge the class partitioning proposed under the plan, claiming that they should have been included in another class and therefore treated as favourably as the members of same.

Since such disputes are engaged in by creditors that either did not participate in the vote or are deemed to have voted against the plan, the behaviour is not aimed at extracting

[38] As in the sanction decision in *Re Virgin Atlantic Airways Limited* [2020] EWHC 2376 (Ch), 2020 BCC 997, [64]-[67].

[39] G Tullock, *Rent seeking* (1st edn, Edward Elgar 1993) 22.

[40] Oxford English Dictionary.

[41] For example, Chapter 11, s 1126(g), providing that a class which, under the plan, is not entitled to any distribution because out-of-the-money, is deemed not to have accepted the plan. Consistently with this view, Welch defines "rent-seeking" as the activity of creditors' lobbying and litigation (I Welch, 'Why Is Bank Debt Senior? A Theory of Asymmetry and Claim Priority Based on Influence Costs' (1997) 10(4) Review of Financial Studies 1203, 1204).

[42] LoPucki and Whitford (n 18) 130.

[43] DG Baird and DS Bernstein, 'Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain' (2006) 115(8) The Yale Law Journal 1930, 1939.

a higher value of a surplus that the opportunistic creditors can contribute to create, and therefore cannot be included under the label "holdout", which instead assumes a contribution by the opportunistic creditors to the generation of value. Moreover, the "rent" – ie the benefit, deriving to these creditors from the dispute (in the event the court decided in their favour) – would not be dependent on a mere contingency or choice of the other participants, but from an active initiative of the opportunistic creditor, and therefore the behaviour cannot be categorised as "free-riding", which covers only a passive attitude. Therefore, it is proposed here to include under the label "rent-seeking" only those opportunistic behaviours engaged in by out-of-the-money creditors who, aiming at extracting rents in the form of an undue recovery, create deadweight losses in the form of expensive and time-consuming litigation or objection to a restructuring plan.

3.4 Holdup

The holdup problem has been defined, in contract law, as the situation in which a party, who could benefit from entering into a contractual relationship requiring her to make a prior specific investment, may desist for fear that doing it could give the other party too much bargaining power.[44] This issue stems from the incompleteness of contracts, which prevents the parties from being able to foresee any possible contingency that may arise over the duration of the agreement and thus to agree in advance how they will behave in case of occurrence of such contingencies. This entails that the party who should make a contract-specific investment may fear that, in a non-foreseeable contingency, the other party may exploit the situation of economic dependence of the former, deriving from said investment, to gain an advantage.[45]

In the context of a debt restructuring, the holdup problem may be identified in relation to the creditors' decision to pursue the rescue of the company. Indeed, choosing the rescue of the company over liquidation, particularly for those creditors who are (partly) in-the-money and hope to get a greater recovery in a rescue scenario, entail a certain investment of time and money: the involved parties typically need to appoint and remunerate legal and financial advisors and to negotiate the plan with the other parties. Part of such investment is "rescue-specific" because, if rescue is not achieved, the time and money spent represent a loss. The holdup problem may arise when this rescue-specific investment increases the bargaining power of certain essential counterparties. A first example of essential counterparties are the suppliers or providers of services that are essential for the business to be carried on and the rescue to be achieved, because replacing them with other suppliers or providers would be excessively costly and time-consuming.[46] Another example is represented by pre-bankruptcy – typically secured – creditors who, after filing, agree to provide new finance necessary to the company's rescue, especially when no other creditor would be available to concede it.[47] A third example is that of managers-shareholders,[48] whose collaboration is essential to the rescue – for

[44] See Miceli and Segerson who expressly distinguish holdup from holdout (TJ Miceli and K Segerson, 'Opportunism in Sequential Investment Settings: On Strategies for Overcoming Holdups and Holdouts' (2015) www.law.umich.edu/centersandprograms/lawandeconomics/workshops/Documents/Paper%207.%20Miceli.%20Opportunism%20in%20Sequential%20Investment%20Settings.pdf accessed 24 April 2021).

[45] ibid, 12.

[46] SJ Lubben, 'The Overstated Absolute Priority Rule' (2016) 21(4) Fordham Journal of Corporate & Financial Law 581, 605-06; Baird, Casey and Picker (n 21) 1708-09); Roe and Tung (2013, pp. 1254-1258).

[47] Baird, Casey and Picker (2018, p. 1710); Roe and Tung (n 22) 1250-54.

[48] Which is particularly likely for small companies (LM LoPucki and WC Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 141(3) University of Pennsylvania Law Review 669, 688-89).

example because they know the business best and have a close and trustful relationship with commercial counterparties.[49] In these cases, the fact that the cooperation of the manager/essential creditor is indispensable for the rescue to succeed means that the counterparty (ie the debtor or the other creditors, as the case may be) might be forced to make a greater concession to her, often in terms of repayment of the pre-filing debts owed to same or in terms of maintenance of a stake in the rescued company. These concessions can be considered as the consideration for the continuation of the (contractual) relationship with a financially distressed company, which may entail opportunity costs and increased risks for the essential counterparty. However, if a creditor fears that such essential counterparty will exploit her greater bargaining power, the former may be discouraged from choosing the company's rescue over a fire sale or a piecemeal liquidation, and this represents a holdup problem.

In literature, the (potential) exploitation by essential counterparties of their position of bargaining strength has been labelled under different categories, which however are not suitable for encompassing it. Certain authors have addressed the position of essential stakeholders using the term "rent-seeking".[50] However, considering the definition of rent-seeking given above, such categorisation seems incorrect, because – unlike a rent-seeking party – the essential creditor or shareholder contributes a valuable asset to the bankruptcy estate, either in terms of essential goods or services or financial support, or in terms of knowledge and expertise, and this may justify granting her an increased recovery.[51] For the same reasons, these critical counterparties cannot be considered free-riders. Some other authors have claimed that the essential creditors/stakeholders' position can be categorised under the "holdout" label,[52] because they are offered a return or a stake in the rescued company which is higher than that to which they would be entitled, and they are benefitting from this privilege due to their ability to impede the rescue through a refusal to participate. However, this latter term – as discussed in Section 3.1 above – should be deemed to include only the opportunistic behaviour of those subjects who are not in a contractual relationship, but find themselves in a situation in which their cooperation, in terms of favourable vote to a restructuring plan, would increase the overall value of the common assets. Therefore, the holdup problem can be clearly distinguished from the other categories of opportunistic behaviour and can be defined as the situation in which

[49] Stanghellini and others (n 11) 46-47; Casey (n 15) 1767; according to Tollenaar, *Pre-Insolvency Proceedings* (n 13) 238, the "*liquidity requirement or interests offered to or retained by*" shareholders or managers do not belong to the rescue surplus and are not offered or retained on account of their pre-filing claims. See also: Baird and Bernstein (n 43) 1937-1938, contending that deviations from absolute priority in such cases are justified; LoPucki and Whitford (n 18) 149, 187; Adler and Triantis underline how offering a stake in the reorganised firm allows both to encourage managers to stay in the company and establish the "*appropriate effort and risk-taking incentives*" (BE Adler and GG Triantis, 'The Aftermath Of North Lasalle Street' (2002) 70(4) University of Cincinnati Law Review 1225, 1235ff).

[50] Baird, Casey and Picker (n 21) 1692ff; Roe and Tung (n 22) 1250-58.

[51] Lubben (n 46) 596-97; Baird makes the example of future customers, but the same considerations should be deemed to apply to the future collaboration of essential counterparties (DG Baird, 'The Fraudulent Conveyance Origins of Chapter 11: An Essay on the Unwritten Law of Corporate Reorganizations' (2020) 36(2) Bankruptcy Developments Journal 699, 717); as Skeel (n 23) 733 puts it, the critical vendor doctrine has to deal only with "*maximis*[ing] *the value of the debtor's estate*".

[52] Skeel and Triantis (n 34) 1803-04 maintain that gifting implies that what is conceded to junior is property of the senior and that it should be prohibited when it represents an "*implicit extortion of the senior class*" or exploitation of the valuation uncertainty to the detriment of intervening classes, while it should be permitted when it helps to overcome "*holdouts that might otherwise interfere with the best reorganization option*", where the term seems to be used in this context to indicate essential creditors who refuse to participate in the rescue of the company if they do not receive any payment.

pursuing the rescue of the distressed company would increase the bargaining power of certain contractual counterparties and this may discourage the other parties from participating in the procedure.

4. Priority rules

The categorisation and analysis provided above represent the starting point to assess how each type of opportunistic behaviour is affected by the various priority rules. The specific features of a priority rule, indeed, influence the choices made by the parties involved in the procedure, as well as their ability to engage in opportunistic behaviours. In the following paragraphs, I will assess how the four categories of opportunistic behaviour formulated above interact with each of the APR, the RPR and the NPR. For the sake of simplicity, the analysis will assume a simple capital structure, in which there are only three classes – secured creditors, unsecured creditors and shareholders – and only one creditor for each of the first two classes. Moreover, it is assumed that each priority rule applies to a procedure in which cram-down is available both within a class and among classes; this excludes from the analysis those forms of holdout deriving from the necessity of unanimous consent among creditors.

4.1 Absolute Priority Rule

4.1.1 The rule

The specific characteristics of the APR vary from jurisdiction to jurisdiction, but it is possible to identify the minimum common denominator: under the APR, creditors in a class cannot receive any distribution until all creditors in classes having a higher seniority have not been repaid in full and shareholders cannot retain their shares unless unsecured creditors have been granted full recovery. In the following paragraphs, I will distinguish between two types of APR: a “strict” APR, under which the waterfall senior-junior-shareholders is mandatory in any case, and a “loose” APR, which allows a derogation from APR when there is unanimous consensus and requires adherence to the waterfall only when the cram-down mechanism is triggered; the most famous example of this second type of APR is the one applicable under Chapter 11.[53]

4.1.2 Holdup

As discussed in Sub-section 3.4, when the company’s rescue requires the collaboration of certain creditors or managers-shareholders, a holdup problem is, to a greater or lesser extent, always present. In fact, regardless of the applicable priority rule, the other (ie non-essential) creditors may fear that, by undertaking the rescue process, they may give an excessive bargaining power to the essential counterparties, which may result in a serious impairment of their own recovery. However, the holdup problem seems to be greater under a loose APR than under a strict APR. Indeed, since under a loose APR it is possible for the parties to consensually derogate from the order of priority provided by the rule, the essential counterparties could demand such derogation in the form of a disproportionate recovery for themselves, in return for their collaboration. By contrast, under a strict APR such derogation is not possible; hence the essential counterparties are prevented from demanding a disproportionate repayment of their pre-filing debts. This is not to say that, under a strict APR, the essential creditors or shareholders have no means to exercise their increased bargaining power, because they could still, for instance, charge a disproportionate price for their post-petition supplies or provision of services, or demand an inflated salary as employees or directors of the company. However, a strict APR prevents them from

[53] More precisely, Chapter 11 is a variation of the loose APR, because it comprises two different standards: APR in case of cram-down of unsecured creditors and “value of the collateral” in case of cram-down of secured creditors (Jacoby and Janger (n 29) 690-91).

extracting value from the other creditors in the form of a disproportionate recovery on their pre-filing debts.[54]

4.1.3 Holdout

While the holdup problem exists regardless of the applicable sub-type of APR, the holdout problem may arise only upon application of the loose APR. A necessary precondition for the holdout problem, indeed, consists in the fact that a deviation from the APR, necessary for an efficient restructuring, requires the unanimous consent of all voting parties.[55] Such precondition lacks under a strict APR because a plan derogating from this priority rule could not be sanctioned. Conversely, under a loose APR such deviation is possible, provided that all parties agree, hence a creditor could threaten to vote against the plan in order to extort a ransom payment.[56]

4.1.4 Free-rider

As for the free-rider problem, the way in which the APR interacts with same depends on the type of free-riding under consideration. In fact, the analysis requires a distinction between two sub-categories of the problem: the "contingency-dependent" free-riding, benefitting those creditors who are offered full repayment because negotiations with them would be too costly and time-consuming, and the "priority-dependent" free-riding, deriving from the direct application or the strategic exploitation of a specific priority rule.

The first sub-category of free-riding may occur only under a loose APR, while it is prevented upon application of a strict APR. Indeed, under a strict APR, the "contingency-dependent" free-riding is excluded by the priority rule, at least when the full repayment of such "minor" claims would represent a deviation from the APR. Under a loose APR, instead, this form of free-riding would be possible if all classes of creditors agreed to the plan.

The second sub-category of free-riding, instead, may occur under both a strict and a loose APR, because it concerns secured creditors. Some authors, indeed, have argued that, by granting secured creditors full recovery even when the liquidation value of their collateral is lower than the value of their claim, the APR allows them to appropriate a disproportionate amount of the rescue surplus, which instead should be shared with the unsecured creditors.[57] The reason is that, when the liquidation value of the secured creditor's collateral is lower than the amount of her claim, but the amount available for distribution in case of rescue is lower than the amount of all debts due, APR grants full recovery to the secured creditor while imposing a partial or full haircut of the unsecured creditor's claims, as well as of shareholders' interests. However, such appropriation of the rescue surplus by the secured creditor does not always amount to free-riding. Indeed, if the amount available for the immediate distribution to the secured creditor is lower than the amount of her claim, the difference between these two values is typically reinstated or converted into equity. This amounts, to a certain extent, to a modification (*rectius* impairment) of the rights

[54] To this claim it may be objected that senior creditors would be still entitled to "gift" part of their recovery to creditors or shareholders who are essential to the rescue, thus circumventing the application of a strict APR. However, the practice of gifting is, at least in the context of Chapter 11, controversial (Skeel (n 23) 718-20).

[55] As illustrated in Sub-sections 3.2 and 3.4, the need for such derogation may derive from various contingencies, such as the existence of a numerous class of creditors holding very small claims or the fact that the rescue of the company requires the collaboration of certain parties.

[56] Some authors have argued that, in this case, holdout can be overcome by a rule allowing deviation from the APR, even in the absence of unanimous consent, when the court is satisfied that such deviation is necessary for achieving the rescue. See Ballerini (n 9) 24-31; de Weijs, Jonkers and Malakotipour (n 9) 22; Restructuring Directive, art 11(2).

[57] Jacoby and Janger (n 29) 708-09); Madaus (n 3) 622.

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of the senior creditor,[58] who therefore must be considered to have contributed to the rescue with her sacrifice. However, the analysis is different when the repayment of the secured creditor is immediate upon confirmation of the plan and is made possible, for example, by the injection of equity by the existing or new shareholders or by the provision of new finance by a lender, while the unsecured creditor's claim is (partially or fully) wiped out. In this case, the secured creditor would be effectively free-riding on the shoulders of the unsecured creditor because she would be benefitting from a resource (ie the rescue surplus) to which she did not contribute by any means.

4.1.5 Rent-seeking

As for the rent-seeking problem, the APR, in both its sub-types, creates opportunities for engaging in such strategic behaviour. The APR, indeed, typically requires the classification of creditors and the assessment of both the liquidation value of the business or of the company and the rescue surplus,[59] thus favouring the opportunistic behaviour of those out-of-the-money creditors disputing the valuation or the class composition in order to achieve a (higher) recovery.[60] A valuation is indeed required not only to determine "where the value breaks" in the relevant alternative and thus which creditors are in- and which are out-of-the-money, but also to determine the rescue surplus, in order to allocate it according to the APR.[61] Similarly, the creation of classes is necessary to determine the seniority of creditors and the waterfall of payments, again pursuant to the APR.

4.2 Relative Priority Rule

4.2.1 The rule

The term "RPR" has been used in literature to indicate the priority rule introduced by the Restructuring Directive. Under this rule, a plan can be imposed on a dissenting voting class of affected creditors only if *(i)* such dissenting class is treated at least as favourably as any other class of the same rank and more favourably than any junior class,[62] and *(ii)* any dissenting creditor is no worse off under a plan than she would have been in the relevant alternative.[63]

The same term "RPR", however, has been used both before and after the introduction of the Restructuring Directive to describe something different: a rule under which junior creditors are entitled to get (the monetary equivalent of the value of) an option to get a stake in the company after the senior creditors have received their pre-bankruptcy entitlement.[64] More specifically, the American Bankruptcy Institute ("ABI") has proposed to grant junior creditors the monetary equivalent of the value (if any) of an option to get a stake in the company after having repaid senior creditors their whole claims.[65] Both Professors Baird and Casey, instead, proposed to recognise junior creditors a real option to get a stake in the company, at a price equal to the senior creditors' pre-bankruptcy entitlement and at a determined exercise date.[66] Each of these option-preservation proposals differs from the others

[58] Tollenaar, 'The European Commission's Proposal' (n 13) 75-76.

[59] Tollenaar, 'The European Commission's Proposal' (n 13) 69, 74-75.

[60] Baird and Bernstein (n 43) 1935-36); Seymour and Schwarcz (n 9) 13-16.

[61] Ballerini (n 9) 17.

[62] Restructuring Directive, art 11.

[63] Restructuring Directive, artt 2 and 10.

[64] Ballerini (n 9) 18 expressly distinguishes between simple and option-related RPR; de Weijs, Jonkers and Malakotipour (n 9) 11-13.

[65] MM Harner, 'Final Report of the ABI Commission to Study the Reform of Chapter 11' (2014) <http://digitalcommons.law.umaryland.edu/books/97> accessed 6 October 2020, 207ff.

[66] DG Baird, 'Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy' (2017) 165(4) University of Pennsylvania Law Review 785; Casey (n 14).

in various respects,[67] but they all envisage an option for (partly) out-of-the-money creditors to receive, at a future date, the distribution to which they are entitled according to their pre-bankruptcy claim.

However, for the sake of brevity and simplicity, the present analysis will take into consideration only the "simple version" of both priority rules, and, in the present Section, "RPR" will be used to indicate a rule under which junior creditors can start getting distributions before more senior creditors have been repaid in full, as long as the latter get a "relatively" higher recovery than the former. In the following paragraphs, I will distinguish between two sub-categories of RPR: a "strict RPR", which cannot be derogated even with the consent of all voting parties, and a "loose RPR", which instead applies only when the cross-class cram-down mechanism is triggered due to the negative vote of a party and requires that dissenting creditors receive at least what they would have got in the relevant alternative.

4.2.2 Holdup

As for the holdup problem, the RPR does not represent a solution in either of its forms, although the magnitude of the problem is greater under the loose RPR. Under a strict RPR the holdup problem is mitigated by the fact that the rule imposes a relatively higher recovery for more senior creditors; indeed, an unsecured critical counterparty or a manager-shareholder could not demand full recovery unless more senior creditors have been repaid in full. This does not mean, however, that such critical stakeholder is prevented from demanding a higher and disproportionate recovery or from extracting wealth to the detriment of the other creditors in other ways. Under a loose RPR, instead, the essential counterparty can rely on the possibility of a consensual deviation from the rule, which may encourage her to demand a higher recovery. Therefore, a holdup problem may arise under both a strict and a loose RPR, albeit to a different extent, thus discouraging certain creditors from engaging in the rescue effort.

4.2.3 Holdout

As for the holdout problem, again the RPR does not represent a solution: contrary to the analysis of the APR, an assessment of the RPR demonstrates that the problem may arise under both the loose RPR and the strict RPR. Indeed, since the RPR – unlike the APR – does not impose a predetermined distribution of the recovery among the various classes of creditors, even if a strict RPR applied, a creditor could still demand a higher recovery – although not a full recovery, if she is not in the most senior class – in exchange for her favourable vote, when the same is required for the plan to be confirmed.[68] Moreover, under a loose RPR it would be possible for the parties to unanimously consent to a deviation from the rule when this is necessary to achieve the rescue of the company or the business or even an efficient capital restructuring, and this may incentivise holdout creditors to threaten a negative vote in order to extract a higher recovery.[69] Therefore, holdout behaviours may materialise upon application of any of the sub-types of RPR.

4.2.4 Free-rider

[67] For example, while under ABI's proposal there is no real option, but the mere value of a hypothetical option is calculated in order to verify whether junior creditors can get a recovery (Harner (n 65) 207ff), both Baird (n 66) and Casey (n 14) proposed to grant junior creditors a real option.

[68] This seems to be suggested also by Krohn when he writes "*it is difficult to imagine that certain sophisticated parties with the necessary financial strength will not, in larger cases, try to exploit this ubiquitous uncertainty* [of the EU RPR] *to their own advantage—for example, by threatening to hold-up the proceedings to the detriment of all parties*" (Krohn (n 7) 87).

[69] S Madaus, 'Is the Relative Priority Rule right for your jurisdiction? A simple guide to RPR' (Restructuring Law, 20 January 2020) <https://stephanmadaus.de/2020/01/20/a-simple-guide-to-the-relative-priority-rule/> accessed 20 July 2021, 6.

As for the free-rider problem, the one related to state-contingencies – such as the fact that negotiating with certain junior creditors would be too costly and time-consuming than paying them in full – may occur under a loose RPR but not under a strict RPR, for the same reasons illustrated under Sub-section 4.1.4.

When, instead, we consider the free-rider problem created by the applicable priority rule, the analysis is more complex.[70] On the one hand, it must be recognised that the RPR represents a solution for those authors who argue that, when a creditor is undersecured, this creditor should share the rescue surplus equally with the unsecured creditor. Indeed, the RPR would allow the secured creditor to get a recovery equal to the liquidation value of her collateral plus her share of the rescue surplus while the unsecured creditor would be able to share the remaining amount of the rescue surplus. In this scenario, neither the secured nor the unsecured creditor would be free-riding on the other's sacrifice. On the other hand, the RPR allows shareholders and the senior creditor to collude to the detriment of the unsecured creditor. Imagine a restructuring plan envisaging the full recovery of the secured creditor, a partial recovery for the unsecured creditor and the shareholders' right to retain their interest in the company.[71] As for the secured creditor, the same considerations offered under Sub-section 4.1.4 apply: the secured creditor would be free-riding only if she were granted immediate repayment with funds made available through the injection of new equity or finance by other parties; if instead she was offered a debt-to-equity swap or a reinstatement of the debt, for the part of the same that is undersecured, free-riding should be excluded. As for the shareholders retaining their equity, some authors have argued that if, at the time of confirmation, the stakes in the company are worthless or less valuable than the recovery offered to junior creditors, a plan of this sort would be deemed compliant with the RPR, and thus sanctionable even without the consent of the unsecured creditor.[72] This way, shareholders would be effectively free-riding on the sacrifice of the unsecured creditor.[73] Therefore, not only the RPR does not prevent senior creditors from appropriating (a disproportionate share of) the rescue surplus, but it also allows collusion between shareholders and senior creditors aimed at free-riding on the sacrifice of unsecured creditors.

4.2.5 Rent-seeking

Lastly, it must be verified if and how the RPR affects the rent-seeking problem. Under the RPR, it appears that an *ex ante* assessment of both the liquidation value of the company and/or the business – or the value of same under the relevant alternative – and of the rescue surplus is required in order to prove that no creditor is getting proportionally more than a more senior creditor and that any dissentient gets what she would be entitled to in the relevant alternative.[74] According to certain authors, RPR would even exacerbate rent-seeking, encouraging junior creditors, and especially shareholders, to litigate the valuation and the plan on fairness grounds[75] or to engage in activities aimed at making the company seem less valuable.[76] Moreover, the classification of creditors is typically required anyway, in order to ensure the respect of the

[70] de Weijs, Jonkers and Malakotipour (n 9) 19-20; Ballerini (n 6) 9-10.

[71] de Weijs, Jonkers and Malakotipour (n 9) 17-18.

[72] ibid; Seymour and Schwarcz (n 9) 21.

[73] The correctness of this argument, however, depends on how "more favourable treatment" is interpreted. See de Weijs, Jonkers and Malakotipour (n 9) 17-18.

[74] Seymour and Schwarcz (n 9) 18-19; Madaus (n 69) 7.

[75] de Weijs, Jonkers and Malakotipour (n 9) 19 claim that, since RPR gives more prospects of recovery to junior creditors and shareholders than APR, under RPR they are more incentivised to engage the cram-down mechanism and litigate the valuation and the fairness of the plan.

[76] Seymour and Schwarcz (n 9) 25.

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pari passu rule.[77] For these reasons, it can be claimed that the application of the RPR does not solve the rent-seeking problem.

4.3 No Priority Rule

4.3.1 The rule

For the purposes of the present article, "NPR" can be defined as the absence of any predetermined priority rule, which leaves the decision on how to distribute the proceeds of the bankruptcy estate to the parties, provided that each dissenting party is no worse off compared to the relevant alternative. An example of NPR is the one introduced recently by the UK Corporate Insolvency and Governance Act 2020 in the context of the new restructuring plan procedure ("UKRPP"). The UK legislator, introducing a statutory cross-class cram-down mechanism for the first time, simply omitted any reference to a mandatory priority rule, envisaging only a minimum recovery for creditors to be crammed down. More specifically, in order to impose a plan on dissentients under the new UKRPP, it is required *inter alia* that, under the plan, such creditors are granted at least as much recovery as they would have received in the relevant alternative, which may be not only liquidation but also administration or other forms of rescue ("best interest of creditor test").[78] This ensures that, even in the absence of a predetermined waterfall of payments, the plan is not detrimental for dissentients.

4.3.2 Holdup

The holdup problem seems to be exacerbated by the NPR. Indeed, since there are no limits to a stakeholder's recovery under the plan, other than the requirement that all dissenting creditors get paid the equivalent of what they would have got in the relevant alternative, the rule allows essential creditors or managers-shareholders to demand the highest recovery for their pre-filing debt in exchange for their collaboration. This may significantly deter the other creditors from engaging in the rescue effort, for fear that the rescue surplus be disproportionally appropriated by the essential counterparties. Therefore, the flip side of the great flexibility granted by the NPR is that it aggravates the holdup problem.

4.3.3 Holdout

As far as the holdout problem is concerned, the NPR could be considered a solution. Indeed, when the achievement of the rescue necessitates a derogation from a priority rule, it being either the APR or the RPR, this – under the NPR – can be done even without the unanimous consent of all creditors, as long as the dissentients receive at least what they would have got in the relevant alternative and the other conditions for the cross-class cram-down are met. Therefore, a plan envisaging that, for example, a trade creditor who is out-of-the-money in the relevant alternative gets a 100% recovery while a more senior creditor who is partly in-the-money in the relevant alternative gets a 30% recovery, could be imposed on such senior creditor if, again in the relevant alternative, the recovery of such senior creditor would have been equal to 30%. In such an event the senior creditor would be prevented from holding out and from requiring a higher recovery in exchange for her favourable vote, since the plan could be imposed on her even if she voted against it. Consequently, one of the advantages of the NPR is that it prevents the parties from holding out.

4.3.4 Free-rider

As for the free-rider problem, the analysis depends on the sub-type of free-riding under consideration: the contingency-dependent free-riding is facilitated under the NPR,

[77] On class composition under the Restructuring Directive, see G McCormack, 'Corporate restructuring law - a second chance for Europe?' 2017 42(4) EL Rev 532, 550-551.

[78] J Payne, 'Debt Restructuring in the UK' (2018) 15(3) European Company and Financial Law Review 449, 470.

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because, if the plan is not consensual, it can be imposed more easily on dissentients by simply ensuring the respect of the best interest of creditors test; for the priority-dependent free-riding, instead, the analysis is more complex. On the one hand, the NPR allows the parties to devise a plan under which the secured creditor gets the equivalent of the liquidation value of her collateral while sharing with the unsecured creditor and shareholders the rescue surplus, in which case neither of these categories would free-ride on the shoulders of the others. On the other hand, however, the great flexibility granted to the parties by the NPR gives more leeway to collusion among certain classes of creditors to the detriment of other classes. Indeed, the NPR allows one or more of the colluding parties to grant themselves full unimpaired recovery,[79] while the non-colluding parties – albeit no worse off than in the relevant alternative – are imposed a substantial haircut. This collusion may occur not only to the detriment of unsecured creditors or shareholders, but also against secured creditors. According to certain authors, in fact, the NPR would allow the so-called "cram-up", which is the imposition of the plan by junior (unsecured) creditors on senior (secured) creditors.[80] Indeed, as long as the senior secured creditor is granted a repayment at least equal to the amount she would have received in the relevant alternative, the plan could be imposed on her even in the absence of her favourable vote and even if the other more junior creditors were granted a higher recovery than the one available in the relevant alternative. Therefore, the wide operating space granted to the parties under the NPR may favour free-riding by certain creditors at the expense of others.

4.3.5 *Rent-seeking*

As for the rent-seeking problem, the NPR still offers creditors opportunities to delay and derail the procedure. Indeed, the NPR still requires – as under the new UKRPP – to divide the creditors into classes.[81] Moreover, it still requires to determine the recovery that each class of creditors would get in the relevant alternative, which in turn requires a valuation of the liquidation value of the company or of the business, or, if the relevant alternative were another restructuring procedure or a competing plan, the value that would be distributed to creditors under that procedure or plan.[82] In addition, under the UKRPP it is possible to exclude from the vote those creditors who do not have a "genuine economic interest" in the company,[83] which again demands an assessment of their prospects of recovery.[84] Consequently, rent-seeking represents an issue also under the NPR.

[79] See Sub-section 4.1.4 for an analysis of the circumstances in which secured creditors can be considered as effectively unimpaired.

[80] R Dicker and A Al-Attar, 'Cross-Class Cram Downs Under Part 26A Companies Act 2006, Corporate Insolvency and Governance Act 2020, Schedule 9' (2020) South Square Digest < https://southsquare.com/articles-publications/south-square-digest-editions/> accessed 24 November 2020, 52-53.

[81] See *Re Virgin Atlantic Airways Limited* [2020] EWHC 2191 (Ch), [2020] BCC 997 (leave to convene) [38]–[48].

[82] CA 2006, ss 901(G)(3) and 901(G)(4).

[83] CA 2006, s 901(C)(4). In the decision issued in *Re Virgin Active Holdings Limited* [2021] EWHC 1246 (Ch), [2021] 5 WLUK 129 (sanction) [247ff] Snowden J specified that the absence of genuine economic interest is to be tested with reference to the relevant alternative.

[84] M Phillips, W Willson and C Johnson, 'Corporate Insolvency and Governance Act 2020 - A breath of fresh air' (2020) South Square Digest https://southsquare.com/articles-publications/south-square-digest-editions/ accessed 24 November 2020, 11-13; Payne (n 78) 470.

4.4 Summary

Table 1 below illustrates the findings of the analysis offered under the present Section. In particular, it shows that no priority rule can *per se* prevent the rent-seeking problem, the "priority-dependent" free-riding and the holdup problem, although this latter is affected by the rules to a different extent. By contrast, as far as the other categories of opportunistic behaviour are concerned, the table shows that each priority rule has a different impact.

Table 1: Opportunities to engage in opportunistic behaviours

<table>
<tr><th colspan="2" rowspan="2">Priority rule</th><th rowspan="2">Holdup</th><th rowspan="2">Holdout</th><th colspan="2">Free-riding</th><th rowspan="2">Rent-seeking</th></tr>
<tr><th>Contingency-dependent</th><th>Rule-dependent</th></tr>
<tr><td rowspan="2">APR</td><td>Strict</td><td>Yes*</td><td>No</td><td>No</td><td rowspan="2">Yes</td><td rowspan="2">Yes</td></tr>
<tr><td>Loose</td><td>Yes</td><td>Yes</td><td>Yes</td></tr>
<tr><td rowspan="2">RPR</td><td>Strict</td><td>Yes*</td><td>Yes</td><td>No</td><td rowspan="2">Yes</td><td rowspan="2">Yes</td></tr>
<tr><td>Loose</td><td>Yes</td><td>Yes</td><td>Yes</td></tr>
<tr><td colspan="2">NPR</td><td>Yes**</td><td>No</td><td>Yes</td><td>Yes</td><td>Yes</td></tr>
</table>

* Mitigated compared to loose APR/RPR.

** Aggravated.

5. Conclusion

This article has offered an overview of the literature concerning opportunistic behaviours in a debt restructuring, showing how a lack of categorisation and agreement on the meaning of the terms used to label such opportunistic behaviours has led to some confusion. In order to fill this gap, the paper has presented a systematic analysis of four categories of strategic behaviour: the "holdout" problem, referring to the threat that voting creditors carry out in order to obtain a disproportionate recovery; the "holdup" problem, defined as the risk that the increase in bargaining power for certain essential counterparties and managers-shareholders may deter certain creditors from participating in the rescue effort; the "free-rider" problem, defined as the disproportionate recovery obtained by certain creditors at the expense of other creditors, deriving not from a ransom threat, but from contingencies or the application of certain priority rules; the "rent-seeking" problem, referring to the activities carried out by out-of-the-money creditors in order to obtain a (higher) recovery through the creation of deadweight losses. Based on the above-mentioned categorisation, the paper has also offered an analysis of the way in which each category of opportunistic behaviour is affected by the application of each of the APR, the RPR and the NPR. In conclusion, no priority rule represents a solution: each of them enables creditors to engage, to a lesser or greater extent, in one or more types of strategic behaviour. The relevance given – within a certain policy – to each of such types, and thus the preference for the priority rule that solves the ones that should be deemed more important, is a matter for another paper.