DISTRESSED DEBT TRADING

BRAVE NEW EU LEGAL RULES IN RELATION TO BOLD NEW STRATEGIES

PREADVIEZEN / REPORTS 2019

Nederlandse Vereniging voor Rechtsvergelijkend en Internationaal Insolventierecht **(NVRII)** / Netherlands Association for Comparative and International Insolvency Law **(NACIIL)**

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This book contains the four reports (preadviezen) presented at the 2019 NACIIL annual meeting on 'Distressed debt trading: brave new EU legal rules in relation to bold new strategies'.

It is easy to be critical of distressed debt investors and the practice of acquiring debt at a discount and subsequently making a profit. On the other hand, distressed debt investors provide a relatively easy and quick way out for non-professional and professional creditors alike. Curbing the rights of distressed traders would therefor also indirectly curb the rights of original creditors. Furthermore, the European Union views distressed debt trading as a way of dealing with excessive Non-Performing Loans (NPL).

Whatever your take is on the practice of distressed debt trading, it is here to stay and is likely to influence European insolvency practice in ways similar to US and even more so as a result of COVID-19.

The Private International Law developments in this field are set out and reflected upon by dr. Lilian Welling-Steffens. She makes a strong case for easier, more predictable International Private Law rules as to the transfer of claims.

Prof. J.A. Ellias analyzes the US developments and how distressed debt trading has transformed US bankruptcy practice under Chapter 11. In his report he integrates the actual development of claims trading in numbers over the years and identifies risks and opportunities of claims trading.

Dr. S.W. van den Berg applies a comparative law perspective, comparing Dutch and American law and legal practice. He carefully builds up to his conclusion that the preparation of enforcement procedures and especially the market testing, or the M&A process upfront, has not been given the required attention.

Prof. T. Florstedt provides valuable insights on how German insolvency law and practice has tried to come to terms with claims trading.

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Preface

The 2019 NACIIL annual meeting theme was 'Distressed debt trading: brave new EU legal rules in relation to bold new strategies'. The questions being addressed were: how do we deal with distressed debt traders? Do we give them the same rights as the 'original' creditors or should the practice of distressed debt trading somehow be regulated? Can creditors become too strong and powerful? And whose interests are at stake?

It is easy to be critical of distressed debt investors and the practice of acquiring debt at a discount and subsequently making a profit. On the other hand, distressed debt investors provide a relatively easy and quick way out for non-professional and professional creditors alike. Curbing the rights of distressed traders would therefor also indirectly curb the rights of original creditors. Furthermore, the European Union views distressed debt trading as a way of dealing with excessive Non-Performing Loans (NPL), which hamper the economy and stand in the way of a revitalization of the European financial sector.

In order for banks faced with NPL's to be able to use distressed debt trading as a way out, there should first be a clear International Private Law framework. The Private International Law developments in this field are set out and reflected upon by dr. Lilian Welling-Steffens. She focusses on the Proposed EU Regulation on the law applicable to the third-party effect of assignment of claims. Dr. Lilian Welling-Steffens makes a strong case for easier, more predictable International Private Law rules as to the transfer of claims.

Three other Reports deal with the question of how the landscape of insolvency law and practice changes as a result of the emergence of distressed debt trading and loan-to-own strategies.

Prof. J.A. Ellias analyzes the US developments and how distressed debt trading has transformed US bankruptcy practice under Chapter 11. He writes "The increased utilization of Chapter 11 fed a virtuous cycle as an increasingly capable group of lawyers, investment bankers and judges entered the practice and developed it." In his report he not only integrates the actual development of claims trading in numbers over the years, he also identifies risks and opportunities of claims trading and provides a framework to asses these.

Dr. S.W. van den Berg applies a comparative law perspective, comparing Dutch and American law and legal practice. While discussing the dynamics of distressed debt trading from the perspective of loan-to-own strategies and credit bidding, he also raises many new issues as to the acquisition of claims, execution procedures and creditor protection in general, both from a legal and a company valuation perspective. He carefully builds up to his conclusion that the preparation of enforcement procedures and especially the market testing, or the M&A process upfront, has not been given the required attention.

Prof. T. Florstedt provides valuable insights with respect to how German insolvency law and practice has tried to come to terms with claims trading. In discussing the leading German cases, his report clearly lays out what kind of court battles we can expect in the near future in the Netherlands and how this will force us to rethink creditor protection both in a substantive and a procedural way.

Distressed debt trading is here to stay and is likely to influence European insolvency practice in ways similar to the US. The NACIIL board notes that regretfully the topic of distressed debt trading has gained even more importance due to the COVID-19 crisis, than we could possibly have foreseen at the end of 2019.

The NACIIL board is very pleased by the joint efforts of the authors and wishes to thank each of them for their interesting and relevant contributions in writing and in presenting their reports.

NACIIL Board, 2020
Rolef de Weijs (chair)

Transfer of Claims: Harmonized EU Rules on the Law Applicable to the Assignment of Claims and the Quest for Legal Certainty*

*Lilian Welling-Steffens***

1 Introduction

As a purchaser of a distressed claim you want to be sure that you have acquired legal and beneficial title to the claim that you have purchased. You want to know that you can assert and enforce this title against anyone and everyone, including the assignor, the debtor, the bankruptcy trustee of the seller/assignor, any third party claiming an interest in the claim, and any creditors of the seller/assignor of the claim – the proprietary effect of an assignment *erga omnes*. In a cross-border situation, there is, however, uncertainty as to which law or laws determine whether the assignment effecting the sale is legal, valid, binding and enforceable against everyone. You may end up having to comply with several jurisdictions as the conflict of laws rules are currently still locally determined and vary greatly per jurisdiction. This means that to determine which laws to comply with the assignee must have some idea where it might end up in court if the assignment is contested. This could be the court of an unwilling debtor, the court where the assignor has been declared insolvent or the court where a third party asserting a right in the assigned claim starts proceedings against the assignee or the assignor. In each such court, the law governing the question whether the assignee can assert its entitlement to the claim may be different depending on the conflict of laws rules applied. Currently, one can distinguish six different conflict of laws rules in Europe to determine the law governing the effectiveness and validity of the assignment of a claim (i.e. the question whether the assignee can assert its entitlement to the assigned claim against everyone) depending on the jurisdiction in which the assignee wants to assert its entitlement:

1. The law chosen by the assignor and assignee (with the consent of the debtor of the claim) (Switzerland);

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* Parts of this report have previously been published in Dutch: Lilian Welling-Steffens, 'Met een kluitje het riet ingestuurd? Onduidelijke taal in de voorgestelde verordening over het toepasselijke recht op de derdenwerking van cessie', in *TvI,* 2018/6.

** Lilian Welling-Steffens is a lawyer at Greenberg Traurig LLP in Amsterdam and an affiliated lecturer at the Universities of Amsterdam and Leiden.

2. The law governing the agreement to assign between assignor and assignee (the Netherlands and England, Germany and Switzerland as between the assignor and assignee) either through a direct application of Article 14(1) Rome I Regulation or based on national law;
3. The law governing the assigned claim (England and Germany as against third parties including the debtor, France on occasion, Italy, and Switzerland in the absence of a choice) generally through direct or analogous application of Article 14(2) Rome I Regulation or statute;
4. The law of the habitual residence of the assignor (Belgium, Luxembourg(?), France (?) and Norway) based on statute or case law;
5. The law of the habitual residence of the pledgee (Switzerland applies different conflict of laws rules to security rights over claims and assignment of claims); and
6. The law of the habitual residence of the debtor of the assigned claim (occasionally applied in France and according to the Insolvency Regulation (recast)[1] the fictitious location of the claim).

So for a purchaser of distressed debt harmonization of conflict of laws rules in respect of the validity, effectiveness and enforceability of an assignment of claims is definitely a good thing.

To achieve legal certainty it is vital that, when formulating a uniform conflict of laws rule to determine the law applicable to the proprietary effects of an assignment of a claim (*erga omnes*), its application result in the applicability of the laws of one jurisdiction. Which of the currently applied conflicts of laws rule would, however, be the most suitable? In this report I will conclude that the assignor and the assignee should be given limited freedom to choose the law to be applicable to all proprietary elements of an assignment of a claim: either the law applicable to the assigned claim or the law of the habitual residence of the assignor at the time of the conclusion of the contract to assign; in the event no such choice has been explicitly made, the default position should in my view be that the law of the claim applies to all of the proprietary aspects of an assignment of a claim. In this report I will explain why.

In March 2018 the EU Commission published a proposal for a Regulation on the law applicable to third-party effects of an assignment of claims[2] (the **Proposal**). The Proposal does not aim to modify or replace the conflict of laws rules on assignment laid down in Article 14 Rome I Regulation.[3] Article 14(1) Rome I Regulation provides that the

1 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency proceedings (recast), L 141/19.

2 Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims COM/2018/096 final – 2018/044 (COD).

3 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), L 177/6.

relations between assignor and assignee are governed by the law applicable to the agreement which includes the obligation to assign (or create a security right over) a claim in accordance with the provisions of the Rome I Regulation. Article 14(2) Rome I Regulation provides that the law governing the assigned claim governs the matters set out therein, including the question of assignability of the claim, whether the assignment can be invoked against the debtor. This means that the existing European private international law rules that apply to an assignment already lead to the applicability of the laws of (potentially) two jurisdictions, regardless of the question of whether these rules also govern certain proprietary elements or only contractual elements of an assignment. In short, the Proposal introduces a possible third jurisdiction – the law of the habitual residence of the assignor at the material time – that applies to an assignment of a claim to determine the 'third-party effects' of an assignment of claims. According to the Commission, the uniform conflict of laws rules laid down in the Proposal will "eliminate legal risk and potential systemic consequences. The introduction of legal certainty will promote cross-border investment, access to cheaper credit and market integration." The question is: will the proposed rules achieve those goals? The fact that the EU Commission aims to harmonize is to be supported as the debate about the applicable law to the proprietary or third-party effects of an assignment has been going on for a long time, and the debate itself has not led to any consensus between the EU Member States or within Europe.

2 A Long Time Debate

In April 1997 I obtained my PhD, which (partly) relates to this exact topic.[4] In 2006, when negotiations in the EU were in full throttle to convert the Rome Convention on the law applicable to contractual obligations[5] to an EU Regulation,[6] negotiations that also included heated discussions on the conflict of laws rules on the assignment of claims, I wrote an article on the proposed rule for determining the applicable law to the third-party effects of an assignment of a claim.[7] Throughout the years, from the early years of the Rome Convention, through the coming into force of the Rome I Regulation, right up to the publication by the EU Commission of the Proposal there have been many (and

4 Lilian F.A. Steffens, *Overgang van vorderingen en schulden in het Nederlandse Internationaal Privaatrecht* (the transfer of claims and debts in Dutch private international law), Kluwer – Deventer, 1997.

5 Rome 19 June 1980 (80/934/EEC).

6 This resulted in the Rome I Regulation.

7 Lilian F.A. Steffens, 'The New Rule on the Assignment of Rights in Rome I – The Solution to All Our Proprietary Problems?', in *Journal of European Review of Private Law*, 2006, vol. 14, no. 4, pp. 545-578.

more) publications by other authors both in the Netherlands and abroad on this topic.[8] All have advocated various conflict of laws rules with various scopes. And here we are at the end of 2019, and we seem to be none the wiser. The longed for legal certainty on (the applicable law to) the effects (third-party, property, proprietary or however one wishes to specify these effects) of an assignment of claims still seems far off. The question is whether the Proposal, in combination with the provisions of Article 14 of the Rome I Regulation, finally provides that legal certainty when it comes to the applicable law to an

8 G. van Haegenborgh, 'Grensoverschrijdende aspecten: Cessie in het Internationaal Rechtsverkeer', in *Overdracht en inpandgeving van schuldvorderingen*, (ed. Eric Dirix) Instituut Zekerheden en Executierecht, Faculteit der Rechtsgeleerdheid KU Leuven (Kluwer Rechtswetenschappen, België, 1995), pp. 169-173; E.M. Kieninger, 'Das Statut der Forderungsabtretung im Verhältnis zu Dritten', in *RabelsZ.*, Band 62, 1998, pp. 679-711; D. Pardoel, *Les conflits de loi en matière de cession de créance*, L.G.D.J. – Paris – 1997, pp. 174-188 and 269-316; M. Moshinsky, 'The Assignment of Debts in the Conflict of Laws', in *Law Quarterly Review,* 1992, vol. 9, pp. 591-625; E.M. Kieninger and E. Schütze, 'Die Forderungsabtretung im Internationalen Privatrecht', in *IPRax,* 2005, Heft 3, pp. 200-208; D. Rijpma, 'Tussen Duisenberg en Apeldoorn, Internationale cessie', in *WPNR,* 1998, 6297, pp. 21-27; H.L.E. Verhagen, 'Annotation', in *JOR,* 1997, pp. 547-551; J. Willeumier, 'Internationale cessie: uitleg van art. 12 EVO', in *V&O,* 1999, no. 6, p. 62; A. Stadler, 'Der Streit um das Zessionsstatut – eine endlose Geschichte?', in *IPRax,* 2000, Heft 2, pp. 104-110. Others more skeptical: Th.M. de Boer, 'Annotation', in *NJ,* 1998, 585; L.F.A. Steffens, 'Goederenrechtelijke aspecten van de cessie in het IPR', in *NTBR*, 1997, no. 7, pp. 212-217; T.H.D. Struycken, 'The Proprietary Aspects of International Assignment of Debts and the Rome Convention, Art. 12', in *Lloyd's Maritime Commercial Law Quarterly*, 1998, vol. 24, pp. 345-360; M.E. Koppenol-Laforce, 'The Property Aspects of an International Assignment and Article 12 Rome Convention', in *Netherlands International Law Review,* 1998, vol. 45, issue 1, pp. 129-137; H.C.F. Schoordijk, 'De cessie in het internationaal privaatrecht. Een arrest met grote gevaren voor het interne kredietverkeer', in *WPNR,* 1999, 6354, pp. 281-286; M. Veder, *Cross-Border Insolvency Proceedings and Security Rights*, Kluwer Legal Publishers – Deventer, 2004, pp. 289-298; O. Peltzer, 'Die Forderungsabtretung im Internationalen Privatrecht', in *RIW,* 1997, Heft 11, pp. 893-899. R.I.V.F. Bertrams and H.L.E. Verhagen, 'Goederenrechtelijke aspecten van de internationale cessie en verpanding van vorderingen op naam', in *WPNR,* 1993, 6088, pp. 261-266; F. de Ly, 'Zakelijke zekerheidsvormen in het Nederlandse IPR', in *NIPR,* 1995, pp. 329-341; Chr. von Bar, 'Abtretung und Legalzession im neuen Deutschen Internationalen Privatrecht', in *RabelsZ.,* 1989, pp. 467-468; Chr. von Bar, 'Zessionsstatut, Verpflichtungsstatut und Gesellschaftsstatut', in *IPRax,* 1992, pp. 22-23; '[2001] Q.B. 825', annotated by R. Stevens and T.H.D. Struycken, in *Law Quarterly Review,* 2002, vol. 118, pp. 15-20; J. Erauw, 'Internationaal privaatrechtelijke aspecten van schuldoverdracht', in E. Wymeersch (ed), *Financieel recht tussen oud en nieuw* (Maklu, Antwerpen, 1996); V. Sagaert, 'De zakenrechtelijke werking van de cessie: de nieuwe IPR-regeling na de wet van 2 augustus 2002', in *T.P.R.,* 2003, p. 570 ff; C. Clijmans, 'Een nieuwe Belgische IPR bepaling inzake cessie van schuldvorderingen', in *Tijdschrift@ipr.be*, 2003, pp. 88-94; A. Flessner and H.L.E. Verhagen, *Assignment in European Private International Law*, GPR Praxis – Sellier, European Law Publishers – 2006; Trevor C. Hartley, 'Choice of Law Regarding the Voluntary Assignment of Contractual Obligations Under the Rome I Regulation', in *International and Comparative Law Quarterly*, January 2011, vol. 60, pp. 29-56; J. Perkins, 'A Question of Priorities: Choice of Law and Property Aspects of the Assignment of Debts', in *Financial Markets Law Review,* 2008, p. 238; M.G. Bridge, 'The Proprietary Aspects of Assignment and Choice of Law', in *Law Quarterly Review*, 2009, vol. 125, p. 671; H.L.E. Verhagen and S. van Dongen, 'Cross-Border Assignments Under Rome I', in *Journal of Private International Law,* 2010, vol. 6, pp. 1-26; J. Perkins, 'Choice of Law and the Assignment of Debts', in *South Square Digest*, 2010, vol. 2-4, p. 20; J. Perkins, 'Proprietary Issues Arising from the Assignment of Debts: A New Rule?', *Journal of International Banking and Financial Law,* 2010, p. 333; R. Fentiman, 'The Voluntary Assignment of Contract Debts', in J. Ahern and W. Binchy (eds), *The Rome I Regulation: Implications for International Commercial Litigation* (Brill/Martinus Nijhoff, Leiden, forthcoming). P. Lagarde, 'Retour sur la loi

assignment of claims. I daresay not. That, however, does not have so much to do with the conflict of laws rule that the Commission has chosen for the third-party effects of an assignment as it does with its proposed scope and (uncertain) relationship with the rules laid down in Article 14 of the Rome I Regulation. Furthermore, the interpretation of these rules set out in the Explanatory Report and the Preamble to the Proposal and the amendments made by the European Parliament[9] seem to cloud things further rather than clarify them.

In this article the focus is on the Proposal as amended by the European Parliament and its implications for the wider topic of 'Distressed debt trading: brave new EU legal rules in relation to bold new strategies.' The new rules proposed by the Commission may be characterized as brave, but whether they will turn out to be practical or will provide the legal certainty they claim to bring is doubtful. The topic is highly technical, and I will try to illustrate the rules by using example case positions, some taken from real life. To understand the complexities not only from a technical point of view but also from a political one, it is important to look at the history of the EU conflict of laws rules regarding the assignment of claims or rights. The ultimate idea of the Proposal, harmonization, is in itself a good thing.

3 A Short History

As is clear from the introduction, the topic of this report – the harmonized EU private international law rules on the assignment of claims – has a long history. Conflict of laws rules regarding the assignment of claims were already included in Article 12 of the Rome Convention on the law applicable to contractual obligations of 1980.[10] There was a general consensus that the scope of those conflict of laws rules was limited to the

applicable à l'opposabilité des transferts conventionnel de créances', in J. Bigot et al. (eds), *Droit et actualité: études offerts à Jacques Béguin* (Litec, Paris, 2005), p. 415; H.G. Sigman and E.M. Kieninger, 'The Law of Assignment of Receivables: In Flux, Still Uncertain, Still Non-Uniform', in H.G. Sigman and E.-M. Kieninger (eds), *Cross-Border Security over Receivables* (Sellier, Munich, 2009), pp. 41-73; F.J. Garcimartín, 'Assignment of Claims in the Rome I Regulation: Article 14', in F. Ferrari and S. Leible (eds), *Rome I Regulation: The Law Applicable to Contractual Obligations in Europe* (Sellier, Munich, 2009), p. 217; C. Walsh, 'The Law Applicable to the Third-Party Effects of an Assignment of Receivables: Whither the EU?', in *Uniform Law Review*, 2017, vol. 22, pp. 781-807; A. Flessner, 'Between Articles 14 and 27 of Rome I: How to Interpret a European Regulation on Conflict of Laws?', in R. Westrik and J. van der Weide (eds), *Party Autonomy in International Property Law* (Sellier, Munich, 1st edition, 2011), p. 207; P. van der Grinten, 'Article 14 Rome I: A Political Perspective', in R. Westrik and J. van der Weide (eds), *Party Autonomy in International Property Law* (Sellier, Munich, 1st edition, 2011), p. 145.

9 On 13 February 2019 the European Parliament agreed on a revised text of the Proposal consisting of 24 amendments: P8_TA-PROV(2019)0086 – European Parliament legislative resolution of 13 February 2019 on Proposal.

10 Convention on the law applicable to contractual obligations, Rome 19 June 1980 (80/934/EEC), L 266/1.

contractual aspects of the assignment of claims, mainly considering the fact that these were included in a convention that solely dealt with the law of contractual obligations. However, owing to local interpretation and the fact that in some EU states the Rome Convention did not have direct effect and was thus implemented into national legislation,[11] the scope of the conflict of laws rules of Article 12 had been extended to also apply to proprietary aspects of assignment. The way in which this extension of scope was achieved differed substantially between the EU states.

Article 12(1) of the Rome Convention provided that the 'mutual obligations' under an assignment of a claim between the assignor and the assignee were governed by "the law which under this Convention applies to the contract between the assignor and assignee". It was generally held that reference was made to the contract in which the agreement or obligation to assign a certain claim was laid down and to determine the applicable law to such contract the rule referred to the general rules of Article 3 (Choice of law) and Article 4 (applicable law in absence of a choice) of the Rome Convention. The second subsection of Article 12 provided that the law governing the claim to which the assignment relates governed the question of assignability of the claim, the relationship between the assignee and the debtor after assignment of the claim, whether the assignment of the claim could be *invoked*[12] against the debtor and the question of whether payment by the debtor of the claim discharges the debtor. As it was generally assumed that Article 12 Rome Convention did not extend to the question on the applicable law to proprietary aspects of an assignment of a claim, national rules of private international law were, and are to this day, applied to determine the applicable law to the proprietary or third-party effects of an assignment.

In June 2008 the Rome I Regulation was a fact, and its rules have been applicable since December 2009.[13] The Rome I Regulation has replaced the Rome Convention in the EU (other than for Denmark). Article 14 of the Rome I Regulation lays down the rules on the assignment of claims that are – barring a few minor drafting changes[14] – the same as set forth in Article 12 of the Rome Convention. Subsection 3 of Article 14 clarifies that the provisions apply equally to an assignment by way of security or the creation of a pledge or other security right over a claim. The Proposal to include a separate rule on the third-

11 In Germany the provisions of the Rome Convention were implemented in the 'Bürgerliches Gesetzbuch' through the "Einführungsgesetz zum Bürgerliches Gesetzbuche Internationales Privatrecht" (EGBGB), in Münchener Kommentar zum Bürgerliches Gesetzbuch, Internationales Privatrecht, Band 7, 1990. In England & Wales the Rome Convention has been implemented by the Contracts (Applicable Law) Act 1990, Sched. 1, All England Law Reports, Statutes 1990 (III), chapter 36.

12 The English version uses the term 'invoked' rather than 'enforced'. The latter term is more generally used where reference is made to a more proprietary effect vis-à-vis the debtor. In the German version the term used is 'entgegengehalten', in the French version it is 'opposabilité' and in the Dutch version it is 'tegengeworpen'.

13 *See* Art. 29 Rome I Regulation.

14 Where Art. 12(1) Rome Convention referred to 'mutual obligations' and 'right', Art. 14(1) Rome I Regulation refers to 'relationship' and 'claims'.

party effects of an assignment – which provided that the law of the state in which the assignor had its habitual residence at the material time would apply[15] – did not make it to the final adopted Rome I Regulation as the Member States simply could not agree on the proper conflict of laws rule for third-party effects or on the meaning or scope of 'third-party effects'. As a result of abandoning the idea of including a separate rule on third-party effects of an assignment, two provisions were added to the Rome I Regulation; in Article 27(2) of, and in recital 38 of the Preamble[16] to, the Rome I Regulation.

Article 27(2) Rome I Regulation instructs the EU Commission to submit a report on the question of the applicable law to the effectiveness of an assignment of a claim against third parties and issues of priority, which report must include a proposal to amend the Rome I Regulation and an assessment of the impact of the provisions to be introduced. Recital 38 provides the following rather curious interpretation clause:

> In the context of voluntary assignment, the term 'relationship' should make it clear that Article 14(1) also applies to the property aspects of an assignment, as between assignor and assignee, in legal orders where such aspects are treated separately from the aspects under the law of obligations.

In jurisdictions like Germany, England and the Netherlands, this has generally been interpreted to mean that the property aspects of an assignment as between the assignor and the assignee – i.e. the question whether the claim has been effectively transferred from the estate of the assignor to that of the assignee and thus constituting a so-called true sale between the assignor and assignee – is governed by the law governing the agreement in which the agreement to assign has been laid down. This leaves the door open to a choice of law on the basis of Article 3 Rome I Regulation.

Germany and England have subsequently interpreted Article 14(2) Rome I Regulation to also have property effect and apply – as a result of that interpretation – the law governing the assigned claim to the enforceability of the assignment against the debtor and third parties.[17] However, in these jurisdictions the bankruptcy trustee of the assignor is not a third party, and so the question of whether the assignment can be enforced

15 Proposal for a regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), presented by the Commission, Brussels 15 December 2005, COM (2005) 650 final, 2005/0261 (COD).

16 Recital 38 was instigated by the Dutch government and was based on the Dutch conflict of laws rule regarding property aspects of an assignment laid down in Art. 10:135 Dutch Civil Code.

17 Prior to the entry into force of the Rome I Regulation, under German private international law all property aspects of an assignment were governed by the law governing the assigned claim on the basis of Art. 33 subsection 2 of the EGBGB. However, with the entry into force of the Rome I Regulation, this provision was deleted from the EGBGB as all these aspects were now covered, per the German legislature, by Art. 14 Rome I Regulation. *See* the considerations of the Saarländisches Oberlandesgericht in its case of 8 August 2018 (Case 4 U 109/17) – which case is discussed under the heading 'Intermezzo' in this report and *see also* https://dejure.org/gesetze/EGBGB/33.html (last accessed on 26 November 2019).

against the bankruptcy trustee is governed by the law applicable in accordance with Article 14(1) Rome I Regulation. I will return to the question of whether the bankruptcy trustee is a third party within the meaning of the Proposal.

The Netherlands, however, continues to apply its national private international law rule to the property effects of an assignment. The Dutch rule provides that all property aspects of an assignment (as between the assignor and assignee, against the debtor and third parties including a bankruptcy trustee of the assignor) are governed by the law governing the agreement between the assignor and assignee, which includes the agreement or obligation to assign the claim. The same rule is set out in Article 14(1) Rome I Regulation. Under Dutch private international law no distinction is made between the various legal relationships that play a role in an assignment of a claim. The law governing the assigned claim governs only the question of assignability of the claim,[18] the relationship between the assignee and the debtor, the question of whether the debtor may assert any remedies against the assignee so that the assignment cannot be invoked against the debtor and the question whether a payment made by the debtor discharges the debtor. Other jurisdictions continue to apply different conflict of laws rules to different aspects of the assignment that still cover the range set out above.

In light of the above the EU Commission fulfilled its obligation under Article 27(2) Rome I Regulation (albeit a couple of years late) and presented a report (the **Explanatory Report**) on the third-party effects of an assignment of claims that includes a proposal not to amend the Rome I Regulation but to introduce a separate regulation on the law applicable to the third-party effects of an assignment of claims, which proposal basically introduces a third jurisdiction that applies to an assignment of claims. Article 14 Rome I Regulation is not set aside and thus continues to apply to certain aspects of an assignment of claims. The Proposal has been amended through 24 amendments to provisions of both the preamble and the regulation itself by the European Parliament. It is the original proposal that will be discussed in this report and to which I will refer to as **Proposal**. The proposed amendments will be discussed wherever relevant.

18 In the Netherlands the district court of Amsterdam in two separate cases (Rb Amsterdam 7 August 2019 ECLI:NL:RBAMS:2019:5729 and 4 September 2019 ECLI:NL:RBAMS:2019:6359) has referred preliminary questions to the Dutch Supreme Court (*Hoge Raad*) in which it wishes to know whether the nature of a claim of a bank against a client entails that such claim is nonassignable (*onoverdraagbaar*) within the meaning of Art. 3:83(1) DCC in the event it is intended that such claim is assigned to a nonbank.

4 Intermezzo

Before going into the Proposal and the Explanatory Report it must be mentioned that after the publication of the Proposal, on 8 August 2018 the Saarländisches Oberlandesgericht[19] submitted a request for a preliminary ruling to the European Court of Justice on the interpretation of Article 14 Rome I Regulation in relation to the third-party effects of an assignment in case of multiple assignments of the same claim. The questions were limited to the priority question between the two conflicting assignees. It submitted the following questions:

- Is Article 14 Rome I Regulation applicable to the third-party effects of multiple assignments of the same claim by the same assignor?
- If the first question is to be answered in the affirmative, which law is applicable to such third-party effects?
- If the first question is to be answered in the negative, is Article 14 Rome I Regulation to be applied per analogiam?
- If the third question is to be answered in the affirmative, which law is applicable to such third-party effects?

The facts of the case were as follows and are good to keep in mind once we discuss the provisions of the Proposal.

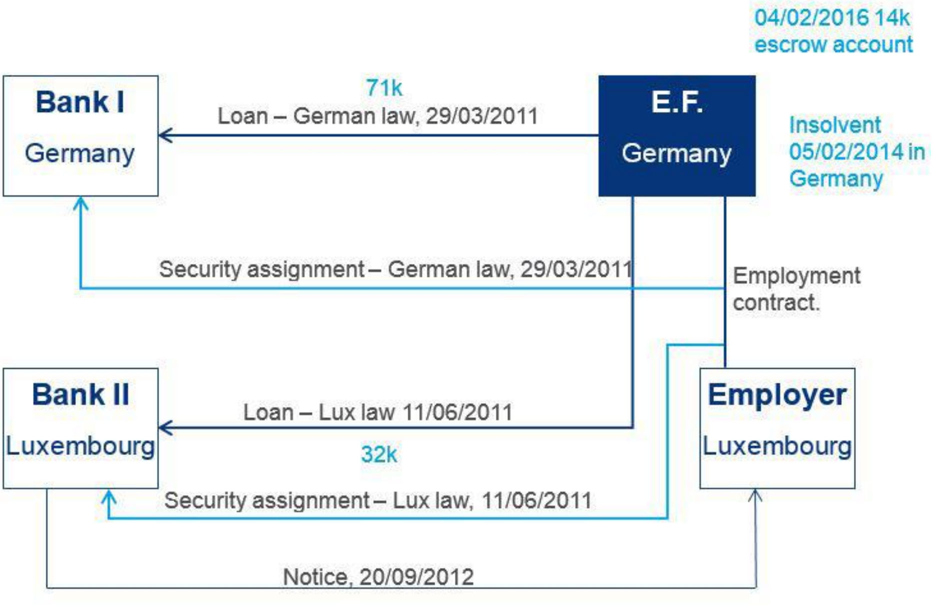
> E.F. is a natural person habitually resident in Germany but working in Luxembourg. On 29 March 2011 E.F. enters into a German law-governed loan agreement (the **German Loan**) with TeamBank AG Nürnberg, with its registered seat in Germany (**TeamBank**). As security for the German Loan E.F. grants security over wage claims arising out of her Luxembourg law-governed employment contract[20] with the employer in Luxembourg (the **Luxembourg Claims**) through a security assignment effected in accordance with German law dated the same date as the German Loan (the **German Security Assignment**). The Luxembourg employer (the debtor of the Luxembourg Claim) is not notified of this assignment. On 11 June 2011 E.F. enters into another loan agreement, this time with BGL BNP Parisbas S.A., with its registered office in Luxembourg (**BNP**), which is governed by Luxembourg law (the **Luxembourg Loan**). As security for the Luxembourg Loan, E.F. grants BNP security over the same Luxembourg Claims through a security assignment effected in accordance with Luxembourg law (the **Luxembourg Security**

19 Case 4 U 109/17. *See* on this decision: Peter Mankowski, 'The Race is On: German Reference to the CJEU on the Interpretation of Art. 14 Rome I Regulation with Regard to Third-Party Effects of Assignments', posted on *conflictsoflaws.net* by Matthias Weller on 10 September 2018.

20 That the employment contract is governed by Luxembourg law is based on Art. 8, Rome I Regulation.

Assignment). BNP notifies the Luxembourg employer of this assignment on 20 September 2012. E.F. is subsequently declared bankrupt by a German court on the 5 February 2015. On the date of the declaration bankruptcy, there is EUR 71,000 outstanding under the German Loan and EUR 32,000 under the Luxembourg Loan, whereas the amount of the outstanding Luxembourg Claims is EUR 14,000. Both TeamBank and BNP claim to be entitled to the Luxembourg Claims on the basis of the security assignments, and as the bankruptcy trustee acknowledges that the Luxembourg Claims will, in any event, not form part of the bankrupt estate, he deposits the amount of the Luxembourg Claims on a separate account until a court ruled which assignee is entitled to the Luxembourg Claims.

Figure 1



Whether the Luxembourg Claims were assignable is governed by the law governing these claims on the basis of Article 14(2) Rome I Regulation; i.e. Luxembourg law. Whether the assignments could be invoked against the debtor is also governed by the law governing the Luxembourg Claims on the basis of Article 14(2) Rome I Regulation. Whether the assignments could be enforced against the bankruptcy trustee and the bankrupt estate was, however, not in dispute in this matter as the bankruptcy trustee had already

> acknowledged that the bankrupt estate would not be entitled to the Luxembourg Claims and deposited the amount collected on a separate account. The German court applied Article 14(1) Rome I Regulation to determine the validity of each of the assignments as between the assignor (E.F) and each of the assignees (TeamBank and BNP, respectively) separately. The obligation for E.F. to assign by way of security the Luxembourg Claims to each of the assignees was included in the German Loan and Luxembourg Loan, respectively. Ignoring the fact that there are two competing assignments, the German court found that pursuant to the respective applicable laws both assignments were valid and effective as between the assignor and the respective assignee, such that under such applicable law the Luxembourg Claims were transferred from the estate of the assignor to the estate of the relevant assignee. Furthermore, under German law nothing further was required for the assignment to have third-party effect. Under Luxembourg law notification of the debtor is required for the assignment to have third-party effect, but BNP had notified the debtor. So under the respective applicable laws both assignments were effective as between the parties and against third parties.
>
> What was left to determine was the question of priority between the two – on their own valid and effective – assignments. Under German law TeamBank would have priority as the assignment had third-party effect prior to the assignment to BNP. However, under Luxembourg law BNP would have priority, as under Luxembourg law priority is determined by the date of notification of the assignment to the debtor. The priority question is part of the question of third-party effect as a second assignee is a third party against whom the first assignee wants to assert its entitlement to the claim and vice versa. Which law governs this priority issue? Which law governs the third-party effects of an assignment of claims? Is this also covered by Article 14 Rome I Regulation? As this was unclear the German court decided to put the preceding preliminary questions to the European Court of Justice.

If the European Court of Justice would answer any of these questions in the affirmative and thus consider either the first or the second subsection of Article 14 Rome I Regulation applicable to the issue of priority in case of multiple assignments of the same claim (and thus to the third-party effects of an assignment), whether directly or by analogy, it would effectively state that it does not consider it necessary to formulate a separate conflict of laws rule on the matter, and the Proposal may have been taken off the table by the EU Commission.

However, on 9 October 2019 the European Court of Justice[21] did no such thing and ruled as follows on the preliminary questions set out above:

> Article 14 of Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations ('Rome I') must be interpreted as not designating, directly or by analogy, the applicable law concerning the third-party effects of the assignment of a claim in the event of multiple assignments of the claim by the same creditor to successive assignees.

It based this conclusion on the following considerations: (i) the wording of Article 14 itself does not in any way indicate that it is applicable to the third-party effects of an assignment; (ii) recital 38 is clearly limited to matters between the assignor and assignee and not to questions of matters of priority or other third-party effects; (iii) the legislative history of Article 14 (the proposed limb on third-party effects of an assignment had not made it into the final text); (iv) the instruction to the EU Commission in Article 27(2) Rome I Regulation, which clearly indicates that it was not at any time intended that Article 14 would apply to the third-party effects of an assignment and (v) the fact that the EU Commission has published the Proposal.[22]

Although the European Court of Justice could have given an easy and quick answer to put an end to all questions, it should not come as a surprise that it did not.

This means that until the Proposal has been adopted by the European Parliament and the Council as a regulation, each jurisdiction will continue to apply its national conflict of laws rules on the matter. It is uncertain whether the Proposal in its current form will in fact be adopted. On 24 May 2019 the Council of the European Union published a progress report[23] on the Proposal. In the progress report the Council refers to several non-public Presidency texts, the last one dating from 15 May 2019, which are in the process of being discussed by the Working Party. The main points of discussion concern the scope of the conflict of laws rules of the Proposal, certain definitions included in the Proposal and, most importantly, which rule should be the main conflict of law rule in respect of the third-party effect of an assignment of claims: the law of the habitual residence of the assignor or the law governing the claim. The Council is revisiting the choice for the habitual residence as the main rule as opposed to the law governing the claim as it is clear and unchallenged that the latter already governs the question of assignability of the claim and is the law that may be relied on by the debtor

21 CJEU 9 October 2019, C-548/18 ECLI:EU:C:2019:848 (BGL BNP Paribas SA/TeamBank AG Nürnberg).
22 *See* considerations 31 through to 34 of the CJEU ruling.
23 Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims – Progress report from the Presidency to the Permanent Representatives Committee/Council, Brussels 24 May 2019, ST 9562/19.

in its relationship with the assignee and for the question of whether it has been discharged. Depending on which rule is chosen as the main rule, certain exceptions to such main rule are being discussed. Finally the Working Party has indicated, according to the progress report, that certain recitals must be amended to clarify the meaning and scope of other provisions of the Proposal. This progress report is the last published document regarding the Proposal. It must therefore be kept in mind that the Proposal, including the main conflict of laws rule, as discussed in this report may still be subject to substantial amendments. It is unclear when the Council will present its final proposal.

Despite the uncertainty surrounding the Proposal, it is important to set out and (attempt) to explain its rules, the scope and its relationship with Article 14 Rome I Regulation.

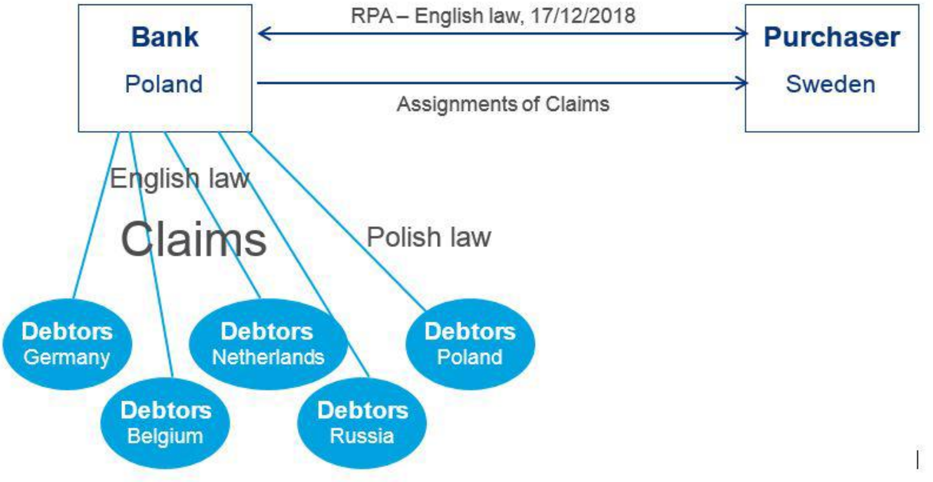
5 Case Studies

Before discussing the Proposal let me present two more case studies that, together with the European Court of Justice case set out previously, will be revisited at the end of this report.

> 'Purchase and assignment of distressed debt'
> A Polish bank (Bank) has a large portfolio of distressed loans that it wants to take off its balance sheet. Although these loans are secured and the Bank could enforce its security, the cost of doing so (in both a monetary and reputational sense) would be too high for it to be worth it. It is therefore willing to sell and assign the due and outstanding claims under these distressed loans (the Claims) at a discount. The borrowers of the Polish Bank under the distressed loans are mainly Polish entities, but some of these entities are part of a larger group of companies located in various other EU Member States or third States, whereby several entities of the group act as borrower or are jointly and severally liable under the loan. Some of the borrowers are foreign entities, including Belgian, Dutch, German and Russian entities. The loans are governed by Polish law in the event the borrowing entity is a sole Polish company or by English law in the event of a loan to a cross-border group of companies or a foreign company. A Swedish company (**Purchaser**) in the business of purchasing distressed debt offers the Bank to purchase the Claims at quite a substantial discount. On 17 December 2018 the Bank and the Purchaser entered into a receivables purchase agreement that contains a choice of law clause for English law. The laws of which states must the Purchaser take into account for the assignment of the Claims, so that it is certain that it can assert its entitlement to the Claims

pursuant to such assignment against anyone and everyone in and outside of a possible bankruptcy of the Bank?

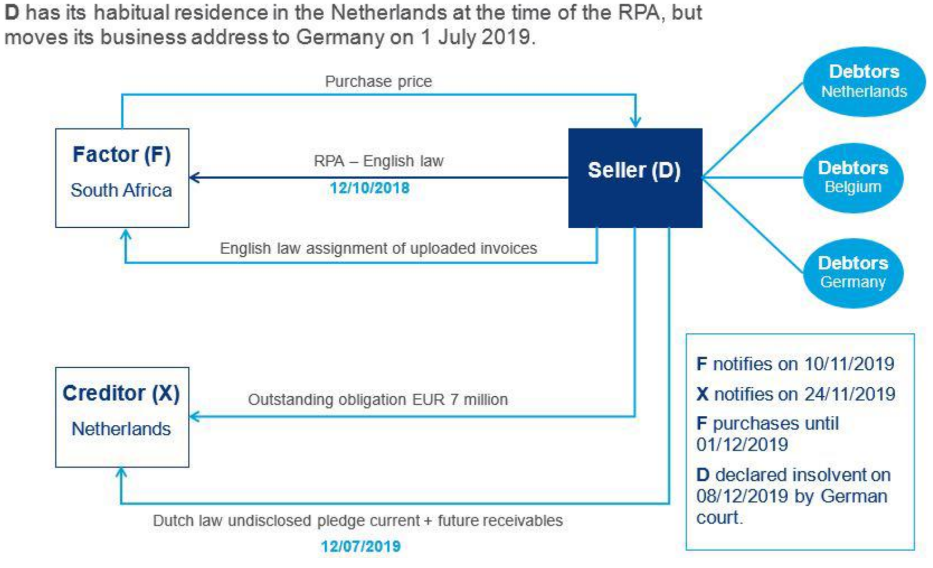
Figure 2



'Competing entitlements to claims'
A South African factoring company (F) enters into a receivables purchase agreement under English law (RPA) with a Dutch (habitual residence in the Netherlands) company (D) on 12 October 2018. Under the RPA it is agreed that D will upload onto a platform all of the invoices sent to its customers (located in the Netherlands, Belgium and Germany) indicating for each invoice if the receivables arising out of such invoice fit the eligibility criteria agreed in the RPA. F subsequently decides which receivables to purchase and sends a notice to D indicating the purchased receivables, whereupon under English law the so indicated receivables are transferred to F pursuant to an equitable assignment, constituting a so-called true sale under English law, against a purchase price equal to 95% of the amount of the purchased receivable. Important to note is that the RPA does not constitute a transfer in advance of future receivables. F only purchases existing receivables arising out of the uploaded invoices from D which upon notice to D are automatically assigned to F. D continues to collect the purchased receivables and is under the obligation to settle the collections with F on a weekly basis. The RPA includes representations and covenants by D that the receivables arising out of the uploaded invoices are not and will not be encumbered by any right or

lien in favor of a third party. On 1 July 2019 D moves its head office and central administration to Germany where it has most of its customers and registers its new business address with the Dutch trade register. D's business is doing very well initially, but around June 2019 things decline and D has a substantial outstanding liability to another major (Dutch) creditor (X). D enters into negotiations with X to settle the outstanding liability in instalments. X agrees provided that D grants X security. As D's only valuable assets are receivables against its customers, D enters into a Dutch law settlement and pledge agreement and agrees to pledge and pledges (in advance) on 12 July 2019 all of its current and future receivables to X by way of a Dutch law undisclosed right of pledge. D does not inform X of the existence of the RPA nor does it inform F of the right of pledge granted to X over the receivables arising under the invoices it continues to upload onto the platform and which F continues to purchase. As F only purchases receivables at the time that the invoices are uploaded, all of the receivables that it purchases after 12 July 2019 are already encumbered by the undisclosed right of pledge of X. By the beginning of November 2019 F has become aware of the financial difficulties of D as the settlement payments are no longer forthcoming, and on 10 November 2019 it decides to notify the assignments to all the debtors of the purchased receivables. X also loses faith in D and proceeds to notify its right of pledge to all of the debtors of the pledged receivables on 24 November 2019. A substantial number of debtors have now received two notices – one of an assignment and another of a right of pledge – in which F and X respectively instruct the debtors to pay the receivables to them. The debtors are understandably confused and refrain from paying their outstanding receivables to anyone until it has been determined which party – F as assignee or X as pledge – has priority and is thus entitled to collect the receivables. D is declared insolvent by a German court on 8 December 2019.

Figure 3



6 THE PROPOSAL

6.1 Introduction

A consultation process regarding the Proposal invited responses from different organizations throughout the EU,[24] and since its publication the Proposal has been the

24 In April 2017 the Commission launched a consultation on the Proposal: https://ec.europa.eu/info/consultations/finance-2017-securities-and-claims_en (last accessed on 26 November 2019). The responses to the consultation can be accessed on: https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en (last accessed on 26 November 2019).

topic of several articles by leading authors.[25] The conclusion one can draw from the responses to the consultation and the various publications is that you are either a fan or an opponent of the Proposal and that there is not much in between.

The Proposal is accompanied by an explanatory report of the Commission in which the background of the proposed rules is explained and which provides a short explanation of each provision (**Explanatory Report**). Included in the Proposal is a preamble with 37 recitals, each providing an introduction or interpretation of the provisions of the Proposal (**Preamble**). The Proposal counts 15 articles.

As mentioned in the introduction of this report, the Proposal intends to put an end to the uncertain scope of Article 14 Rome I Regulation. Currently, recital 38 of the preamble to the Rome I Regulation has introduced a property aspect to the rule of Article 14(1) Rome I Regulation, which on that basis governs both the contractual aspects and the property aspects of the relationship between the assignor and the assignee. In some jurisdictions (like the UK and Germany) Article 14(2) Rome I Regulation is now also applied to property aspects of the assignment as against the debtor and third parties.

The **Dutch private international law rule** on the property aspects of an assignment of claims is laid down in Article 10:135 (2) Dutch Civil Code (**DCC**) and is in line with Article 14(1) Rome I Regulation. It provides that all property aspects of an assignment of claims (other than the question of assignability of the claim) are governed by the law governing the agreement containing the obligation to assign the claim. That governing law is determined by the rules of the Rome I Regulation, and thus assignor and assignee are free to choose the law applicable to that agreement (subject to the limitations set forth in the Rome I Regulation). The same rules apply to the creation of a security right over a claim. This rule has not been replicated in other EU Member States, mainly because most jurisdictions are unwilling to accept the freedom to choose the law where it concerns property aspects of a transaction that directly affects the position of third parties.

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25 H. Labonté, 'Third-Party Effects of the Assignment of Claims: New Momentum from the Commission's Capital Markets Union Action Plan and the Commission's 2018 Proposal', in *Journal of Private International Law*, 2018, vol. 14, no. 2, pp. 319-342; A. Dickinson, 'Tough Assignments: The European's Commission's Proposal on the Law Applicable to the Third-Party Effects of Assignment of Claims', in *IPRax,* 2018, vol. 4, p. 337; P. Mankowski, 'Der Kommissionsvorschlag zum Internationalen Privatrecht der Drittwirkungen von Zessionen', in *Recht der Internationalen Wirtschaft*, 2018, vol. 8, p. 488; Mankowski, *supra* note 20; R. Freitag, 'A King Without Land – the Assignee Under the Commission's Proposal for a Regulation on the Law Applicable to the Third-Party Effects of Assignments of Claims', posted on *Conflictoflaws.net* by J. von Hein on 14 March 2019; M. Lehman, 'Assignment and Conflict of Laws: The New Commission Proposal', in *Journal of International Banking and Finance Law,* 2018, vol. 6, p. 370; L.F.A. Welling-Steffens, *supra* note 1; L. Huebner, 'Die Drittwirkungen der Abtretung im IPR', in *ZeuP,* 2019, Heft 1, p. 41 (*see* a short summary of this article posted by G. Ruehl on *Conflictoflaws.net* on 6 May 2019); C. Walsh, 'The Role of Party Autonomy in Determining the Third-Party Effects of Assignments: of "Secret Laws" and "Secret Liens"', in *Law & Contemporary Problems,* 2018, vol. 81, p. 181; H. Kronke, 'Assignment of Claims and Proprietary Effects: Overview of Doctrinal Debate and the EU Commission's Proposal', in *Oslo Law Review*, 2019, vol. 6, no. 1, pp. 8-18.

If the Proposal enters into force in its current form (and, as mentioned earlier, that is still a big if), the main rule provides that the law applicable to the 'third-party effects'[26] of an assignment of claims is the law of the habitual residence of the assignor. It thus introduces a possible third jurisdiction that applies to the already complex cross-border assignment of claims.[27] As the Proposal will have a universal formal scope, its rules will apply to all assignments of claims as defined therein, regardless of the location of the parties, the law governing the claim or the law governing the assignment. The entry into force of the Proposal would also mean curtains for the Dutch rule on property aspects of an assignment of claims; at least in as far as it concerns the third-party effects of such assignment. The Dutch rule that applies to all property aspects of an assignment has failed despite the fact that since it was introduced by the Dutch Supreme Court in the Hansa case[28] it has worked very well for over 20 years.

6.2 The Proposed Conflict of Laws Rules

6.2.1 Scope of the Proposal

6.2.1.1 Material Scope

The Proposal applies to "the third-party effects of assignments of claims in civil and commercial matters" in situations where different laws could claim applicability (Art. 1 (1) Proposal). Recital 17 of the Preamble makes clear that the Proposal is not applicable to a transfer or novation of contracts.[29] The European Parliament has suggested two amendments that relate to the material scope of the Proposal. In Article 1(1) it has proposed to add the following wording at the end: "other than third-party effects to the debtor of the claim assigned". I will come back to this when discussing the relationship between the Proposal and Article 14 Rome I Regulation. Another remarkable amendment made by the European Parliament is to Recital 17, which provides for the opposite in relation to a transfer or a novation of a contract than the original text; instead of excluding a transfer or novation of contracts, the amendment refers to transfer and

26 I will come back to what exactly is meant by 'third-party effects'.

27 It only increases the complexity but also complicates matters for European banks when wanting to use claims as collateral in respect of funding by their central banks. Art. 97 of the ECB General Documentation (Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60), [2015] OJ L91/50) provides that "no more than two governing laws in total" shall apply to the provision of such collateral. *See also* Labonté, *supra* note 26, at 339.

28 Dutch Supreme Court 16 May 1997 NJ 1998, 585.

29 The Proposal does provide for a rule in the case of a priority issue between an assignee and a transferee of the same claim as a result of a transfer or novation of contract.

novation of contracts as prime examples of an assignment of claims and thus, 'in particular', includes these in the scope of the Proposal.[30] A transfer or a novation of contract is a completely different legal act than an assignment as the transfer or a novation of a contract leads to the transferee of the contract becoming the contract party instead of the transferor under the transferred or novated contract. It has nothing to do with the transfer of property in general or the assignment of a claim in particular and, in general, requires the cooperation of the counterparties to the contract. I trust this amendment will not be accepted by the Commission.

Article 1(2) of the Proposal provides a list of exceptions to its material scope, which mainly excludes certain types of claims (for instance, claims arising out of family relations and matrimonial property regimes, out of bills of exchange and promissory notes, under company law, trust and certain insurances). These exceptions broadly copy those set forth in the Rome I Regulation, the Rome II Regulation[31] and the Brussels I Regulation (recast),[32] which regulations also apply to civil and commercial matters. In light thereof, recital 9 of the Preamble provides that the material scope of the Proposal must be interpreted in the same way as in those regulations. The European Parliament has added an additional exception that does not so much reflect a type of claim but the circumstances under which claims are transferred. The proposed amendment provides that an assignment of claims in the course of an insolvency proceeding under the Insolvency Regulation should be excluded from the material scope of the Proposal. It seems that the European Parliament has added this to the exceptions list on the basis of an incorrect perception of the Insolvency Regulation. In the explanatory statement[33] the rapporteur states that assignment of claims in the course of an insolvency proceeding under the Insolvency Regulation have been excluded from the scope of the Proposal because the Insolvency Regulation contains rules on applicable law. Although it is correct that the Insolvency Regulation contains certain conflict of laws rules in relation to the insolvency proceedings, it definitely does not contain a conflict of laws rule on the (third-party effects) of the assignment of claims. The fact that an assignor is declared insolvent does not and should not change the applicable law to the question of the third-party effects of an assignment. It seems that the European Parliament has perhaps been confused by the fact that Article 7 Insolvency Regulation provides that the *lex*

30 The amendment to Recital 17 reads: "This Regulation concerns the third-party effect of assignment of claims. ***In particular, it covers*** the transfer of contracts … or the novation of contracts." The original text on that point reads: "***It does not cover*** the transfer of contracts etc."

31 Regulation (EC) no. 864/2007 of the European Parliament and the Council of 11 July 2007 in respect of the law applicable to noncontractual obligations (Rome II), L 199/40.

32 Regulation (EU) no. 1215/2012 of the European Parliament and the Council of 12 December 2012 regarding the jurisdiction and recognition and enforcement of judgments in civil and commercial matters (recast) (Brussel I Regulation (recast)), L 351/1.

33 P. 18 of the Report on the proposal for a regulation of the European Parliament and of the Council on the law applicable to the third party effects of assignments of claims (COM(2018)0096 – C8-0109/2018 – 2018/0044(COD)). Committee on Legal Affairs; Rapporteur: Pavel Svoboda.

concursus determines which assets form part of the insolvent estate or that Article 2(9) (viii) Insolvency Regulation provides that claims – for the purpose of the Insolvency Regulation – are located at the center of main interest of the debtor of such claims. That the *lex concursus* is not applicable to the question of ownership of or entitlement to assets, where such ownership or entitlement is challenged has been confirmed by the European Court of Justice in the German Graphics case.[34] The determination of a fictitious location of claims has been included in the Insolvency Regulation for the purpose of Article 8 thereof, which provides that secured creditors with rights *in rem* over assets located in a Member State other than where the insolvency proceedings have been opened, are not affected by such insolvency proceedings. This does not mean that in insolvency proceedings the question of whether a security right created over a claim has third-party effects is suddenly governed by the law of the center of main interest (COMI) of the debtor. We must trust that this amendment will not be accepted by the Commission as the Insolvency Regulation does not and is not intended to contain a conflict of laws rule to determine the law to govern an assignment of a claim.

6.2.1.2 Formal Scope

As mentioned earlier, the Proposal has a universal formal or territorial scope (Art. 3). This means that it is applicable regardless of the law that is to be applied in accordance with the conflict of laws rules of the Proposal, regardless of the domicile or habitual residence of the parties involved (assignor, assignee, debtor or third parties) and regardless of the law governing the claim that is being assigned. The provisions of the Proposal would therefore apply to the German case explained under the heading Intermezzo and to the two case studies set out earlier. This means that the Proposal sets aside the national rules of private international law of the EU Member States

34 In the German Graphics-case (CJEU 10 September 2009, C-292/08) the issue to be decided was whether the fact that Art. 4(2)(b) Insolvency Regulation (Art. 7(2)(b) Insolvency Regulation (recast)) explicitly provides that the *lex concursus* is applicable to determine which assets form part of the insolvent estate also entails that a claim brought by a seller under a retention of title in a bankruptcy of the buyer to confirm the seller's ownership of the asset sold under the retention of title is excluded from the scope of the Brussels I Regulation (recast) (Regulation (EU) no. 1215/2-12) on the basis of Art. 1(2)(b) of the Brussels I Regulation (recast). The ECJ rules in consideration 37 that this is not the case and that the fact that the *lex concursus* is applicable to the question regarding the composition of the bankrupt estate under the Insolvency Regulation does not have any bearing on the question of whether a claim to ownership by a seller under a retention of title falls within the scope of the Insolvency Regulation and thus outside of the Brussels I Regulation (recast).

(excluding Denmark[35] and probably the UK and Ireland[36]) applicable to assignments of claims that fall within the material scope of the Proposal.

6.2.1.3 Temporal Scope

Article 14 Proposal provides that the provisions of the Proposal only apply to 'assignments concluded' after the date of application of the Proposal. Article 15 stipulates that the Proposal will enter into force on the 20th day after its publication in the official journal of the EU and that it shall apply 18 months from the date of its entry into force. It is unclear what is meant by 'assignments concluded'. This is especially important for factoring and securitization transactions as these transactions often work with long-term programs where the conclusion of the agreement to assign (the RPA) does not always coincide with the actual assignment of the receivables that are intended to be part of the factoring or securitization program. Furthermore, the factoring or securitization documentation generally also provides for the assignment of future receivables. The question is whether the provisions of the Proposal apply only where the agreement to assign is concluded after the date of application so that none of the assignments effected pursuant to such agreement concluded before the date of application of the Proposal fall under the Proposal's scope or whether they apply to each assignment of a receivable pursuant to such agreement to assign which assignment is effected after the date of application, regardless of the date of conclusion of the agreement to assign. The latter explanation could mean that current long-running securitization or factoring programs may have to be amended to comply with the new conflict of laws rules of the Proposal.

6.2.2 Certain Defined Terms That Are Important to Determine the Scope of the Proposal

The second article of the Proposal contains a list of defined terms. To determine the scope of the Proposal the following terms, in particular, are important: 'assignment', 'claim' and last but not least 'third-party effects'.

6.2.2.1 Assignment

The term 'assignment' indicates a voluntary transfer. The definition included in Article 2 (c) Proposal provides that this does not only include a transfer by way of an outright

35 Denmark has opted out of all EU private international law legislation and does not have a right to opt in unlike the UK and Ireland, which have until now opted in to all EU private international law legislation.

36 The UK and Irish governments have indicated that in this case they will not make use of their right to opt in. In a letter dated 9 July 2018 (http://europeanmemoranda.cabinetoffice.gov.uk/files/2018/07/Assignment_of_claims_-_HOC_letter_from_the_Economic_Secretary.pdf (last accessed on 12 July 2018)) the UK government indicated that it does not wish to make use of the possibility to opt in as the government has concluded it is in the UK's interest not to opt in to the regulation, as it would create legal and practical uncertainty in the UK financial services markets.

assignment of the claim but also an assignment by way of security, contractual subrogation and the creation of security rights over claims (including pledges). Legal subrogation (i.e. subrogation by operation of law) does not fall within the meaning of assignment and hence not fall within the scope of the Proposal. The applicable law to a legal subrogation is determined in accordance with the conflict of laws rule of Article 15 Rome I Regulation.

6.2.2.2 Claim

The definition of 'claim' is also fairly broad. It is defined as "the right to claim a debt of whatever nature, whether monetary or non-monetary, and whether arising from a contractual or a non-contractual obligation". The Explanatory Report distinguishes three categories of claims: traditional claims, claims arising out of financial instruments and claims that consist of cash deposited with a credit institution, where the account holder is the creditor and the credit institution is the debtor of the claim. The terms 'financial instruments', 'cash' and 'credit institution' are further defined in Article 2 Proposal.

It is not hard to imagine what is meant by traditional claims and claims arising from a current account. It gets more difficult in respect of claims arising out of financial instruments. Traditional claims would include trade receivables and receivables arising out of loans and facilities. The latter, once defaulted, generally form the subject matter of a purchase of distressed debt. The definition of financial instrument refers to financial instruments within the meaning of Section C of Annex I of MIFID II.[37] The Proposal is only applicable to 'financial claims'[38] that arise out of such financial instruments and not the financial instruments themselves, even though a financial instrument could very well qualify as a claim depending on the type of financial instrument and the applicable law; like listed notes for instance. It seems that the Commission is concerned mainly with clearly differentiating between claims and book-entry securities. On page 7 of the Explanatory Report the Commission states that the Proposal is applicable only to claims arising out of financial instruments, which claims are not registered or traded through a book-entry system and do not qualify as securities under the applicable law. What exactly the Commission regards as 'securities' is not clear, but the Commission probably only refers to book-entry securities for which Article 9 of both the Finality Directive[39] and the Collateral Directive[40] and Article 24 of the Winding-up Directive

37 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 12 June 2014, pp. 349-496.

38 *See* p. 7 of the Explanatory Report.

39 Directive 98/26/EC of the European Parliament and the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, PB L 166 of 11 June 1998.

40 Directive 2002/47/EC of the European Parliament and the Council of 6 June 2002 on financial collateral arrangements, PB L 168 of 27 June 2002.

Credit Institutions[41] each provide a similar conflict of laws rule. The conflict of laws rules regarding book-entry securities as set forth in these Directives have been consolidated into one rule in Dutch legislation and laid down in Article 10:141 DCC. Despite the fact that a book-entry security may under the applicable law qualify as a claim, such claim is thus excluded from the scope of the Proposal, although the recitals of the Preamble or the provisions of the Proposal do not in so many words exclude such claims.

After all that it is still not exactly clear what is meant by 'claims arising out of a financial instrument'. The question also remains whether financial instruments that, in accordance with their governing law, qualify as receivables and at the same time as securities (registered – as opposed to bearer bonds, for example) but are not recorded in a book-entry system do fall within the scope of the Proposal. It is important to get clarity on these questions as the Proposal makes an exception to the main rule, discussed hereinafter, for claims arising out of financial instruments.

6.2.2.3 Third-Party Effects

'Third-party effects' are defined as 'proprietary effects'. What is meant by 'proprietary effects' is further set out in the definition itself:

> the right of the assignee to assert his legal title over a claim assigned to him towards other assignees or beneficiaries of the same or functionally equivalent claim,[42] creditors of the assignor or other third parties.

Although the initial definition seems broad, the latter part of the definition limits it to proprietary effects against third parties and to questions of priority. It does not reflect that the Proposal is also applicable to the proprietary effects of the assignment as between the assignor and assignee or against the debtor. It is also unclear what is meant by 'other third parties'. Does that include a bankruptcy trustee in an insolvency of the assignor? Or should the bankruptcy trustee be equated with the assignor? Neither the Proposal nor the Explanatory Report makes any mention of the bankruptcy trustee. It is obviously extremely important for the assignee to know which law would be applied to the proprietary effects of the assignment as against the bankruptcy trustee of the assignor. In an insolvency of the assignor, the assignee does not want to be confronted with another law to govern its position in relation to the assigned claim.

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41 Directive 2001/24/EC of the European Parliament and the Council of 4 April 2001 on the reorganization and winding up of credit institutions, PB L 125 of 5 May 2001.

42 The reference to 'the beneficiary of a functionally equivalent claim' probably refers, and can only refer, to the beneficiary of a novated claim pursuant to a novation of contract. A beneficiary of a novated claim has not acquired the original claim, as that claim has ceased to exist owing to the novation, but can be said to be functionally the same as the original claim.

Apart from the uncertainty regarding the bankruptcy trustee, it seems that the definition of third-party effects is limited to just third parties as opposed to parties involved in the assignment. This would or should lead to the conclusion that the proprietary effects as between assignor and assignee fall within the scope of Article 14(1) Rome I Regulation and as against the debtor under Article 14(2) Rome I Regulation. I will return to what the consequences of that conclusion are as the European Parliament has suggested certain amendments that undoubtedly lead to this conclusion. The Explanatory Report and the Preamble, however, seem to give a much broader meaning to third-party effects than its definition. Recital 14 Preamble provides that the law applicable to the *contractual* relationship between the debtor and the creditor of the assigned claim, between the assignor and the assignee and between the assignee and the debtor is determined by the rules set forth in the Rome I Regulation (in particular, Articles 3, 4 and 14). Furthermore, recital 15 provides that the conflict of laws rules in the Proposal *should* be applicable to all proprietary effects of an assignment of a claim as between "all parties involved in the assignment" and as against third parties. The recital provides explicitly that 'between all parties involved in the assignment' means as between the assignor and the assignee and between the assignee and the debtor. The Preamble gives only one example of 'third parties': creditors of the assignor. The Explanatory Report does not provide any additional insights when discussing the definition of 'third-party effects'. However, throughout the Explanatory Report a clear distinction is made between the 'contractual elements' and the 'proprietary elements' or third-party effects of an assignment. 'Contractual elements', according to the Commission, deal with the obligations that arise between the parties involved in the assignment *inter se*. "Proprietary elements", according to the Commission,

> refer in general to who has ownership rights over a claim and, in particular, to: (i) which requirements must be fulfilled by the assignee in order to ensure that he acquires legal title over the claim after the assignment (for example, registration of the assignment in a public register, written notification of the assignment to the debtor), and (ii) how to resolve priority conflicts, that is, conflicts between several competing claimants as to who owns the claim after a cross-border assignment (for example, between two assignees where the same claim has been assigned twice, or between an assignee and a creditor of the assignor).

The general description of proprietary elements by the Commission is thus broad. The specification comes closer to the definition of third-party effects and refers to perfection requirements (i.e. formalities to make sure the assignment is effective against the debtor and third parties) and issues of priority. The intention of the Commission with the Proposal seems clear when it goes on to state that the Rome I Regulation provides conflict of laws rules for the contractual elements, whereas there are currently no EU conflict of laws rules for the proprietary elements that should thus all be governed by the Proposal.[43]

Considering, in particular, recital 15 of the Preamble, but also the clear distinction made in the Explanatory Report between contractual and proprietary elements of an assignment, it is at least remarkable that neither the definition of third-party effects nor Article 5 of the Proposal on the scope of the applicable law (which provision I will discuss later on in this report) makes any mention of the 'proprietary elements' between the assignor and the assignee and between the assignee and the debtor. Article 5 under (a) explicitly excludes 'the requirements to ensure the effectiveness of the assignment' *against the debtor* from the scope of the applicable law. This ambiguity between the Explanatory Report and the Preamble, on the one hand, and the provisions of the Proposal, on the other, creates a lot of uncertainty as to the true scope of both Article 14 Rome I Regulation and the Proposal.

The European Parliament has suggested quite extensive amendments to the relevant recitals, definitions and provisions of the Proposal, which all have as a result that the proprietary elements as between the assignor and assignee fall within the scope of Article 14(1) Rome I Regulation and as between the assignee and the debtor within the scope of Article 14(2) Rome I Regulation and that only the proprietary elements as against third parties fall within the scope of the Proposal. The amendments include the following: (i) a new recital 14a that explicitly states that the Proposal is not intended to affect the provisions of the Rome I Regulation regarding 'the proprietary effects of a voluntary assignment' as between the assignor and the assignee and between the assignee and the debtor; (ii) an amendment of recital 15 so that it refers solely to the effects of an assignment as against third parties excluding the debtor; (iii) explicit exclusion of the effects of an assignment as against the debtor from Article 1(1) Proposal; and finally (iv) in the definition of third-party effects the European Parliament has deleted the broad reference to 'proprietary effects' and has again excluded the effects against the debtor. None of the amendments made by the European Parliament, however, clarify the question of whether the bankruptcy trustee should be treated as a third party or should be identified with the assignor. For the applicable law that may make a huge difference.[44]

Under Dutch law it is barely conceivable to split the proprietary effects, depending on against which party the assignee wants to assert its rights in respect of the assigned claim. If a transfer of an asset has proprietary effect it means the transfer has *erga omnes* effect;

43 *See* pages 9-10 of the Explanatory Report. The French (p. 10), German (p. 10) and the Dutch (p. 9) versions of Explanatory Report reflect the same.

44 In the feedback provided by Mayer Brown International LLP (https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en (last accessed on 26 November 2019)) the same scope and relationship between the Proposal and Art. 14 Rome I Regulation is advocated.

i.e. against every conceivable party or person. Although it can be said that other EU jurisdictions do not make such a clear split between the law of obligations and property law as in the case under Dutch law, it is vital for an assignee that the question of whether it can assert its rights to the assigned claim against whomever (the assignor, the debtor, the creditors of the assignee, other assignees or beneficiaries of the assigned claim and the bankruptcy trustee of the assignor) is governed by the laws of one jurisdiction. This will also achieve the cost efficiency that the Commission is looking for and will promote legal certainty. From the Explanatory Report and the Preamble as presented by the Commission, it seems that the Commission did intend for all proprietary elements of an assignment of a claim to fall within the scope of the Proposal and that Article 14 Rome I Regulation only governs the contractual elements. However, the use of the term third-party effects, and the way that it has been defined in the Proposal, and the wording of Article 5 of the Proposal regarding the scope of the applicable law do not reflect this intention.[45] The European Parliament and the Council have, considering the proposed amendments, a clear intention to split the proprietary elements of an assignment of a claim between a possible three jurisdictions.

6.2.3 The Applicable Law to the Third-Party Effects

Article 4 Proposal contains both the main rule and the exceptions to such main rule. It furthermore provides rules that aim to solve what I shall call the priority issue or the issue of *conflit mobile*.

6.2.3.1 Main Rule – The Law of the Habitual Residence of the Assignor

The first section of Article 4 provides that the law of the country in which the assignor has its habitual residence will govern the third-party effects of an assignment of a claim. Reference is made to the habitual residence of the assignor at 'the material time'. What the 'material time' is remains unclear, and a review of the Proposal in other languages does not make it any clearer.[46] The Preamble and the Explanatory Report do not shed any light on the interpretation either. The fact that what is meant by 'material time' is totally unclear is already troubling for the application of the main rule but gets even more troubling when attempting to apply the rules on the priority issue between two assignees of the same claim. That results in a conundrum that I have found quite impossible to solve. Thankfully, the European Parliament has proposed one sound and necessary

45 The ECB, in Para. 1.1 of the General Observations of its opinion, – Opinion of the European Central Bank of 18 July 2018 on a proposal for a regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims (CON/2018/33), (2018/C 303/02) (https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2018_33_sign_with_twd.pdf (last accessed on 26 November 2019) – also advocates that all proprietary elements of an assignment should be governed by the provisions of the Proposal.

46 In the Dutch text: "ten tijde van de feiten", in the German text: "zum maßgebenden Zeitpunkt" and in the French text: "au moment considéré".

amendment, which is to replace the wording 'the material time' by 'the time of conclusion of the assignment contract'.[47] Although this brings a lot more clarity, it still needs to be tweaked. This is because it is unclear whether 'the assignment contract' refers to the contract between the assignor and the assignee in which the obligation or agreement to assign has been laid down (for instance, an RPA or a loan agreement – the contract to assign) or the contract or deed of assignment that, in some jurisdictions, forms part of the property law formalities to effect the transfer of a claim.

In my opinion, connecting to the habitual residence of the assignor at the time of the conclusion of the contract to assign provides the most certainty in terms of timing.[48] Connecting to a property law formality for transfer (like a deed of assignment or publication in a register) has the huge downside, namely that whether that formality is a requirement depends on the applicable law.

6.2.3.2 Habitual Residence

For the meaning of 'habitual residence' reference is made to the definition of the same term in the Rome I Regulation (Art. 19). As a result of this reference, for companies, habitual residence means the place of central administration,[49] and for natural persons acting in the course of a business, the principal place of such business. The Rome I Regulation does not give any further guidance on where the central administration of a company can be found. Oddly enough, both the Preamble and the Explanatory Report, where habitual residence is further explained, state that habitual residence must be interpreted in the same manner as the COMI as that term is defined in the Insolvency Regulation, despite the fact that the Proposal explicitly refers to the Rome I Regulation.[50] The Commission's reasoning for referring to the COMI is that most issues regarding the third-party effects of an assignment occur in an insolvency of the assignor.[51] Recital 22 of the Preamble provides explicitly that it is desirable that there is coherence between the conflict of laws rules of the Proposal and the Insolvency Regulation and goes on to say that "the use of the assignor's habitual residence as connecting factor coincides with the debtor's center of main interest used as connecting factor for insolvency purposes".[52] This would then mean that the applicable law to the third-party effects of an assignment is the same as the law governing the insolvency[53] of the assignor. The question is why this is important. It seems to me that the Commission makes the same

47 Amendment 9.

48 *See also* response to consultation on Proposal by Teun Struycken and Lilian Welling-Steffens (https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en (last accessed on 26 November 2019)).

49 In the Dutch text: *hoofdbestuur*; in the French text: *administration central*; and in the German text: Hauptverwaltung.

50 *See* Explanatory Report on p. 19.

51 P. 11 Explanatory Report.

52 *See* explicitly p. 11 of the Explanatory Report.

53 *See* Art. 7 Insolvency Regulation.

mistake as the European Parliament wherein its amendments of the Proposal excluded assignments in the course of insolvency proceedings. The question of whether an assignee can assert its entitlement to an assigned claim in insolvency proceedings of the assignor against the bankruptcy trustee is not governed by the law applicable in accordance with the Insolvency Regulation (the *lex concursus*) as that question does not fall within the scope of the Insolvency Regulation.[54] Whether an assignee can assert its entitlement to the assigned claim against the bankruptcy trustee of the assignor is either governed by the law applicable in accordance with the Proposal or by the law applicable in accordance with Article 14(1) Rome I Regulation – the jury is still out on which of the two.

On top of the question of why this desirable, it is not set in stone that the COMI of the assignor, within the meaning of the Insolvency Regulation, will always coincide with the assignor's habitual residence, within the meaning of the Proposal with reference to the Rome I Regulation. Article 3 Insolvency Regulation defines the COMI as "the place where the debtor conducts the administration of its interests on a regular basis and which is ascertainable by third parties" and is presumed to be at the location of its registered office.[55] The presumption may be set aside, and recital 30 of the preamble of the Insolvency Regulation provides the following:

> In the case of a company, it should be possible to rebut this presumption where the company's central administration is located in a Member State other than that of its registered office, and where a comprehensive assessment of all the relevant factors establishes, in a manner that is ascertainable by third parties, that the company's actual centre of management and supervision and of the management of its interests is located in that other Member State.

The connecting factor 'habitual residence' in the Proposal only coincides with the COMI if the center of administration is at the location of the registered office or, if that is not the case, there are, apart from the fact that the assignor's central administration is located in another state, other relevant circumstances that justify that the presumption is rebutted. Furthermore, the Insolvency Regulation applies only where the COMI is located in a Member State, whereas the Proposal has universal scope. This means that the assignor may very well have its 'habitual residence' (which may or may not coincide with its COMI) outside the EU. The Proposal would still apply but the Insolvency Regulation would not. In consideration of the foregoing the habitual residence of the assignor may

54 *See also* Labonté, *supra* note 26, at 340.
55 In the Dutch text of the Insolvency Regulation: statutaire zetel; in the French text: siege statutaire; and in the German text: Sitz.

very well coincide with its COMI but not by definition.[56] There may finally also be a discrepancy in time. Pursuant to the Proposal (as amended by the European Parliament), the third-party effects of an assignment are governed by the law of the habitual residence of the assignor at the time of concluding the contract to assign, while the COMI under the Insolvency Regulation is determined on the date of the opening of the main proceedings. As these dates will not coincide, the assignor may have shifted its COMI or habitual residence after the date relevant under the Proposal. The desired coherence between the Proposal and the Insolvency Regulation is therefore certainly not a given. So the question remains why the Proposal did not refer to COMI within the meaning of the Insolvency Regulation in Article 4(1) of the Proposal if the coherence was so desirable. As already mentioned earlier, in my opinion the desire for coherence between the applicable law under the Proposal and that under the Insolvency Regulation seem to be based on the incorrect premises that the *lex concursus* would somehow apply to the question whether the assignee could assert its entitlement to the assigned claim against the bankruptcy trustee.[57] If that were the case, legal certainty for the assignee would definitely be out the window. To establish the desired coherence without taking away the legal certainty for the assignee, reference could be made to the statutory or registered seat of the assignor, which under the Insolvency Regulation is presumed to be the COMI. To allow a rebuttal of the presumption in case of a conflict of laws rule would not work, as it leads to further uncertainty.

6.2.3.3 Exceptions to the Main Rule

6.2.3.3.1 Mandatory Application of the Law Applicable to the Assigned Claim

Article 4(2) Proposal provides for an exception to the main rule and sets the main rule aside, where it concerns the assignment of a claim against a credit institution arising out of cash[58] credited to an account maintained with such credit institution and claims arising out of financial instruments.[59] The third-party effects of an assignment of these claims are governed solely by the law governing the claim. Although neither of these claims is of any real interest in a report about the purchase of distressed debt, I will briefly discuss this exception.

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56 The fact that there is plenty of case law before the ECJ shows that the determination of the COMI is not always straightforward. *See*, in particular, ECJ 2 May 2006, C-341/04, ECLI:EU:C:2006:281 (Eurofood); and ECJ 20 October 2011, C-396/09, ECLI:EU:C:2011:838 (Interedil/Fallimento Interedil).

57 I refer again to the judgment of the ECJ in the German Graphics-case (CJEU 10 September 2009, C-292/08).

58 The European Parliament in amendment number 21 has deleted the definition of ‘cash’ and, through amendment number 22, has changed the wording in Art. 4(2)(a) from ‘cash’ to ‘money credited to an account’.

59 According to Art. 2(i) Proposal reference must be made to financial instruments within the meaning of Section C of Annex I of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 12 June 2014, pp. 349-496.

In respect of claims arising out of bank accounts it is already standard practice to apply the law governing the claim to any proprietary aspects of an assignment of such claim. The Explanatory Report[60] and recital 26 Preamble make clear that the law governing such claim is the law applicable to the current account relationship between the account holder and the credit institution in accordance with the Rome I Regulation.[61]

As mentioned earlier, there is no clear definition, or explanation of the scope, of claims arising out of financial instruments. As the exception applies to these claims it is quite vital to know which claims fall in this category. This is also relevant for purchasers of distressed debt if for instance that distressed debt is in the form of registered bonds.[62]

6.2.3.3.2 Freedom to Choose the Law Applicable to the Assigned Claim

Article 4(3) Proposal provides for a second exception to the main rule. In the event the assignment of the claim is effected within the framework of a securitization transaction, parties may choose to have the third-party effects of such assignment governed by the law governing the assigned claims. Several organizations that have commented on the Proposal in the consultation have proposed that this exception also applies to the transfer of loans under credit and facility agreements.[63] The choice of law must be made explicitly. If such choice for the law applicable to the claim to govern the third-party effects of the assignment is not made explicitly, the main rule automatically applies. There is no definition of securitization, and the Explanatory Report only gives a brief and

60 On p. 20.

61 In the consultation on the Proposal no comments have been made to this exception.

62 The ECB, in Para. 2.2 of the Specific observations in its opinion, – Opinion of the European Central Bank of 18 July 2018 on a proposal for a regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims (CON/2018/33), (2018/C 303/02) (https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2018_33_sign_with_twd.pdf (last accessed on 26 November 2019) – proposes to also apply the exception of Art. 4(2) Proposal to credit claims (as defined in the Collateral Directive 2002/47/EC). The ECB supports this suggestion by pointing out that the conflict of laws rule for book-entry securities in the Collateral Directive, which also refers to only one applicable law. The ECB is further of the opinion that the main rule of the Proposal has several shortcomings – "This is because the reference to the law of a third jurisdiction increases the legal due diligence burden on collateral takers where credit claims, i.e., bank loans, are mobilised as collateral on a cross-border basis."

63 Please refer to footnotes 66 and 67.

very general description. As this will lead to uncertainty as to which transactions would fall under the scope of this exception, the Dutch delegation has suggested broadening the scope of this exception to all assignments of claims.[64] Such broader scope would also be very welcome for assignments within the framework of syndicated loans[65] and supply chain financing.[66] The European Parliament has, however, completely deleted this exception from the Proposal as it does not wish to allow freedom of choice of law where the rights of third parties are affected.[67] As previously mentioned, the Council is still undecided whether the main rule should refer to the law of the habitual residence of the assignor or the law of the assigned claim to govern the third-party effects. The choice between the two will also open up the exception discussion again.

6.2.3.4 Conflit Mobile*; Priority Issues*

Article 4 also provides rules to solve what I have called the *conflit mobile*[68] or issues of priority. This is when an assignor assigns the same claim twice and it must be decided which of the assignees has priority over the other. If both assignments are governed by the same law it is obviously this law that determines which assignee has priority over the other. In two circumstances the law governing the first and second assignment may differ. This is the case if the assignor has moved its habitual residence between the first and second assignment or if one of the assignments was effected in connection with a securitization and parties have chosen the law applicable to the claim to govern the third-party effects of such assignment. The question is which law – the law of the first or second habitual residence or the law of the habitual residence or the law governing the claim –

64 *See also* Teun Struycken en Lilian Welling-Steffens in their feedback on the Proposal provided to the Commission (https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en (last accessed on 26 November 2019)). The other 6 reactions in the consultation on the Proposal are quite diverse on this point. Mayer Brown International LLP advocates that Art. 14 Rome I Regulation continues to apply to the proprietary aspects of an assignment as between the assignor and assignee (Art. 14(1) Rome I Regulation) and as between the assignee and the debtor (Art. 14(2) Rome I Regulation) so that the law of the habitual residence of the assignor is applicable only to the proprietary aspects of the assignment against third parties. Mayer Brown further proposes various other transactions to be included in the exception set forth in Art. 4(3) Proposal; the Deutscher Anwalt Verein advocates a cumulative application of the law governing the assigned claim and the law of the habitual residence of the assignor; the EU Federation for Factoring & Commercial Finance proposes that the only exception to the main rule should be in respect of bank accounts; and ISDA and LMA propose to broaden the applicability of the law governing the assigned claim.

65 *See* LMA's plea in their feedback to the Commission (https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en (last accessed on 26 November 2019)).

66 *See* Mayer Brown International LLP's plea in their feedback to the Commission (https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en (last accessed on 26 November 2019)).

67 *See* amendments 12 and 22.

68 *Conflit mobile* is the term used in the event of a transfer of moveable assets when these moveable assets are relocated to another state and an act in relation to such moveable asset is performed that has proprietary relevance so that two or more persons claim to have an interest in the moveable assets but their claimed entitlements are governed by different laws.

determines which assignee can assert its entitlement to the claim against the other assignee and other third parties. The rules laid down in Article 4 are unclear and difficult to apply, especially when read in connection with the relevant paragraphs of the Explanatory Report and the recitals of the Preamble. Also, the provisions do not seem to have been consistently drafted in the various languages. What makes these rules so unclear, however, is mainly the fact that in the original draft of the Proposal (i) the habitual residence must be determined "at the material time and there is no guidance as to how and in relation to what "the material time" must be determined and (ii) the priority provision refers to the assignment that "first became effective against third parties", which would include the other assignee. So instead of trying to explain this unexplainable conundrum, I will set out the rules for these priority issues under the assumption that the amendments made by the European Parliament to Article 4(1) first paragraph whereby "at the material time" is replaced by "at the time of conclusion of the contract to assign"[69] and to Article 4(1) second paragraph "against third parties" is replaced by "against other third parties".

Article 4(1) second paragraph provides the conflict of laws rule for the first priority issue set out above, where, between the first and the second assignment of the same claim, the assignor has moved its habitual residence. It provides that the question of priority between these two assignees is governed by the law of the habitual residence of the assignor at the time of the assignment that first became effective against other third parties under the law designated as applicable pursuant to the first subparagraph of Article 4(1) (the law of the habitual residence at the time of the conclusion of the contract to assign). Recital 24 Preamble,[70] however, provides the following in respect of this question of priority:

> Where the assignor changes its habitual residence between multiple assignments of the same claim, the applicable law [to the question of priority – LWS] should be the law of the assignor's habitual residence at the time at which one of the assignees first makes its assignment effective against third parties by completing the requirements under the law applicable on the basis of the assignor's habitual residence at that time.

You have to read this paragraph a couple of times and ask the following questions: Which law applies? The law of the habitual residence of the assignor applies. The law of the first or the second habitual residence? Well, the law of the habitual residence at the time one of the assignees has fulfilled all requirements for its assignment to be effective against third parties. The requirements of which law, though? Well the requirements of the law of

69 The literal text of the amendment referring to the assignment contract that I have interpreted as the contract including the obligation or agreement to assign the claim.

70 *See also* the Dutch, French and German versions of the Proposal.

the habitual residence of the assignor at that time. At what time? Presumably at the time of the conclusion of the contract to assign the claim to the assignee that has fulfilled all requirements for its assignment to be effective against third parties. So where Article 4(1) second paragraph (read as including the amendments by the European Parliament) seems to point to the law of the habitual residence of the assignor at the time of the conclusion of the contract to assign that lead to the assignment that under that law first became effective against other third parties, the Preamble seems to refer to the law of the habitual residence of the assignor at the time the assignee fulfills the requirements for its assignment to become effective against (other) third parties under the law that is applicable to its assignment. Let us try this out in two examples:

> On T=0 the assignor (A) has its habitual residence in France and enters into a contract with assignee (S1) governed by French law[71] in which parties agree that A assigns its claim against B (Claim B) to S1. Pursuant to French law, the conclusion of the contract to assign effects the transfer of Claim B from A to S1. The third-party effects of this assignment are governed, in accordance with Article 4(1) first paragraph Proposal, by French law, and French law requires notification of B for such third-party effect. Between T=0 and T=1 A moves its habitual residence to England and subsequently enters into a contract with a second assignee (S2) governed by English law in which parties agree that A assigns Claim B by way of an equitable assignment under English law to S2. Pursuant to English law, an equitable assignment effects the transfer of Claim B from A to S2. The third-party effects of this assignment are governed by English law, and English law requires notification of B. Subsequently, on T=3 S1 notifies B of its assignment, and on T=4 S2 notifies B of its assignment. Both S1 and S2 claim they are entitled to Claim B.
> Which law governs the priority issue that has arisen?
> According to Article 4(1) second paragraph, it is French law that is the law governing the assignment to S1 as this assignment under its applicable law – French law – became effective against third parties on T=3, whereas the assignment to S2 under its applicable law – English law – only became effective against third parties on T=4.
> If, however, the slightly differently formulated rule in recital 24 were applied, the question of priority would be governed by English law as the law of the habitual residence of the assignor at the time S1 fulfilled the requirements for its assignment pursuant to its applicable law – French law – to be effective

71 So as not to make this more complicated than it already is. If the contract to assign were to be governed by English law it seems that as things stand the question of whether the claim was transferred to the assignee as between the assignor and assignee would be governed by English law pursuant to Art. 14(1) Rome I Regulation.

> against third parties. This surely is not the desired outcome, and so recital 24 must be amended to conform to Article 4(1) second paragraph as amended by the European Parliament.

One more example to really familiarize ourselves with this provision:

> On T=0 the assignor (A) has its habitual residence in France and enters into a contract with assignee (S1) governed by French law, in which parties agree that A shall assign its claim against B (Claim B) to S1. Pursuant to French law, the conclusion of the contract to assign effects the transfer of Claim B from A to S1. The third-party effects of this assignment are governed, in accordance with Article 4(1) first paragraph Proposal by French law, and French law requires notification of B for such third-party effect. Between T=0 and T=1, A moves its habitual residence to the Netherlands and subsequently enters into a contract with a second assignee (S2) governed by Dutch law, in which parties agree that A shall assign Claim B by way of a nondisclosed assignment under Dutch law to S2. A and S2, simultaneously with the contract to assign, enter into a private deed of assignment under Dutch law and register the deed with the Dutch tax authorities. The third-party effects of this assignment are governed by Dutch law, and under Dutch law nothing further is required for the assignment to be effective against third parties. Subsequently, on T=3, S1 notifies B of its assignment and on T=4 S2 notifies B of its assignment. The notification by S1 is required to give its assignment under French law third-party effect. The notification by S2, however, is under the applicable law of its assignment – Dutch law – not required for the assignment to be effective against third parties but for S2 to become authorized to collect Claim B directly from B. Both S1 and S2 claim they are entitled to Claim B.
> Which law governs the priority issue that has arisen?
> According to Article 4(1) second paragraph, it is Dutch law that is the law governing the assignment to S2 as this assignment under its applicable law – Dutch law – first became effective against third parties. Applying the slightly differently formulated rule in recital 24 would in this case not lead to the applicability of a different law as S2 fulfilled the requirements for its assignment to be effective at the time the assignor had its habitual residence in the Netherlands.

Article 4(4) provides the conflict of laws rule for the second priority issue set out above, whereby the same claim is assigned twice, once within the framework of a securitization to which parties have chosen the law of the claim to be applicable (in accordance with Article 4(3)) and once through a traditional assignment to which Article 4(1) first paragraph applies. The priority issue is governed by the law applicable to the third-party effects of the assignment of the claim that first became effective against third parties under its applicable law. Although the European Parliament has amended the Proposal by deleting both recital 28 Preamble and Article 4(3), it has not deleted Article 4(4) but has even proposed an amendment to it.[72] However, if the possibility of choosing the law governing the claim is no longer a possibility, the priority issue of Article 4(4) cannot occur. So assuming the Proposal will retain a limited freedom of choice of law in case of a securitization, an example of the priority issue that can arise is as follows:

> Assignor A has its habitual residence in France and on T=0 enters into a contract with assignee S1, governed by French law, in which parties agree that A shall assign its claim against B, which is governed by English law (Claim B), to S1. Pursuant to French law, the conclusion of the contract to assign effects the transfer of Claim B from A to S1. The third-party effects of this assignment are governed, in accordance with Article 4(1) first paragraph Proposal by French law, and French law requires notification of B for such third-party effect. On T=1, A requires funding and has decided to enter into a securitization transaction with assignee S2 in respect of claims that include Claim B. Parties choose English law to govern their securitization transaction documents and explicitly provide that the laws governing the various claims being assigned pursuant to the securitization transaction also govern the third-party effects of such assignments in accordance with Article 4(3) Proposal. This means that the third-party effects of the assignment of Claim B pursuant to the securitization are governed by English law. For the assignment of Claim B to have third-party effects, English law requires that B is notified thereof. On T=2, S2 notifies B of the assignment under the securitization, and on T=3, S1 notifies its assignment to B. Both S1 and S2 claim they are entitled to Claim B.
> Which law governs the priority issue that has arisen?
> According to Article 4(4), it is English law that is the law governing the assignment to S2 as this assignment under its applicable law – English law – first became effective against third parties through the notification of B on T=2.

If this provision is read in the Dutch version a completely different rule seems to apply. The Dutch version provides that the priority issue is governed by the law that applies to the third-party effects of the assignment of the claim, which, in accordance with the law governing the claim, is first effective against third parties. This must be a mistake as it would mean that the assignee of the 'traditional' assignment would also have to comply with the requirements of the law governing the assigned claim even though the third-

72 *See* amendments numbers 12 and 22 of the European Parliament.

party effects of its assignment are governed by the law of the habitual residence of the assignor. Only if this assignee would have complied with those requirements before the assignee of the securitization assignment would the priority issue be governed by the law of the habitual residence of the assignor. The French and German versions of the Proposal coincide with the English version, and so the Dutch version must be amended to conform to the English, French and German versions of the Proposal.

Recital 31 Preamble identifies another priority issue: the one between an assignee and a beneficiary of the same, or functionally the same, claim owing to a transfer or novation of contract. Although transfer or novation of contract is excluded from the scope of the Proposal (albeit that the European Parliament wishes both to be particularly included), the Proposal must solve the priority issue that may arise between the assignee and such beneficiary. According to recital 31, the law governing this priority issue should be the law governing the third-party effects of the assignment in accordance with the provisions of the Proposal. This rule has also been laid down in Article 5 Proposal, which determines the scope of the applicable law (see further below). This means that a priority issue between an assignee and a beneficiary is always, regardless of the law applicable to the transfer or novation of contract, governed by the law governing the third-party effects of the assignment.

6.2.4 The Scope of the Applicable Law

The scope of the applicable law found pursuant to Article 4 is given in Article 5 Proposal, which provides a non-exhaustive list of issues that are governed by the applicable law. These are (i) the requirements to ensure the effectiveness of the assignment against third parties *other than the debtor*, such as registration or publication formalities, (ii) the issue of priority of rights between two or more assignees in respect of the same claim, (iii) the issue of the priority of the rights of the assignee over the rights of the assignor's creditors, (iv) the issue of priority of rights between the assignee and the beneficiary of a transfer or novation of contract in respect of the same, or functionally the same, claim.

Where the assignments under (ii) are not governed by the same law, the priority rules of Article 4(1) 2nd paragraph or Article 4(4) Proposal apply.

In this provision the 'third-party effects' against the debtor are explicitly excluded from the scope of the applicable law found through Article 4 Proposal. As mentioned previously, this is in direct conflict with recital 15 Preamble and the interpretation of 'third-party effects' provided in the general part of the Explanatory Report. The Commission, however, seems not to have made up its mind regarding the scope of the applicable law under the Proposal. Where it provides an explanation of Article 5 Proposal in the Explanatory Report,[73] the Commission, seemingly in contradiction of its earlier statements in the Explanatory Report, explicitly states that the

73 *See* p. 21 of the Explanatory Report.

term 'third parties' should be understood as third parties other than the debtor, as all aspects affecting the debtor are, pursuant to Article 14(2) of the Rome I Regulation, governed by the law of the assigned claim.

Whether the proprietary effects of the assignment as between the assignor and assignee fall within the scope of the Proposal is unclear. Recital 15 Preamble seems to suggest that it does, but if that is the case recital 38 of the preamble to the Rome I Regulation should have been disapplied. That recital – or the disapplication thereof – is not mentioned anywhere in the Explanatory Report, the Preamble or the Proposal.

The European Parliament has proposed to add an additional recital to the Preamble[74] and to amend recital 15.[75] These amendments make clear that as far as the European Parliament is concerned, the proprietary effects of an assignment of a claim are governed by three separate conflict of laws rules: Article 14(1) Rome I Regulation as between assignor and assignee; Article 14(2) Rome I Regulation as against the debtor; and Article 4 Proposal as against third parties. So where does that leave us?

Despite the obvious drafting ambiguities by the Commission and, to a lesser extent, the European Parliament it seems that we must anticipate that the scope of the applicable law under the Proposal is indeed limited to the proprietary effects of an assignment against third parties only and more specifically to priority issues. Proprietary effects between assignor and assignee fall within the scope of Article 14(1) Rome I Regulation and those against the debtor under Article 14(2) Rome I Regulation. This also seems to be the point of view of the European Court of Justice in the BGL BNP Paribas SA/TeamBank AG Nürnberg-case[76] discussed previously.

What still remains unclear is the position of the bankruptcy trustee of the assignor: is he considered a third party within the meaning of the Proposal; is he identified with the assignor so that the question whether the assignee can assert its entitlement to the assigned claim against the bankruptcy trustee falls within the scope of Article 14(1) Rome I Regulation; or is this governed by the *lex concursus*?

An example is provided to show what this means for an assignee to be sure that it can assert its entitlement to the assigned claim against anyone and everyone in and outside of a bankruptcy of the assignor:

> A French company (A), with its habitual residence in France (A) with counterparts throughout the EU, enters into an English law-governed loan agreement, as borrower, with a Dutch bank (B) as lender. The loan

74 *See* amendment 6 which adds recital 14a: This Regulation is not intended to alter the provisions of Regulation (EC) No 593/2008 regarding the proprietary effect of a voluntary assignment as between assignor and assignee or as between assignee and debtor.

75 *See* amendment 7.

76 CJEU 9 October 2019, C-548/18 ECLI:EU:C:2019:848, under 32.

agreement provides that, as security for the loan, A is under the obligation to assign by way of security all of its current and future Dutch law-governed receivables against counterparts in the Netherlands to B. The loan agreement, in other words, contains the obligation to assign the receivables. In accordance with the loan agreement, A and B enter into an English law-governed security assignment in respect of the Dutch law-governed receivables. Which law or laws govern the question of whether B can assert its entitlement to the receivables assigned to it pursuant to the legal, valid and binding security assignment under English law?

Between A and B

The contractual relationship in respect of the assignment between A (assignor) and B (assignee) is, in accordance with Article 14(1) Rome I Regulation, governed by the law governing the loan agreement (English law). This means that as between A and B the security assignment must comply with the proprietary requirements of English law. As set forth previously, the security assignment constitutes a legal, valid and binding assignment to B under English law, and so B can assert its entitlement to the receivables against A.

Against the debtor of the assigned receivable

To be able to assert its entitlement to the receivable against the debtor of the receivable, B must make sure that the assignment also complies with the proprietary requirements of Dutch law as the law governing the receivables (on the basis of Article 14(2) Rome I Regulation). Pursuant to Dutch law, a security interest in a receivable must be created by a deed and either notified to the debtor or registered with the appropriate unit of the Dutch tax authorities. B can comply with these formal requirements by either notifying the debtors of the English law security assignment or registering the security assignment with the Dutch tax authorities. However, Dutch property law also requires a valid title. The title is laid down in the loan agreement that requires A to assign the receivables by way of security. Although the title is governed by English law, it does not constitute a valid title for the purposes of Dutch property law as the obligation to transfer an asset by way of security is not considered a valid title under Dutch property law. This may lead to either the security assignment being null and void as against the debtor or to a re-characterization of the security assignment to a pledge. Another limiting factor for B under Dutch law is that if the security assignment is not notified but registered, as against the relevant debtor, only receivables arising out of legal relationships existing at the time of the security assignment would be assigned to B, and so B must register supplemental security assignments on a daily basis to catch all future receivables.

Against third parties

For B to be sure it can assert its entitlement to the assigned receivables against third parties, it must comply with the requirements of French law, as the law of the habitual residence of the assignor A at the time of entering into the loan agreement (constituting the contract to assign) pursuant to Article 4(1) Proposal.

Against the bankruptcy trustee of the assignor

B must comply either with English law, if the bankruptcy trustee is identified with the assignor, or with French law if he is considered a third party. Another possibility that seems to be (erroneously in my opinion) suggested by the European Parliament and the Commission is that the law applicable in accordance with the Insolvency Regulation is considered to govern the proprietary effects of an assignment against the bankruptcy trustee of the assignor. If the COMI and the habitual residence of the assignor are indeed both in France at the relevant time, then French law would govern not only the third-party effects against third parties but also against the bankruptcy trustee. This is, however, not necessarily the case. The COMI and the habitual residence may for several reasons not be located in the state. For instance the adjudicated court may determine that the COMI of the assignor under the Insolvency Regulation (recast) is in a different state than its habitual residence under the Proposal in connection with the Rome I Regulation as these concepts are not defined in the same way. Moreover, the location of the habitual residence is determined at the time of the (contract to) assign whereas the location of the COMI is determined at the time of opening insolvency proceedings. In the event the assignor has moved to to another EU Member State after the conclusion of the contract to assign these locations will differ.

Is there a practical solution?

There is, and that is to comply with the applicable law that has the strictest and/or most elaborate requirements for an assignment to have proprietary effect against anyone and everyone in and outside of bankruptcy. This still requires, however, that the assignee is aware of the various laws that may be applicable so that it can obtain local law advice as to such requirements.

6.2.5 Overriding Mandatory Provisions[77]

As in most private international law instruments, the Proposal contains a provision on the applicability of overriding mandatory provisions. Article 6 provides that nothing in

77 Art. 7 Proposal contains a public policy provision, which I will not discuss further. It conforms to the public policy provisions in the Rome I and Rome II Regulations and stipulates that a court may refrain from applying a provision of the applicable law if such provision is manifestly incompatible with the public policy of the state of the forum.

the Proposal will limit the application of the overriding mandatory provisions of the law of the forum – the law of the court before which a dispute regarding the third-party effects of an assignment is brought. The second subsection of Article 6 describes what must be understood by overriding mandatory provisions, which description does not differ from descriptions in other EU private international law instruments.[78] Overriding mandatory provisions are rules that are regarded as crucial by a Member State for safeguarding its public interests to such an extent that they are applicable to any situation falling within their scope, irrespective of the applicable law pursuant to the Proposal. Under Dutch law no such rule comes to mind. In its comments to Article 6 in the Explanatory Report,[79] the Commission states that the requirement to register the assignment in a public register could be considered an overriding mandatory provision of the law of the forum. This example, however, conflicts with Article 5 Proposal on the scope of the applicable law, which, under paragraph (a), explicitly mentions registration or publication as formalities that fall within the scope of the applicable law pursuant to Article 4 Proposal. Also, recital 30 Preamble specifically mentions registration with a public register as a formality or step that needs to be taken in accordance with the applicable law. Recital 32 Preamble, furthermore, provides that Article 6 should be applied only in 'exceptional circumstances' and be 'interpreted restrictively'. What public interest of the Member State is at stake here? Or has the Commission confused two concepts? Making public in the sense that it is known to third parties and public as in the public interest of a state? If courts would be allowed to apply these publication rules of their law regardless of the applicable law and if the assignment in question has not been registered simply because the law of the forum was not one of the laws already applicable to the assignment on the basis of the Rome I Regulation and the Proposal, the assignee may very well be denied to assert its entitlement to the assigned claim. This cannot be the intention of the Proposal as the question of third-party effects of the assignment would be totally dependent on the court before which a dispute regarding the assignment is brought. It would basically undermine the whole purpose of the Proposal. The assignee would have to take into consideration the laws of all the courts where a dispute may possibly be brought; this could, for instance, be a court of any state where a debtor resides and who refuses to pay the assignee. To make matters even worse for the assignee, the European Parliament has proposed an amendment to Article 6 that broadens the scope tremendously. It proposes to add an additional subsection that provides that a court should also give effect to overriding mandatory provisions of the law of a Member State where the assignment has to be or has been performed, insofar as those provisions render the performance of the assignment contract unlawful.[80] I, for one, am in the dark as to what the European Parliament means by 'performance of the

78 *See* Art. 9 of the Rome I Regulation and Art. 16 of the Rome II Regulation.
79 *See* p. 22 of the Explanatory Report.
80 *See* amendment 15.

assignment', and so it could be interpreted as any Member State in which the assignee wishes to assert its entitlement to the assigned claim. This would be an almost impossible task for the assignee to ascertain. The European Parliament does not provide any guidance in this respect.

7 Application of the New Conflict of Laws Rules to the Case Studies

7.1 BNG/TeamBank (Figure 1)

In this case the dispute concerned a priority issue between two assignees (under two separate security assignments) of the same claim. Under German law, TeamBank would have priority, but under Luxembourg law BNG would have priority. The German court first determined whether each assignment of the claim was a valid assignment under its applicable law.

The governing law of the proprietary effects of the assignment to TeamBank is determined under the new (interpretation of the) rules as follows: (i) as between the assignor (E.F.) and TeamBank by the law applicable pursuant to Article 14(1) Rome I Regulation – German law as the law governing the German Loan, which constitutes the agreement to assign; (ii) as against the Employer (debtor of the assigned claim) by the law applicable pursuant to Article 14(2) Rome I Regulation – Luxembourg law as the law governing the Claim; and (iii) as against *other* third parties (other than BNG as the second assignee) by the law applicable pursuant to Article 4(1) first paragraph Proposal – German law as the law of the habitual residence of E.F. (the assignor) at the time of the conclusion of the German Loan. In this case the bankruptcy trustee of E.F. had already collected the Claim from the Employer and so whether the assignment to TeamBank had proprietary effect against the debtor of the Claim was not in dispute. The German court determined that under German law the assignment did have proprietary effect as between the parties and as against (other) third parties.

The governing law of the proprietary effects of the assignment to BNG is determined under the new (interpretation of the) rules as follows: (i) as between the assignor (E.F.) and BNG by the law applicable pursuant to Article 14(1) Rome I Regulation – Luxembourg law as the law governing the Luxembourg Loan, which constitutes the agreement to assign; (ii) as against the Employer (debtor of the assigned claim) by the law applicable pursuant to Article 14(2) Rome I Regulation – Luxembourg law as the law governing the Claim; and (iii) as against *other* third parties (other than TeamBank as the first assignee) by the law applicable pursuant to Article 4(1) first paragraph Proposal – German law as the law of the habitual residence of E.F. (the assignor) at the time of the conclusion of the Luxembourg Loan. As mentioned previously, in respect of the assignment to TeamBank, whether the assignment to BNG had proprietary effect against the debtor of the Claim was not in dispute. The German court determined that under Luxembourg law the assignment did have proprietary effect as between the parties and as against (other) third parties. However, the latter question (proprietary effects against (other) third parties) would not be governed by Luxembourg law but by German law as the law of the habitual residence of the assignor at the time of the conclusion of the Luxembourg Loan.

Which of the assignees – TeamBank or BNG – has priority over the Claim is determined by the law of the habitual residence of the assignor on the basis of Article 5(b) in connection with Article 4(1) first paragraph Proposal is determined by German law as the law of the habitual residence of the assignor that was in Germany at the time of the conclusion of both the German Loan and the Luxembourg Loan.

7.2 Case I (Figure 2)

The Purchaser of the distressed debt in this case study must take the requirements of the law of property of the following jurisdictions into account for the assignment of the Claims by the Polish bank, as assignor to the Purchaser as assignee: English law (as the law governing the proprietary effects of the assignment between the Bank and the Purchaser pursuant to Article 14(1) Rome I Regulation); Polish or English law as the law governing the Claims pursuant to Article 14(2) Rome I Regulation (as the law governing the proprietary effects of the assignment against the debtors); Polish law as the law of the habitual residence of the bank pursuant to Article 4(1) first paragraph Proposal (as the law governing the proprietary effects of the assignment against third parties) and possibly as the *lex concursus* under the Winding-up Directive; and possibly Russian law if the Russian debtors refuse to pay the Purchaser or the law that would be applicable pursuant to Russian private international law. In addition, the Purchaser must also be aware of any requirements that under the law of the forum (which, of course, could be Polish, Swedish or the forum of any of the debtors) or under the law where the assignment is performed or will be performed that would qualify as an overriding mandatory provision. Once all of this has been ascertained by the Purchaser the practical approach would be to comply with the strictest requirements for a valid assignment of claims to be enforceable against anyone and everyone in and outside of a bankruptcy.

7.3 Case II (Figure 3)

In this case the dispute concerns a priority issue between an assignee (assignment pursuant to a true sale) and a pledgee (under a nondisclosed right of pledge) of the same claim. Which law governs this priority issue?

The governing law of the proprietary effects of the assignment to F is determined under the new (interpretation of the) rules as follows: (i) as between the assignor (D) and F by the law applicable pursuant to Article 14(1) Rome I Regulation – English law as the law governing the RPA, which constitutes the agreement to assign; (ii) as against the debtors of the assigned claims by the law applicable pursuant to Article 14(2) Rome I Regulation – either Polish or English law as the law governing the Claims against the various debtors; and (iii) as against *other* third parties (other than X as pledgee of the same Claims) by the law applicable pursuant to Article 4(1) first paragraph Proposal – Dutch law as the law of the habitual residence of D (the assignor) at the time of the conclusion of the RPA. Which law applies to the proprietary aspects of the assignment as against the German bankruptcy trustee of D? As set out above, this is still rather unclear and could be any of the following laws: English law if Article 14(1) Rome I Regulation is applicable); Dutch law if Article 4(1) first paragraph Proposal is applicable; or German law if this is governed by the *lex concursus* under the Insolvency Regulation.

The governing law of the proprietary effects of the right of pledge created in favor of X is determined under the new (interpretation of the) rules as follows: (i) as between the pledgor D and pledgee X by the law applicable pursuant to Article 14(1) Rome I Regulation – Dutch law as the law governing the settlement agreement that constitutes the agreement to pledge; (ii) as against the debtors of the pledged claims by the law applicable pursuant to Article 14(2) Rome I Regulation – either Polish or English law as the law governing the Claims against the various debtors; and (iii) as against *other* third parties (other than F as assignee of the same Claims) by the law applicable pursuant to Article 4(1) first paragraph Proposal – German law as the law of the habitual residence of D (the assignor) at the time of the conclusion of the settlement and pledge agreement. Which law applies to the proprietary aspects of the right of pledge assignment as against the German bankruptcy trustee of D? As set out above, this is still rather unclear and could be any of the following laws: Dutch law if Article 14(1) Rome I Regulation is applicable; German law if Article 4(1) first paragraph Proposal is applicable or as the *lex concursus* under the Insolvency Regulation.

Both F and X inform the bankruptcy trustee that they are entitled to the Claims. The German bankruptcy trustee now has to figure out the following: (i) can either the assignment or the pledge or both or neither be invoked against the bankrupt estate? (ii) if both the assignment and the pledge could be invoked against the bankrupt estate, which of the two creditors of D (F or X) has priority in relation to the Claims? To answer the first question, the bankruptcy trustee is confronted with four possible applicable laws: English law and Dutch law (Art. 14(1) Rome I Regulation); Dutch law and German law (Art. 4(1) first paragraph Proposal); or German law as the *lex concursus*. The priority question under (ii) between F as assignee and X as pledgee of the same Claims is governed by the law applicable in accordance with Article 4(1) second paragraph Proposal as the law applicable to the third-party effects of the assignment (Dutch law) and the law applicable to the third-party effects of the pledge (German law) are different. In accordance with this provision, the law governing the disposal over the Claims that, under its applicable law, first became effective against other third parties is the law that determines the priority issue.

Finally, whoever has priority on the basis of the applicable law may then be confronted by unwilling debtors who may claim that the assignment or pledge is not enforceable against such debtor, not because it has a remedy or a right of set-off under the law governing the claim but on the basis that certain formal requirements of the law of property of the law governing the claim against such debtor have not been fulfilled. This may result in the situation that as between the assignor/pledgor and the assignee/pledgee, as against third parties (including the pledgee/assignee), and as against the bankruptcy trustee, the assignment or pledge has proprietary effect but does not have such effect as against the debtor, which ultimately leaves the assignee or pledgee empty-handed.

Enough complexity there, and I have not even included a reference to possible overriding mandatory provisions that may apply and that may determine that the assignment or pledge should have been registered in a public register in the jurisdiction of the forum or in the jurisdiction where the assignment or pledge is to be or has been performed.

8 Conclusion

It is commendable, even brave, considering the vast difference of opinion between the Member States, that the Commission, 10 years after the entry into force of the Rome I Regulation, has published a proposal for a regulation in respect of uniform private international law rules for the 'third-party effects' of an assignment of claims. The intention behind the proposed regulation – uniformity in the private international law rules regarding the third-party effects of assignments – must be supported. Considering the ratio behind the proposed regulation – increased legal certainty and cost efficiency which is to lead to an increase in cross-border assignments of claims – it is in my opinion vital that the number of possible applicable laws to the question of whether an assignee can assert its entitlement to the assigned claim against anyone and everyone in and outside of a bankruptcy of the assignor (the proprietary effects of an assignment of claims) is limited to one applicable law. In the current state of the Proposal this is not being achieved.

As proprietary effects of an assignment have no place in a regulation that aims to deal with the applicable law to contractual obligations (the Rome I Regulation), all such proprietary effects should be dealt with in the proposed regulation. This means that the definition of 'third-party effects' should be amended to include proprietary effects as between the assignor and the assignee, against the debtor and against third parties (including the bankruptcy trustee), or perhaps, clearer still, reference should be made to 'proprietary effects', which is then accordingly defined. The law of the habitual residence of the assignor has been chosen as the main rule to govern the 'third-party effects' to which three exceptions have been made in favor of the law applicable to the assigned claim. The choice of the main rule may from a Dutch perspective be a disappointing outcome. The conflict of laws rule laid down in Article 10:135 (2) DCC has worked most satisfactorily for the past 20 years. This rule, however, was the first to be discarded by the Commission as a possible main rule. Arguments against this Dutch rule referred mainly to the fact that it provides for – albeit indirectly – the possibility for the assignor and assignee to choose the law applicable to proprietary aspects of an assignment that affects the rights of third parties who are not a party to the assignment. In practice, however, the Dutch rule has not been abused and has shown to be flexible and to provide legal certainty, mainly because it refers to the law of just one state to govern all proprietary effects of assignments of claims. There is no sense in crying over spilt milk, and so the Dutch must take their loss. The Council is, however, still trying to decide whether the law of the habitual residence of the assignor or the law governing the assigned claim is the better main rule. It has also indicated that exceptions to the main rule will in any event need to be made. Exceptions quite often lead to differences in interpretation by the national courts.

The Proposal is a first step to uniformity, but there are still too many uncertainties and ambiguities, too many differences of opinion, to actually achieve not only uniformity but also the legal certainty and cost efficiency that the Commission wants to achieve.

If these are not solved, the current state of the Proposal and its proposed relationship with Article 14 Rome I Regulation would lead to a possible application of the laws of three different states. That is without having regard to the possible application of the *lex concursus* in an insolvency of the assignor and the applicability of overriding mandatory provisions. With respect to the possible application of the *lex concursus* I would like to stress again that the Insolvency Regulation does not contain and does not intend to contain a conflict of laws rule to determine the law applicable to an assignment of claims.

The practical solution for the assignee would be to just comply with the law that has the strictest requirements for an assignment to have proprietary effect. It would still need to know, however, with the laws of which state it may be confronted when it wants to assert its entitlement to the assigned claim. That, as we have seen, is not always an easy task.

Private international law should make cross-border transactions more accessible, not more difficult. It should be made easy to determine the applicable law.

I would therefore like to appeal to the Commission, the Council and the European Parliament to very seriously consider allowing the assignor and assignee a limited option to choose the law to govern all proprietary aspects of an assignment of claims: the law of the habitual residence of the assignor at the time of the conclusion of the contract to assign or the law governing the assigned claim. In the absence of an explicit choice of law the law governing the claim should apply as the default position as this is also the law that the debtor of the claim can rely on for its protection. In the event of a priority issue between two assignees of the same claim whose assignments, owing to the possibility of such choice, are governed by different laws, priority should be determined by the law governing the assigned claim. Exceptions will not be required. I believe that only then will the aim of the Commission – more legal certainty, cost efficiency, flexibility and an increase in cross-border transactions – be achieved.

The Law and Economics of Investing in Bankruptcy in the United States

Jared A. Ellias[*]

Claims trading has become a significant and controversial feature of American bankruptcy practice over the past thirty years. This Report chronicles the rise of claims trading in the second decade of the Bankruptcy Reform Act of 1978 and analyzes the various policy concerns it raises. Most importantly, claims trade has led to, and been accelerated by, the development of an industry of specialized distressed investors who raise billions of dollars of capital to buy and sell the claims of Chapter 11 debtors. Despite attracting periodic concerns from policy makers, the legal institutions of Chapter 11 appear to have mostly proven capable of handling the concerns raised by claims trading. In sum, the best interpretation of the available empirical evidence is that claims trading and activist investing have, at the very least, not harmed Chapter 11 or distressed corporations and may have actually improved the capacity of the American bankruptcy system to reorganize distressed assets.

1 Introduction

When commentators describe American bankruptcy law as "the model to which European restructuring laws should aspire,"[1] they are really speaking about an 'American bankruptcy ecosystem' of which law is only a significant part. The American bankruptcy ecosystem is best understood as a complex system inhabited by bankruptcy judges, law firms, investment bankers and specialized investors. This ecosystem, which grew in its modern form from the bankruptcy code implemented by the Bankruptcy Reform Act of 1978, has proven capable and resilient. It has been tested across the full range of the business cycle and has, for the most part, smoothly resolved the financial distress of firms and entire industries. In 2008, the bankruptcy system faced perhaps its most significant challenge with the global financial crisis yet proved flexible enough to

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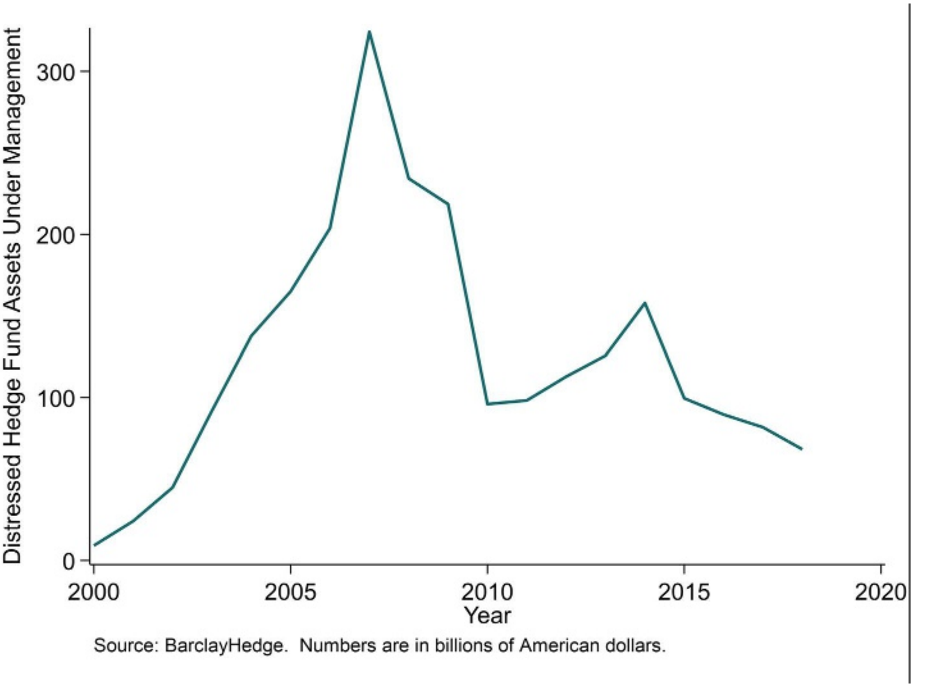
1 *See* Samir D. Parikh, Bankruptcy Tourism and the European Union's Corporate Restructuring Quandary: The Cathedral in Another Light, 42 U. Pa. J. Int'l. L. ___ (*forthcoming*, 2020).

reorganize enormous financial institutions, automakers and municipalities. It is a core strength of the dynamic American economy.

In this Report, I focus on one of the major components of the ecosystem: specialized investors that participate in the 'bankruptcy claims trade'. Beginning in the late 20th century and continuing into the early 21st century, the role of bankruptcy courts evolved within the American system of finance. In the old view, the bankruptcy courts were a place of shame and failure. As I will explain in this Report, American bankruptcy courts today are best understood as an integrated part of the capital markets, similar to the private equity firms of New York and the venture capital investors of Palo Alto. As this new view of bankruptcy law took hold, investors, typically hedge funds, began to accumulate expertise in this part of the capital market and have raised a large stock of capital to deploy in it.[2] As Figure 1 shows, hedge funds went from managing a mere $10 billion in distressed assets in 2000 to more than $300 billion at the height of the financial crisis in the 2008. Importantly, as elaborated on later, while these investors were born of the bankruptcy bar's development of institutions that situated bankruptcy courts within the capital markets, they have deployed their capital to accelerate it.

Figure 1 Distressed Hedge Fund Assets under Management, from 2000 to 2018.



2 For a good introductory discussion, *see* Wei Jiang et al., Hedge Funds and Chapter 11, 67 J. Fin. 513 (2012).

This Report proceeds in four parts. In Section 2, I chronicle the transition of American bankruptcy law into a regular part of the capital markets with a class of service providers and investors that deploy a discrete and specialized body of knowledge. In Section 3, I discuss policy concerns raised by that transition, with special attention to how activist investors use claims trading and the ways in which those strategies can distort the bankruptcy process and bankruptcy outcomes. In Section 4, I examine the regulation of claims trading and activist investors, with a focus on the ad hoc rulemaking function performed by bankruptcy judges. Section 5 briefly discusses additional policy concerns raised by claims trading. Section 6 concludes. The portrait of claims trading that emerges from this Report is a largely positive one, and more evidence is needed before concluding that more regulation is necessary.

2 The Bankruptcy Marketplace: From 1978 to the Present

In this section, I situate the rise of claims trading within the maturation of the modern practice of corporate bankruptcy law. I first discuss the development of Chapter 11 legal practice after the Bankruptcy Act of 1978, which empowered a new industry of courts, lawyers and investment bankers. I then summarize the growth of the 'claims trading business', the biggest investors in which are specialized hedge funds expert in the bankruptcy process. The purpose of this section is to introduce both 'claims trading' and 'claims traders', which raise different concerns that are discussed in greater detail in Section 3.

2.1 The Development of the Modern Restructuring Industry

In the early years of the United States, bankruptcy law was underdeveloped and had very little to do with corporations. While the framers of the United States Constitution expressly reserved to the federal government the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States", federal bankruptcy law only developed in fits and starts over the first hundred years of American independence.[3] At first, the federal government enacted a series of temporary bankruptcy laws in response to financial crises and repealed them shortly thereafter.[4] Finally, a permanent bankruptcy law was passed in 1898, although it expressly excluded corporations from the category of

3 Art. 1, Section 8 of the United States Constitution. James Madison worried that, without federal regulation, state governments would enact their own bankruptcy laws that favored their own residents over creditors in other states. *See* The Federalist No. 42.

4 *See* Charles Jordon Tabb, The History of the Bankruptcy Laws in the United States, 3 Am. Bankr. Inst. L. Rev. 5, 14 (1995).

eligible voluntary debtors.[5] That changed in the 1930s, but that version of the law was not heavily utilized by corporations.[6] Fifty years later, after extensive study, Congress enacted the modern bankruptcy code with the Bankruptcy Act of 1978, which was explicitly designed to make bankruptcy more attractive for struggling businesses.[7]

Importantly, Congress made two policy changes in the new bankruptcy law that made bankruptcy a more attractive practice area for the most talented cohort of attorneys.[8] First, the law increased the level of compensation of bankruptcy lawyers to draw in attorneys who had been deterred by the practice's reputation as a low-paying and stigmatized area of the law.[9] Under the new law, bankruptcy lawyers were no longer expected to work at low rates to avoid further injury to creditors.[10] Now, they could charge market rates for high-end corporate work.[11] As a result, the bankruptcy bar became a subset of the elite corporate bar, a dramatic shift that changed the profile of bankruptcy lawyers and bankruptcy judges.[12] Second, the law upgraded the status of bankruptcy judges by empowering them to hear a wider range of legal issues, improving their relative position within the federal judiciary and improving the prestige of bankruptcy judgeships.[13] As a result of these changes, lawyers embraced the new statute and produced legal work, customs and judicial opinions that streamlined the

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5 *See id.* at 26.

6 *See id.*

7 While corporations obtained the right to file for corporate bankruptcy in the 1930s, many of the legal doctrines that are key to Chapter 11 practice have their roots in railroad receiverships. *See id.* at 28.

8 *See* Geraldine Mund, Appointed or Anointed: Judges, Congress and the Passage of the Bankruptcy Act of 1978: Part One: Outside Looking In, 81 Am. Bankr. J. 1, 3 (2007). Congress stopped short of making bankruptcy judges Art. III judges after a campaign of sustained resistance to the idea led by Art. III judges. Instead of Presidential Appointment with lifetime appointment, bankruptcy judges would be selected from the practicing bar of bankruptcy lawyers by the local Circuit Court and appointed to fourteen-year terms.

9 *See* Mund, *supra* note 8. Congress stopped short of making bankruptcy judges Article. III judges after a campaign of sustained resistance to the idea led by Article. III judges. Instead of Presidential Appointment with lifetime appointment, bankruptcy judges would be selected from the practicing bar of bankruptcy lawyers by the local Circuit Court and appointed to fourteen-year terms.

10 *See In re Drexel Burnham Lambert Grp., Inc.*, 133 B.R. 13, 18 (Bankr. S.D.N.Y. 1991) (discussing Congress' rationale in raising the level of compensation of bankruptcy lawyers to market levels).

11 *See id.*

12 New York's leading firms would enter bankruptcy practice over time – for example, it took another thirty years before Cravath, Swain & Moore created a bankruptcy practice. *See* Karen Donovan, Big Law Firm Embracing Bankruptcy Practice, N.Y. Times (3 August 2007), available at https://www.nytimes.com/2007/08/03/business/03bankrupt.html.

13 *See* Arthur L. Moller & David B. Foltz Jr., Chapter 11 of the 1978 Bankruptcy Code, 58 N.C. L. Rev. 881 (1980).

'onerous and complex procedures' created by the comprehensive reorganization section of the statute, Chapter 11 of the new bankruptcy code.[14]

Congress made further changes to make the bankruptcy system more attractive to American businesses. Most importantly, existing management would normally remain in control of the reorganization process and could hope to run the firm after the firm exited bankruptcy.[15] Under the prior bankruptcy law, appointment of a trustee was mandatory, and managers and boards of directors of large businesses would effectively lose control – and their jobs – after a bankruptcy filing.[16] American businesses were thus heavily disinclined to seek bankruptcy relief, likely leaving the economy replete with 'zombie firms' that needed to reorganize but lacked a procedure that allowed them to do so.[17] In contrast, the new bankruptcy code left existing managers in control of the business, "reflecting Congress' view that … reorganization would be best effectuated by allowing the debtor to continue to operate its business as debtor-in-possession".[18]

2.2 Rise of Distressed Hedge Funds and the Bankruptcy Marketplace

These three crucial ingredients – attractiveness to talented lawyers, empowered judges and a bankruptcy system newly attractive to businesses – set the stage for the normalization of Chapter 11 as a tool available to firms for liability management. In Chapter 11, firms are able to solve liquidity shortages by borrowing debtor-in-possession financing,[19] tearing up bad contracts, rationalizing a firm's capital structure by forcing creditors to accept partial payments, selling and disposing unnecessary assets and imposing losses on unionized workers. A manager of a Chapter 11 debtor has other rights that she would not have outside of bankruptcy, such as asking the judge to force creditors to accept a restructuring transaction over the objections of hold-out creditors. Importantly, the tools provided by the bankruptcy code supply managers with bargaining power with creditors outside of bankruptcy and lubricate out-of-court debt restructurings as well.

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14 *See id. See also* Harvey R. Miller & Shai Y. Waisman, Is Chapter 11 Bankrupt?, 47 B.C. L. Rev. 129, 146 (2005) ("From the outset, the Bankruptcy Code112 was understood to be a flexible document, with its provisions to be shaped and interpreted to meet the needs of the Congressional policy of furthering rehabilitation. Early case law illustrates the manner in which policy considerations behind the 1978 Act encouraged a pragmatic view and application of the Bankruptcy Code.").

15 *See id.* at 139.

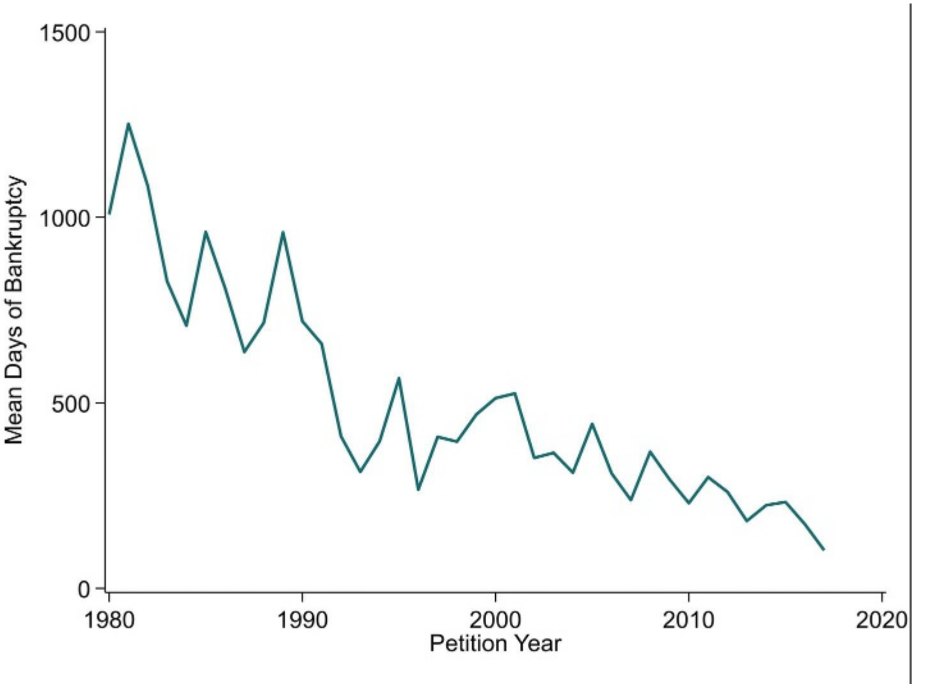
16 *See id.*

17 *See id.*

18 *See id.* at 143.

19 *See* Kenneth Ayotte & David A. Skeel Jr, Bankruptcy Law as a Liquidity Provider, 80 U. Chi. L. Rev. 1557 (2013).

Figure 2 Average Length of Bankruptcy Case, by Year Filing for Chapter 11.[20]



The increased utilization of Chapter 11 fed a virtuous cycle as an increasingly capable group of lawyers, investment bankers and judges entered the practice and developed it. As Figure 2 shows, the average bankruptcy case fell in length from more than three years in 1980 to fewer than three months for the firms that filed for Chapter 11 in 2017. Bankruptcy law proved adept at resolving a wide range of problems, including the business of the automotive industry, investment banks, airlines, industries with asbestos liabilities and the energy industry. By one measure, Chapter 11 has reorganized more than $2.6 trillion in inflation-adjusted current liabilities between 1980 and today.[21] One of the key steps forward in Chapter 11's maturity was the centralization of large corporate cases in the bankruptcy courts in the Southern District of New York and Delaware, which created a cohort of super-experienced judges and lawyers and a store of case law and judicial procedures that other bankruptcy courts could adapt and copy.[22]

As Chapter 11 became more and more utilized by distressed businesses, a new industry of specialized investors that aimed to use their knowledge of the new bankruptcy law grew as part of a profitable investment strategy. While there is

20 Source: UCLA-LoPucki Bankruptcy Research Database (accessed 1 December 2019).

21 *See id.*

22 *See* Jared A. Ellias, What Drives Bankruptcy Forum Shopping? Evidence from Market Data, 47 J. Leg. Stud. 119-149 (2018).

anecdotal evidence of investors buying the claims of bankrupt firms to acquire control of a firm as far back as 1930,[23] the practice was uncommon enough in the early years of the bankruptcy code that an Article written in 1990 by leading bankruptcy lawyers was able to recite the three prominent companies taken over in the bankruptcy code's first decade by name.[24] This soon changed. Writing only a decade later, a practitioner described how 'the face of bankruptcy' had been altered 'by the newfound liquidity in claims' over the 1990s.[25] This liquidity was driven by the emergence of investors who wanted to buy these claims.

To quantify the level of trading in the marketplace, I conducted the first empirical study on the complete record of trading in the public bonds and equity of firms that filed for bankruptcy between 2002 and 2012.[26] Importantly, this is only a part of the claims trading marketplace – there is also heavy trading in corporate loans and trade claims that are not captured in my data set. My data set included 494 bonds issued by 204 firms with an aggregate face value of $512 billion. I rely principally on the TRACE dataset, which has the advantage of containing a complete record of bond trades during the sample period. However, TRACE has an important limitation: it consists of records indicating that a trade occurred on a certain date at a certain price without identifying information on the buyer or seller of the claim. This limits my ability to explore some questions directly, leaving important questions for future research to study, some of which I will highlight below.

Figure 3 summarizes Chapter 11 bond trading volume by calendar year. As the figure shows, this slice of the claims trading market alone is worth tens of billions of dollars a year in trading value, but there is a cyclicality to the marketplace.

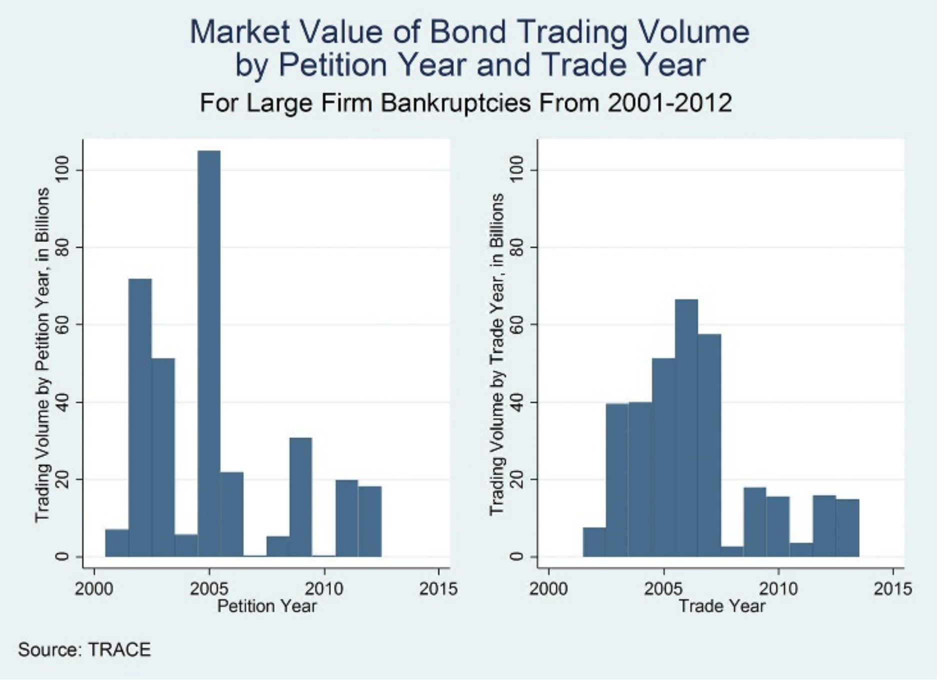
23 *See* Chaim J. Fortgang & Thomas Moers Mayer, Trading Claims and Taking Control of Corporations in Chapter 11, 12 Cardozo L. Rev. 1, 75 (1990).

24 *See id.* at 75-76 ("Since 1979, at least three debtors have been taken over through or in connection with claims purchases: King Resources, Inc., Baldwin United, Inc., Apex Oil Co., and Allegheny International, Inc.").

25 *See* Glenn E. Siegel, Introduction: Abi Guide to Trading Claims in Bankruptcy Part 2 Abi Committee on Public Companies and Trading Claims, 11 Am. Bankr. Inst. L. Rev. 177, 177 (2003). The development of the market was also facilitated by amendments to Bankruptcy Rule 3001(e) in 1991. *See* Harvey R. Miller & Shai Y. Waisman, Does Chapter 11 Reorganization Remain A Viable Option for Distressed Businesses for the Twenty-First Century?, 78 Am. Bankr. L.J. 153, 182 (2004).

26 The data in this section is generally drawn from my prior work on claims trading and includes some unpublished summaries of the underlying data set. *See* Jared A. Ellias, Bankruptcy Claims Trading, 15 J. Empir. Leg. Stud. 772 (2018).

Figure 3 Market Value of Bond Trading Volume by Petition Year and Trade Year.



This figure summarizes aggregate observed market value of trading volume of bonds issued by firms operating under Chapter 11 bankruptcy court administration by both the year of the bankruptcy filing (petition year) and the year of the observed trade.

Studying this marketplace, I learned that the view that claims trading is pervasive is well supported by data. For the median bond in the sample, trading is intense enough during the bankruptcy case that the aggregate turnover is equivalent to more than 113% of the face value of the bond. A limitation of the data set is that I cannot say for sure whether the entire bond issue turned over or whether a small fraction of the bond changed hands several times. However, in either case, it is fair to say that Chapter 11 bonds are heavily traded. In fact, trading is intense enough in these bonds that the median Chapter 11 bond trades at the 84th percentile of the debt market as a whole.[27] Thus, it is accurate to describe the market for Chapter 11 bonds as one of the most active corners of the American bond market.

It is commonly assumed that this marketplace is characterized in the first instance by traditional investors – such as mutual funds and asset managers – selling Chapter 11

27 *See id.* at 781.

claims to specialists in distressed investing. I find indirect evidence supporting this view. Tracking a sample of 1,346 Chapter 11 bonds held by 48 mutual funds or asset managers between 2008 and 2012, I find that the average fund holding the bond of a future Chapter 11 debtor exits the position somewhere between ten and four months prior to a bankruptcy filing.[28] Examining the bankruptcy dockets corresponding to the 130 firms that filed for Chapter 11 bankruptcy in 2009 and 2010, I find evidence of specialized distressed investor involvement in more than 80% of cases and 38% of the 496 unique debt claims that the firm had issued prior to bankruptcy, suggesting that a significant percentage of Chapter 11 creditors are specialist investors.[29]

Similarly, Ivashina et al. (2015) study another segment of the claims trading market: the market for 'trade claims'.[30] If the debtor has an unpaid bill owed to a supplier when it files for bankruptcy, we call that supplier a 'trade creditor'. Claims owed to investors are financial claims, while claims owed to suppliers or tort creditors are trade claims. The existence of a liquid claims trading market means that the supplier will receive offers from investors who want to buy their claim from them, which many prefer to do as many trade creditors are not interested in holding claims through the Chapter 11 process. Ivashina et al. (2015) compare the list of creditors filed with the court at the beginning of the bankruptcy case with the list of voting creditors for 136 Chapter 11 debtors that filed between July 1998 and March 2009. Among other things, they find evidence that activist investors are the largest category of the buyer of Chapter 11 trade claims.[31] It stands to reason that many of the same activists who buy financial claims such as bonds and equity may also buy trade claims to grow their position and bargaining power.

In short, claims trading is the rule in Chapter 11. When a firm files for Chapter 11 bankruptcy, it can expect to see heavy trading in its financial debt and trade debt, and it should also expect to negotiate its bankruptcy plan with distressed hedge funds, not with the investors who had originally provided the firm with capital. An interesting pattern revealed in the data, and illustrated in Figure 4, is that in the early part of the 2000s, trading was heavier for Chapter 11 bonds in bankruptcy than in the year prior to bankruptcy. That changed in 2006, when firms, on average, often began to experience heavier trading in their bonds in the year prior to bankruptcy than they did in bankruptcy. While this is certainly partially related to the shrinking duration of bankruptcy cases, I hypothesize that this is, in part, driven by the increased flow of funds into distressed investing strategies – investors do a better job of identifying firms

28 *See id.* at 790.

29 This an unpublished result from the data collected for *See* Jared A. Ellias, Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11? Evidence from Junior Activist Investing, 8 J. Leg. Anal. 493 (2016).

30 *See* Victoria Ivashina et al., The Ownership and Trading of Debt Claims in Chapter 11 Restructurings, 119 J. Fin. Econ. 316 (2015).

31 *See id.* at 317.

that may file for Chapter 11 and acquire those claims earlier in the distress cycle than had been the case previously.

Figure 4 Percentage of Issue Observed to Trade in Year Prior to Bankruptcy as Compared with Trading in Bankruptcy, by Petition Year.

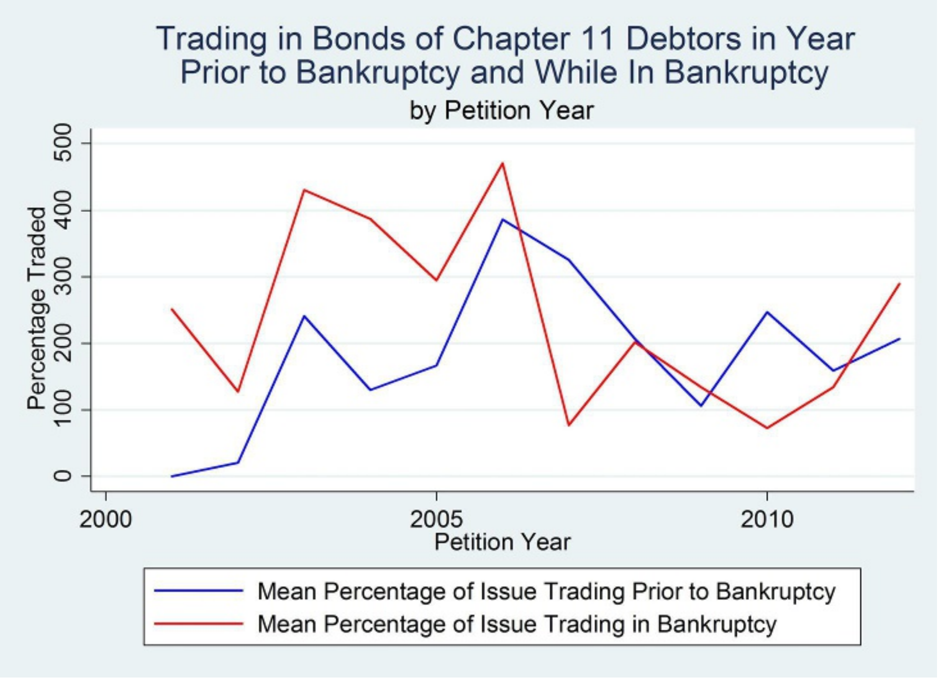


Figure 4 compares the mean percentage of bond issue that traded in the year prior to bankruptcy, as opposed to the period in which the firm's assets are administered by the bankruptcy court, by the year the debtor filed for Chapter 11 bankruptcy.

3 Criticism of Claims Trading

There are two major lines of criticism of claims trading: (1) claims trading hurts Chapter 11 by undermining its statutory design, which depends on negotiations; and (2) claims trading hurts Chapter 11 by allowing for the entry of activist investors into the capital structure, who then abuse the rights of creditors in Chapter 11 to distort bankruptcy outcomes in selfish and inefficient ways. I discuss each in turn.

3.1 Criticism #1: Claims Trading Undermines Chapter 11's Statutory Design

Chapter 11's bargaining ideal is a fully consensual plan of reorganization, and the bankruptcy code is built to prod all of the debtor's creditors to come to agreement on how to reorganize the debtor's assets. While bankruptcy judges have the power to confirm a plan of reorganization over a major creditor's objection, they strongly prefer to approve a plan of reorganization that is supported by all creditors. When creditors are unable to agree, the result is litigation that can be enormously expensive, running from the tens of millions of dollars in medium-sized cases to hundreds of millions of dollars in the largest cases. For example, when the creditors of the Tribune Company were unable to agree on a restructuring plan, the result was a protracted, four-year bankruptcy, where the professional fees exceeded $500 million.[32]

Thus, an important line of criticism of claims trading is that it undermines the bargaining process and makes a fully consensual deal less likely because the debtor has to negotiate with a revolving cast of characters.[33] For example, the debtor could try reaching a bargain with a group of secured lenders, only to see the largest lender sell its claim to a new investor who comes in with their own agenda, forcing the debtor to start bargaining from scratch. In practice, good debtor's lawyers have developed strategies and customs to deal with this concern. For example, the debtor's lawyer may require an ad hoc group of secured lenders to sign a confidentiality agreement to negotiate that requires them to restrict their trading activities as a price for participating in intense negotiations. Once deals are reached, as further discussed later, debtor's counsel can require the creditors it has negotiated with to sign an agreement promising to support the plan on the table, a promise that will be inherited by any subsequent purchasers of the claim.

While some anecdotal cases might suggest that claims trading is a major problem for Chapter 11 bargaining, the question is how problematic it is *on average*: does claims trading cause a churn of negotiating counterparties in the average case? To try to learn more about the answer to this question, I examined court documents for the 158 Chapter 11 debtors that filed for bankruptcy between 2004 and 2012 with publicly available court documents for which I have bond data to look at the pattern of activist entry, exit and churn in those cases.[34] While I cannot observe trading systematically, I can observe the appearance of lawyers representing activists into the Chapter 11 process. I find that the

32 *See* Robert Channick, Tribune Co. Emerges from Bankruptcy, Chicago Tribune (31 December 2012), available at https://www.chicagotribune.com/nation-world/ct-xpm-2012-12-31-chi-a-new-era-dawning-for-tribune-co-20121230-story.html.

33 For a prominent example of this argument, *see* Douglas G. Baird & Robert K. Rasmussen, Antibankruptcy, 119 Yale L.J. 648 (2010). *See also* Frederick Tung, Confirmation and Claims Trading, 90 Northwest. Univ. L. Rev. 1684 (1996); Miller & Waisman, *supra* note 25, at 181 ("Distressed debt trading and changing relationships as a result of globalization and technology have upset the symbiotic relationship of a debtor and its creditors. Traders purchase debt claims at a substantial discount, as they are concerned solely with the return on their investment.")

34 *See* Ellias, *supra* note 27, at 786.

vast majority of them enter the bankruptcy process early on and that groups of creditors appear to be very stable in the average case.[35] This suggests that the average bankruptcy case is not destabilized by claims trading.

Instead, my research suggests that it is probably most accurate to characterize the market for Chapter 11 claims as a market of passive traders who may participate in the bankruptcy process by consolidating classes of creditors and voting. On average, claims trading during Chapter 11 does not appear to lead to the entry of new activist investors. It is important to qualify this conclusion by noting that there have been high-profile examples of cases destabilized by claims trading and that the shadow of claims trading clearly hangs over every case. However, it is fair to conclude that the available evidence suggests that the average Chapter 11 case is not destabilized by trading that happens during the period of the firm's bankruptcy.

3.2 *Criticism #2: Activist Investors Buy Claims and Abuse the Rights of Chapter 11 Creditors*

Critics worry that claims trading creates more than negotiating churn – it also leads to the entry of specialist investors, who are self-interested and disruptive. On closer inspection, distressed activists deploy different strategies that raise different policy concerns. In this part, I identify the major activist investing strategies deployed by these specialists and assess the empirical evidence as to whether the worries raised by these strategies are substantiated in practice.

3.2.1 Active Investing Strategies

A bankruptcy activist investor has several potential moves to make, which are a function of the debtors' prepetition capital structure and level of solvency. At a high level, a distressed activist can profit in three ways from investing in the marketplace. First, an activist can put capital to work and earn attractive fees, either by providing debtor-in-possession financing ('DIP Financing') or by providing a Chapter 11 debtor with a loan that allows it to leave bankruptcy ('exit financing'.) Second, the activist can manipulate the bankruptcy process to obtain value it would not be entitled to if the process were run by an impartial social planner, often by buying control of the restructuring with covenants attached to a DIP Financing or by winning victories in litigation. Third, the activist can use expertise in turnaround management to improve the firm's restructuring transaction beyond what management would have done on their own, for example by

35 *See id.* at 786-793. Interestingly, Ivashina et al., *supra* note 30, show that consolidation does seem to occur in the trade claims market even though it does not seem to occur in the bond market. I hypothesize that this may be a result of the different dynamics of the trade market, where that market may become liquid only once the list of trade creditors is filed with the bankruptcy court.

steering the firm into a value-maximizing sale when the firm is worth more in someone else's hands than when it reorganizes as a going concern, or by improving the firm's operating performance. Appendix Table 1 summarizes these strategies, which are described in greater detail later, as well as the economic and bankruptcy policy concerns each raises.

3.2.1.1 Deploying Additional Capital

The first and most straightforward way an activist can profit by buying the claims of a Chapter 11 debtor is by using their position as a creditor to invest additional capital in the company's restructuring. Indeed, the ability of Chapter 11 firms to borrow new money is a key strength of Chapter 11, and many firms file for bankruptcy to obtain financing through the bankruptcy process to fund a turnaround. There are two common financings that Chapter 11 debtors often seek to obtain: 'DIP Financing' and 'exit financing'. I discuss each in turn.

'DIP Financing' is the bankruptcy-speak shorthand for loans made to firms that have filed for bankruptcy and need money to fund their reorganization.[36] 'DIP' stands for debtor-in-possession. In most Chapter 11 cases, the early part of the bankruptcy process is dominated by disputes among creditors about the terms of the Chapter 11 financing. Examining a data set of the 409 large firms with traded debt or equity that filed for bankruptcy between 2001 and 2012, I find that the average motion seeking to borrow a DIP loan was filed on the same day that the firm filed for bankruptcy and that the borrowing was approved by the bankruptcy judge about a month after the petition date.

In general, bankruptcy law gives the debtor's existing senior creditors enormous advantages in competing to provide the DIP loan.[37] This is because investors are usually cautious about lending money to failed firms reorganizing in Chapter 11, leading most lenders to refuse to lend unless they receive a priming lien – a lien that is senior to all of the debtor's prebankruptcy creditors – on substantially all of the debtor's assets.[38] Priming liens are hard for new lenders to get, because bankruptcy law protects existing lienholders and the vast majority of Chapter 11 debtors enter bankruptcy with a preexisting lien on substantially all of their assets. Of the large firms filing for bankruptcy between 2001 and 2012, approximately 70% had already pledged such a lien. Bankruptcy law requires any Chapter 11 debtor that wants to pledge a new lien on collateral that is already encumbered by a lien to offer 'adequate protection' to its existing secured

36 For a good overview, *see* George G. Triantis, A Theory of the Regulation of Debtor-in-Possession Financing, 46 Vand. L. Rev. 901, 901 (1993).

37 For a fuller description of this dynamic, *See* Ken Ayotte & Jared Ellias, Bankruptcy Process for Sale (2020) (unpublished working paper).

38 *See* George Triantis, Debtor-in-Possession Financing, in Research Handbook on Corporate Bankruptcy Law (B. Adler ed.) (2019).

creditor. Adequate protection normally takes the form of some combination of cash payments, replacement liens and claim priority for the prebankruptcy lienholder. However, the prebankruptcy lienholder can make a legal argument that any proposed adequate protection package is insufficient, forcing outside lenders to litigate if they want to prime the existing lienholder over their objection. Fortunately, an investor who wants to provide DIP Financing can sidestep this dynamic by buying the claims of the debtors' existing creditors so they can benefit from the bargaining power of preexisting lien instead of being hurt by it.

The pseudo-monopoly power that the debtors' existing lenders enjoy in providing DIP Financing raises the troubling possibility that these loans may not be made at arm's length. Sure enough, Eckbo, Li and Wang (2019) study all DIP loans with publicly available documents borrowed by all large firms that filed for bankruptcy between 2002 and 2014 (n=267) and find evidence that the loans usually come from existing lenders in more than 70% of cases.[39] In their analysis, they compare the all-in cost of DIP loans with similar loans made to healthy firms and find that DIP loans appear to be priced 2% higher. In a separate analysis of 94 DIP loans borrowed by the 180 large firms that filed for bankruptcy in 2009 and 2010, I find evidence that every new dollar lent to a Chapter 11 debtor was repaid in full, with interest and fees. While this could imply that the lenders are overcompensated for the risk they take on, DIP loans likely require more effort in monitoring the borrower than is typically required of loans to healthy firms, perhaps offsetting somewhat the 2% premium that Eckbo, Li and Wang found.

Claims trading can also create an opportunity to profit at the end of the bankruptcy case by providing 'exit financing', which is the bankruptcy term for the funding that allows a debtor to leave bankruptcy. As this funding is also often provided by existing creditors, bankruptcy judges often worry that these investments are not being made at arm's length either. Bankruptcy judges often combat this problem by requiring 'market checks' of a proposed exit financing and that the opportunity to invest be open to anyone willing to commit money on the same (or better) terms as existing creditors. However, investors who bought some of the firm's claims earlier in the bankruptcy process often have an informational advantage relative to new investors, which may allow them to profit by earning above-market returns on their investment. To my knowledge, no one has systematically studied this issue to determine whether this problem exists.

3.2.1.2 Improving the Value of a Purchased Claim with Contracting and Litigation

Activists often seek to intervene in a Chapter 11 case to improve the value of their investment. Activists typically use a combination of two methods to do so: (1) buying

39 B. Espen Eckbo et al., Rent Extraction by Super-Priority Lenders, working paper, available at ssrn: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3384389 (16 May 2019).

control of the bankruptcy case; or (2) investing money in litigation to acquire favorable judicial rulings and settlements. They use these methods in support of two main goals: (1) improving the value of the firm (maximizing the size of the pie) or (2) extracting value from other investors (rent extraction). I first discuss the methods and then discuss the goals.

At a high level, DIP lenders routinely ask management to agree to do things and to do them quickly. In an early study of this phenomenon, Ayotte & Morrison examined 153 firms that filed for Chapter 11 bankruptcy in the second half of 2001.[40] They found that 18% of the DIP loans in their sample (n=60) contained deadlines that required management to move through the bankruptcy plan process faster[41] and that 17% of the DIP loans required management to seek a sale (presumably, promptly as well, although these two categories may overlap in their data). Studying a more recent sample (2002-2014, n=269), Eckbo, Li and Wang found that those numbers have crept up – 66% of DIP loans created deadlines for moving through the plan process, and 13% (perhaps overlapping) of cases required deadlines for seeking a sale outside a plan of reorganization process.

Ayotte and Ellias (2020) use a sample of DIP loan contracts from bankruptcies between 1995 and 2015 to show that the average DIP loan agreement has progressed from giving management money to reorganize to dictating the outcome of the Chapter 11 process itself.[42] Ayotte and Ellias (2020) propose a model of a manager who has incentives to sell control of the bankruptcy case in exchange for a side payment (discussed in greater detail later) and identify conditions under which those incentives are exacerbated. They find evidence broadly consistent with their model, suggesting that the DIP lending process often involves a control auction where different creditor groups may bid for control of the debtor. As the firm's most senior creditors are best situated to buy control, these control sales may yield inefficient outcomes.

Baird (2017) shows that DIP loans are not the only way activists can acquire control over a restructuring process with a contract. They can also use agreements that are often entered into prior to a Chapter 11 filing, which are often styled as 'lock-up agreements', 'plan support agreements' or 'restructuring support agreements' (RSAs).[43] In these agreements, management and creditors agree to jointly support a certain restructuring transaction and to do it on an aggressive timetable. RSAs are useful in a world with claims trading as they bind not only the creditor but also the creditor's subsequent assignees in the event the creditor sells the claim.

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40 *See* Kenneth M. Ayotte & Edward R. Morrison, Creditor Control and Conflict in Chapter 11, 1 J. Legal Anal. 511 (2009).

41 These deadlines are generally created by forcing management to file disclosure statements for the plan of reorganization – which creditors use to vote on the plan – and to receive judicial approval ('confirmation') of a plan of reorganization by certain dates.

42 *See* Ayotte & Ellias, *supra* note 37 (2020) (unpublished manuscript, on file with author).

43 *See* Douglas Baird, Bankruptcy's Quiet Revolution, 91 Am. Bankr. L. J. 593 (2017).

In addition to contracting for control, activists can also buy it with side payments to managers. Side payments can take the form of lucrative employment contracts, postbankruptcy stock grants or bonuses during the bankruptcy period. In many cases, management will sell control to an activist, and that control sale will be effectuated through a DIP loan agreement or RSA, as outlined previously.

Alternatively, activists can invest money in litigation and try to obtain judicial rulings and bargain in the shadow of that litigation. In some cases, management will sell control of the firm to an activist investor in a senior claim, and then another activist will buy the junior claim and try to fight the control sale. Ellias (2016) studies a sample of 107 firms that filed for bankruptcy in 2009 and 2010 and finds evidence of pervasive creditor litigation.[44] For example, activist junior creditors objected to 37% of the disclosure statements filed in the sample period and 33% of the proposed DIP financings or cash collateral orders. Importantly, the study shows little evidence that litigation is systematically used by junior creditors to extract value from senior creditors in inefficient transfers. To the extent that a junior creditor uses litigation to obtain an unearned settlement from a senior creditor, such transfer could violate bankruptcy law's absolute priority rule. While those transfers are observed in about 27% of sample cases, the amount of such transfers is relatively small and unlikely to incentivize junior activists to embark on expensive activist campaigns.

3.3 Activist Goals

When hedge funds invest in Chapter 11 activism, they generally seek to improve the value of their claim in one of three ways: (1) by increasing the value of the firm – and, derivatively, the value of their claim; (2) by extracting value that would go to other creditors if the bankruptcy process was run fairly; or (3) by defending their claim from the attempts of others to extract rents.

3.3.1 Improving the Restructuring Transaction

The first activist strategy is to improve the restructuring transaction by contributing their capital and expertise. For example, an activist could offer to fund the reorganization of a firm that would otherwise be forced to liquidate inefficiently. Activists can also confront entrenched managers who, for example, refuse to sell a company and obtain a judicial ruling forcing a sale to go forward. For example, in the bankruptcy of Tropicana Casino, activists forced the management team who had led the company into bankruptcy to resign, laying the foundation for a change of control. Activists can do these things both by buying control and by using litigation to try to block management from selling control inefficiently to another creditor.

44 *See* Ellias, *supra* note 29.

3.3.2 Improve Value of Claim through Rent Extraction

Activists can also improve the value of their claim by trying to capture value that would otherwise go to other creditors. This sort of value extraction can take several different forms, but the most important ones involve buying control of the bankruptcy process and using that control to obtain a disproportionate share of the firm's value. The best ways to do that are: (1) to manipulate the firm's transaction choice; (2) to manipulate the appraised value of the restructuring transaction, which determines distributions to creditors; (3) or to use or threaten litigation to extract rents.

The first way to extract value from another creditor is to obtain ownership of a firm's assets in an inefficient restructuring transaction. Consider a hypothetical firm that has a senior creditor owed $50 and a junior creditor owed $30 and a true value of $70. If the senior creditor buys control of the process and manages to emerge as the owner of all of the firm's assets, it will have parlayed a claim of $50 into assets worth $70 – and it can promptly turn around and sell the assets to realize that value if it so wishes. A common structure for this sort of extractive transaction is a credit bid auction, in which a senior creditor forces a quick auction of the firm's assets before any other bidder can get involved and then bids the amount of their claim as currency to buy the firm. This transaction would be a straightforward expropriation of value from junior creditors by senior creditors.

Another way to extract value from another creditor is to manipulate the appraisal of a reorganization transaction.[45] Consider the same firm, again with a senior creditor owed $50 and a junior creditor owed $30 and a true value of $70. For the firm to reorganize in a restructuring transaction that is not a sale, the judge will need to appraise the firm without the help of a value produced by an auction. The most common way that Chapter 11 firms do this is with the support of an investment banker who offers testimony as to the value of the firm with an analysis – typically a comparable companies analysis, a comparable transactions analysis and discounted cash flow analysis, each of which is prone to manipulation that is hard for judges to detect.[46] If the senior buys control of the bankruptcy process and persuades management to appraise a transaction at $50 when the firm's true value is $70, the senior creditor will receive all of the firm's value, including $20 that could go to senior creditors.

Alternatively, the junior creditor or shareholders can seek to transfer value to them by overappraising the firm. Consider the same firm, again with a senior creditor owed $50 and a junior creditor owed $30 and a true value of $70. If the shareholder acquires control of the bankruptcy process (either by buying it or through litigation), they can seek to

45 *See* Douglas G. Baird & Donald S. Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 Yale L. J. 1930 (2006).

46 *See* Kenneth M. Ayotte & Edward R. Morrison, Valuation Disputes in Corporate Bankruptcy, 166 U. Pa. L. Rev. 1819 (2018); Anthony J. Casey & Julia Simon-Kerr, A Simple Theory of Complex Valuation, 113 Mich. L. Rev. 1175 (2015).

appraise the firm at a value that is in excess of the firm's true value. Simplifying things, consider a hypothetical transaction that values the firm at $100 and transfers to each creditor their proportionate share of the firm value. The senior creditor would be entitled to 50% of the distribution (50/100), the junior 30% (30/100) and the shareholder would receive 20% (20/100). As the firm is worth only $70, the senior would receive 50%*70 = 35, the junior would receive 30%*70 = 21, and the shareholder would receive the remaining 20%*70 = 14. As a result, the transaction would underpay both senior creditors and junior creditors.

A third way to extract value from other creditors is by threatening litigation to compel a settlement. For example, a junior creditor could threaten to challenge an appraisal in the hope of getting the judge to overappraise the firm. Many commentators worry that this is a systematic problem in Chapter 11.[47] On the other hand, Ellias (2016) finds that, on average, junior activist litigation is associated with a relatively higher appraisal relative to the market value of the firm at the beginning of the bankruptcy process, which suggests that junior activists might focus their efforts on contributing capital and expertise to reach the optimal restructuring transaction, not rent seeking.[48] Ellias (2016) finds no evidence that these higher appraisals are caused by value being redistributed from senior classes to junior creditors or shareholders. However, the study does not foreclose the possibility that litigious rent seeking is a feature of at least some cases.

3.3.3 Defend Value of Claim from Rent Extraction

Finally, activists can also intervene in the bankruptcy to defend their claim from rent extraction by other activists or managers. Given all of the various offensive activist strategies, investing in defensive activism can make a lot of sense. One of the downsides of claims trading and activist investing is that it has probably increased the need to invest in defensive activism, which presumably raises the costs associated with a bankruptcy filing.

3.3.4 Activist Strategies to Extract Exogenous Profit from Claims Trade

Additionally, activists can also seek to profit from activism outside of their capacity as claimholders in the Chapter 11 case. For example, activists might try to trigger a default under the firm's debt contracts to profit from an investment in credit default swaps.[49]

47 *See e.g.,* Baird & Bernstein, *supra* note 45; Harvey R. Miller, Chapter 11 in Transition – From Boom to Bust and into the Future, 81 Am. Bankr. L. J. 375, 389 (2007) ("The threat of litigation by junior creditors has become standard operating practice in chapter 11 cases as a means to coerce secured or senior creditors to reach accommodations with unsecured or junior creditors.").

48 *See* Ellias, *supra* note 29.

49 *See* Vincent Buccola et al., The Myth of Creditor Sabotage, 87 Univ. Chicago L. Rev. __ (2020); Robert K. Rasmussen & Michael Simkovic, Bounties for Errors: Market Testing Contracts, 10 Harv. Bus. L. Rev. 501 (2019).

Some activists might also be competitors of the debtor, hoping to delay the debtor's exit from bankruptcy to profit in the product market.

4 How Bankruptcy Law Addresses Legal Issues Created by Claims Trading

Bankruptcy judges have enormous discretion under the structure of the bankruptcy code to use ad hoc rulemaking to establish guardrails for claims trading. The situations in which bankruptcy judges police claims trading tend to fall into four discrete fact patterns: (1) 'claims washing', (2) vote manipulation, (3) insider trading and (4) inadequate disclosure. I discuss each in turn.

4.1 Claims Washing

A 'claims washing' fact pattern typically involves a debtor that has offsetting counterclaims against a creditor's claim, and the creditor sells the claim against the debtor to a claims purchaser. To illustrate this, consider an industrial firm that files for Chapter 11 and owes $100 to a supplier who also received an avoidable transfer prior to the bankruptcy filing of $50. Congress has specified that the debtor does not need to provide the supplier with any distribution from the estate until the creditor disgorges the avoidable transfer of $50.[50] This policy promotes settlement and ensures the debtor is not giving property to a creditor that also owes the debtor money. Now imagine the supplier sells her claim against the debtor to a hedge fund, which then argues that it should not be subject to any infirmities that might have existed if the claim were still owned by the supplier. What result? Do the disabilities of a creditor travel with the claim when it is sold to a claims buyer in an arm's length transaction?

Courts have disagreed about this fact pattern but the trend in the law is toward holding that the disability travels with the claim.[51] This is now clearly the law in the Third Circuit, which is the most important Court of Appeals for bankruptcy decisions.

4.2 Vote Manipulation

A second common problem arises when a claims purchaser is a preexisting creditor and buys the claim to promote the interests of the other class of claims. Oftentimes, the purchaser of the claim aims to exploit bankruptcy voting rules to acquire more

50 *See* 11 USC 502(d).

51 Compare *In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007) ("Enron II") with *In re KB Toys Inc.*, et al., Case No. 13-1197 (3d Cir. 15 November 2013).

bargaining power. One way to do that is to acquire a 'blocking position', which allows the purchaser to control the vote of the creditor class. There are two ways a blocking position can be acquired. Bankruptcy voting rules are such that a creditor class vote is deemed to have 'yes' on a plan of reorganization when at least one-half of the creditors (the 'number' requirement) in the class holding at least two-thirds of the amount of claims in the class (the 'amount' requirement) vote in favor of the plan. Accordingly, a claims trader can acquire a blocking position in the class by, alternatively, acquiring at least one-third of the amount of the claim *or* buying sufficient claims to hold more than half of the preexisting number of claims.

To illustrate this, consider the facts of *In re Fagerdala USA-Lompoc*.[52] Simplifying things, the owner of property in California filed for bankruptcy with two significant creditor groups: a bank with a lien on the property and unsecured trade creditors. As bankruptcy rules allow a debtor to confirm a plan over the objection of the secured creditor if the unsecured creditors support the plan and certain conditions are satisfied, the bank decided to buy a blocking position in the unsecured class of claims. After the bank successfully purchased a blocking position, the debtor moved under 11 USC 1126(e) of the bankruptcy code to designate the vote as having been cast in 'bad faith', which would allow the bankruptcy judge to confirm a plan over the bank's objection, notwithstanding the 'no' vote of all the unsecured claims that the bank had purchased. This law gives the bankruptcy judge broad discretion to eliminate the vote of a creditor that voted in some way that undermines the structure of the bankruptcy code.

However, the statute provides little to guide a judge in distinguishing 'impermissible' strategic voting from 'permissible' strategic voting. How do we draw the line? The trend in the law is to distinguish voting for 'enlightened self-interest' (which is permissible) from voting with an 'ulterior motive' (which is impermissible). In practice, the distinction is whether the creditor's strategic concerns are driven more by protecting its existing claim (which is permissible) and profiting in some way from disrupting the debtor's reorganization (which is impermissible). As the court said in Fagerdala, quoting another Ninth Circuit decision, "The mere fact that a creditor has purchased additional claims for the purpose of protecting his own existing claim does not demonstrate bad faith or an ulterior motive." While the law in this area is still developing, it is clearest to summarize it to say that a strategic competitor of the debtor who buys a claim to improve its own market position is probably acting in bad faith and will have its vote designated,[53] while a senior creditor buying a junior claim to block a plan of reorganization is probably permissibly voting its purchased claim against the plan.

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52 2018 WL 2472874 (9th Cir. 4 June 2018).

53 *See e.g.* Dish Network/DBSD.

4.3 Insider Trading

A third major area that is less well developed than the first two is the area of insider trading.[54] Consider this situation: a hedge fund that owns a debtor's unsecured bonds is simultaneously negotiating a plan of reorganization with the company while trading the company's equity. Through its trading in the equity, the hedge fund earned profits, perhaps using confidential information from the settlement talks. Should the hedge fund's bonds be 'equitably disallowed' because it acted in bad faith by engaging in insider trading? While one court initially found the answer to be potentially yes,[55] the judge later reversed herself and allowed the plan to be confirmed without changing the status of the bondholders.

4.4 Inadequate Disclosure

One of the most important policy debates in the claims trading area is over the level of disclosure that claims traders must provide to bankruptcy judges, the debtor and the public. Critics of claims trading often advocate for additional disclosure to reduce the disruption trading allegedly causes to the creditor class.[56] Supporters of trading rebut this claim and allege that additional disclosure regulation could drain liquidity from the market.[57] While the market for the claims of bankrupt firms is typically referred to as 'an unregulated securities market',[58] one provision of the Federal Bankruptcy Rules of Procedure directly impacts claims traders who deploy activist investing strategies: Rule 2019.[59] Rule 2019 requires these activist investors to provide verified disclosure to the bankruptcy court, and it has been the subject of a 'roaring controversy' among scholars, practitioners and judges.[60] This part first summarizes that debate and then examines how a 2011 change to Rule 2019 might have changed the market for the claims of bankrupt

54 For a good overview, *see* Andrew Verstein, Insider Trading: Are Insolvent Firms Different?, 13 Brook. J. Corp. Fin. & Com. L. 53, 53 (2018).

55 *In re Washington Mut., Inc.*, 461 B.R. 200 (Bankr. Dist. Del. 2011), vacated in part, No. 08-12229 MFW, 2012 WL 1563880 (Bankr. Dist. Del. 24 February 2012).

56 *See e.g.* Harvey Miller, Congressional Testimony to the House Judiciary Committee, "Circuit City Unplugged: Why did Chapter 11 fail to save 34,000 jobs?" (11 March 2009).

57 *See e.g.* Sharon Levine, Bankruptcy Beat, The Examiners: Increasing Disclosures Would Chill Claims Trading, Wall St. J. (18 February 2016), available at http://blogs.wsj.com/bankruptcy/2016/02/18/the-examiners-increasing-disclosures-would-chill-claims-trading/.

58 *See* Jonathan C. Lipson, The Shadow Bankruptcy System, 89 B.U. L. Rev. 1609, 1645 (2009).

59 *See* Edward Janger, The Costs of Liquidity Enhancement, 3 Brook. J. Corp. Fin. & Comm. L. 39, 53-55 (2009). While another Federal Bankruptcy Rule of Procedure regulates claim trading, it explicitly exempts the public debt studied here. Rule 3001(e) creates procedural rules for trading in claims "other than a publicly traded note, bond, or debenture." *See* Chaim J. Fortgang & Thomas M. Mayer, Developments in Trading Claims: Participations and Disputed Claims, 15 Cardozo L. Rev. 733 (1990).

60 *See* Henry T.C. Hu & Jay L. Westbrook, Abolition of the Corporate Duty to Creditors, 107 Colum. L. Rev. 1321, 1375 n. 193.

firms, which may serve as a test case for understanding how additional regulation impacts this market. The story, as a whole, demonstrates the various interests that are often at stake in claims trading debates.

4.4.1 The History and Debate over Rule 2019

Bankruptcy law has long regulated the behavior of 'groups' of creditors that act in concert in response to perceived abuses in the 1930s.[61] At that point in history, management teams corrupted bankruptcy negotiations by creating fake 'protective committees' that purported to represent bondholders and other dispersed creditors but promoted the interests of management and large investors, often to the detriment of small investors.[62] The Securities and Exchange Committee studied the issue and proposed a set of disclosure requirements to stop the practice. Importantly, their new disclosure requirements, now implemented by the Supreme Court as Federal Rule of Bankruptcy Procedure 2019, required all 'committees' to file a statement with the court, including, among other things, the name of the holders of the claims, the amounts paid for the claim and the time of acquisition of the claim.[63]

After hedge funds emerged in the 2000s as important players in the bankruptcy process, their activist investing tactics quickly put them on a collision course with Rule 2019. As a general matter, activist hedge funds often pooled resources with other hedge funds that hold claims of the same priority, such as hiring a single law firm to represent them in court.[64] However, by joining forces, groups of hedge funds ran the risk of being forced to make Rule 2019 disclosures. Hedge funds found Rule 2019 extremely problematic for two reasons. First, hedge funds did not wish to disclose details of their investing activities, which they saw as proprietary information that was the outcome of expensive research. Second, hedge funds worried that disclosing the price they paid for the claim would undermine their position in bankruptcy negotiations.[65] For example, if a hedge fund purchased bond debt with a face value of $100 for a 75% discount, the debtor

61 More recently, a group of creditors acting together was discussed in *In re Premier Int'l Holdings, Inc.*, 423 B.R. 58, 67 (Bankr. Dist. Del. 2010).

62 *See* Lipson, *supra* note 58, at 1635.

63 *See* Mark G. Douglas, Rule 2019 Update: Jones Day Business Restructuring Review, Jones Day, available at www.jonesday.com/Rule-2019-Update-12-01-2010 (accessed 24 January 2018).

64 An example of this "pooling" can be found in *In re Nw. Airlines Corp.*, 363 B.R. 701, 702 (Bankr. S.D.N.Y. 2007), where an 'Ad-hoc Committee of Equity Holders' was formed and represented by a single firm. Judge Gropper found that the ad hoc committee was a 'committee' for the purposes of Rule 2019, thus compelling disclosure of individual holding and member trading history.

65 This worry was especially apparent in the response to Judge Gropper's ruling in *In re Nw. Airlines Corp.* (2007), as creditors quickly moved to keep ordered disclosures under seal. *See* Mark Berman & Jo Ann J. Brighton, Will the Sunlight of Disclosure Chill Hedge Funds? The Tale of Northwest Airlines, 26 Am. Bankr. Inst. J. 24-65 (2007) ("The affidavits all contained statements alleging a dire need to keep the information ordered by the bankruptcy court under seal. One of them likened themselves to car dealers who cannot disclose the original cost of vehicle purchases in order to preserve the competitive marketplace for cars.").

might be able to efficiently calibrate a settlement offer to pay the hedge fund a small profit, even though the hedge fund held a claim of $100.

Hedge funds responded to Rule 2019 mostly by ignoring it, leading one lawyer to call it 'a forgotten rule'.[66] As Judge Gerber of the Southern District of New York wrote in a letter to the Advisory Committee on Bankruptcy Rules,

> in the absence of a court order requiring otherwise, failures to provide the information actually required by Rule 2019, as it is now written are widespread, and failures to make all of the required disclosures are the rule, not the exception.[67]

Judge Gerber complained that the large law firms that specialize in representing distressed activist investors developed a practice of making filings that purported to comply with the Rule, while reporting only a list of hedge funds and their holdings in the aggregate, without breaking out individual information. Additionally, even when there was partial compliance, Judge Gerber complained that he had 'never seen' disclosure of dates or the acquisition price.

In the late 2000s, hedge funds began to complain that Rule 2019 had become an 'offensive weapon against activist investors'.[68] When debtors or other creditors wanted to acquire bargaining leverage over hedge funds, they filed a motion demanding that the lawyer appearing on behalf of a group of hedge funds file a full Rule 2019 disclosure. This most famously occurred in the bankruptcy of Northwest Airlines, where the bankruptcy judge in the Southern District of New York rejected an argument by a group of hedge funds that they did not constitute a 'committee' and ordered them to make Rule 2019 disclosures. This decision 'sent shockwaves through the "distressed" investment community,' which were partially reduced after a Texas bankruptcy court reached a contrary conclusion on a similar motion.[69]

The *Northwest Airlines* decision led to a ferocious lobbying effort by hedge funds and their trade associations to ask the Committee on the Rules of Practice and Procedure of the Judicial Conference of the United States to repeal Rule 2019.[70] To do otherwise, warned the main trade associations representing hedge funds, could "lead to an exodus of distressed investors from the market of distressed securities … decreas[ing] liquidity

66 *See* Michael D. Fielding, Remember the Forgotten: Fed. R. Bankr. P. 2019, Presented at the 35th Annual Southern Bankruptcy Law Conference, Atlanta, Georgia (25 April 2009).

67 *See* Robert Gerber, Letter 8-BK-M to the Advisory Committee on Bankruptcy Rules (9 January 2009), available at www.uscourts.gov/sites/default/files/fr_import/08-BK-M-Suggestion-Gerber.pdf.

68 *See* Securities Industry and Financial Markets Association & The Loan Syndication and Trading Commission, Letter 8-BK-G to the Advisory Committee on Bankruptcy Rules (30 November 2007), available at https://www.uscourts.gov/sites/default/files/fr_import/07-BK-G-.pdf ["SIFMA"].

69 *See* Douglas, *supra* note 63.

70 *See* SIFMA, *supra* note 68.

for the debt and equity of bankrupt companies."[71] The controversy faded from view and largely lay dormant as hedge funds mostly continued to ignore Rule 2019, until a series of bankruptcy court decisions in 2009 and 2010 reached contrary determinations as to whether Rule 2019 compelled hedge funds to file disclosures.[72]

In the wake of controversy over the 2009 and 2010 decisions, the Advisory Committee on Bankruptcy Rules began to consider amending Rule 2019. To the hedge funds' surprise, the Advisory Committee began to discuss strengthening the requirements instead of repealing them.[73] To avoid a worse outcome, the main trade associations representing hedge funds reversed course from 2007's repeal effort and agreed to accept increased disclosure obligations of their identity and holdings so long as the price and time of purchase requirements were removed from the Rule.

In the end, the Advisory Committee agreed with the hedge fund trade associations and proposed a new Rule 2019 that was approved by the Supreme Court on 26 April 2011 and became effective on 1 December 2011.[74] The new Rule 2019 eliminated the two requirements that the hedge fund community found most troubling: the disclosure of price and time of acquisition.[75] This eliminated the 'offensive use' of Rule 2019 that hedge funds had complained about in 2007. However, the price of the elimination of those requirements was the elimination of any ambiguity as to whether Rule 2019 applied to hedge fund groups acting in concert to influence bankruptcy cases, increasing the disclosure obligations of activist investors – but to a level they had already decided to voluntarily comply with in most cases, as Judge Gerber noted previously.

This leads to a testable hypothesis: if the new Rule 2019 eliminated the risk that activist investors would be forced to disclose sensitive information, we might expect to see higher levels of trading but lower levels of information in the market. While the old Rule 2019 was clearly not an overwhelming concern for traders, the fact that they waged such a ferocious lobbying campaign that resulted in an amended rule suggests that it was, in fact, something they cared enough about to devote resources to amending.

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71 *See id.* at 24.

72 The decisions were *In re Wash. Mut.*, 419 B.R. 271 (Bankr. Dist. Del. 2009) (holding groups of hedge funds needed to file Rule 2019 statements), *In re Premier Int'l Holdings*, 423 B.R. 58 (Bankr. Dist. Del. 2010), *In re Accuride,* 439 B.R. 364 (Bankr. Dist. Del. 2010) (holding in an oral ruling that groups of hedge funds do need to file Rule 2019 statements).

73 For a detailed explanation of the heightened disclosure requirements, *see* Tom Mayer et al., New Bankruptcy Rule 2019: Brighter Lights, Darker Shadows. Kramer Levin Naftalis & Frankel, LLP (27 June 2011), available at https://www.kramerlevin.com/images/content/2/0/v4/2073/Bankruptcy-Client-Alert-June-27-2011-Rule-2019-Brighter-Lights-Darker-Shadows.pdf.

74 The court order approving the amendments, as well as the official text of the amendments, can be found at https://www.supremecourt.gov/orders/courtorders/frbk11.pdf.

75 The new Rule also required disclosure of 'economic interests' whose value was affected by the bankruptcy case, a requirement aimed at Credit Default Swaps and other short positions but outside the scope of this article.

4.4.2 Did the New Rule 2019 Affect Trading in Distressed Bonds?

My identification strategy to evaluate the effect of the new Rule 2019 is to compare changes in bond market trading for bonds that appear to be more likely to default, where traders might anticipate having to make Rule 2019 disclosures in bankruptcy or sell to those who might make Rule 2019 disclosures, with healthy bonds that are less likely to default and where bankruptcy activism is likely further from the mind of investors. Accordingly, I assemble a data set for all bond trades that took place in the three months before and after the new Rule 2019 implementation period in December of 2011 from TRACE and join it to CompuStat's dataset of firm financial characteristics and MergentFISD's information on bond issues.[76] I use the trading week as the unit of analysis because it allows me to identify trading subsequent to the implementation of the new Rule 2019 on 1 December 2011, and it also allows time fixed effects in all specifications. Time fixed effects are important, because liquidity is generally thought to have declined over the bond market generally after the financial crisis. I focus on short time periods around the change to try to avoid confounding effects.

I use the price of the bond as a measure of distress and default risk, which is consistent with prior literature that uses bond price to identify distressed debt.[77] I first compute a mean average traded price for each bond; then I divide the entire bond market into ten deciles corresponding to their price, with the lowest priced bonds in the tenth decile and the bonds with the highest mean price in the first decile.[78] I recompute the deciles for each week in the sample. My independent variable of interest is a categorical variable that takes on a value corresponding to the decile of each week's average bond price. To account for unobserved heterogeneity across bond issues, I use a bond fixed effects specification with dummy variables for each bond issue. I omit the sixth decile, which means I am comparing trading in all of the other deciles with trading in the bonds whose market implied default risk is average.[79]

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76 I join the three data sets using CUSIP codes, which results in considerable attrition.

77 *See* Edward I. Altman & Brenda J. Kuehne, The Investment Performance and Market Dynamics of Defaulted Bonds and Bank Loans: 2011 Review and 2012 Outlook. NYU Salomon Center, Working Paper, New York (2012). Henry F. Owsley & Peter S. Kaufman, Distressed Investment Banking: To the Abyss and Back 6-7 (2005) call bond prices 'sensitive to concerns about credit quality and solvency' and 'a more reliable indicator of a company's financial health than stock price'. In unreported results, I find that the results displayed below are similar if I instead use the yield-to-maturity implied by the bond's trading price.

78 The results below are qualitatively similar if I use weekly price quarters as the independent variable of interest instead of deciles. This strategy is similar to the identification strategy in Schoenherr (2017), who divides his sample into five quintiles based on measures of default risk to explore the impact of a bankruptcy reform, where the firms less exposed to bankruptcy law might be, in theory, less affected.

79 The results below are the same if I instead omit the first decile of bonds, to compare trading in the most distressed decile with trading in the least distressed decile.

Figure 5 **Average Days before the Filing of First Rule 2019 Statement, by Comparable Firm Return over Chapter 11 Process.**

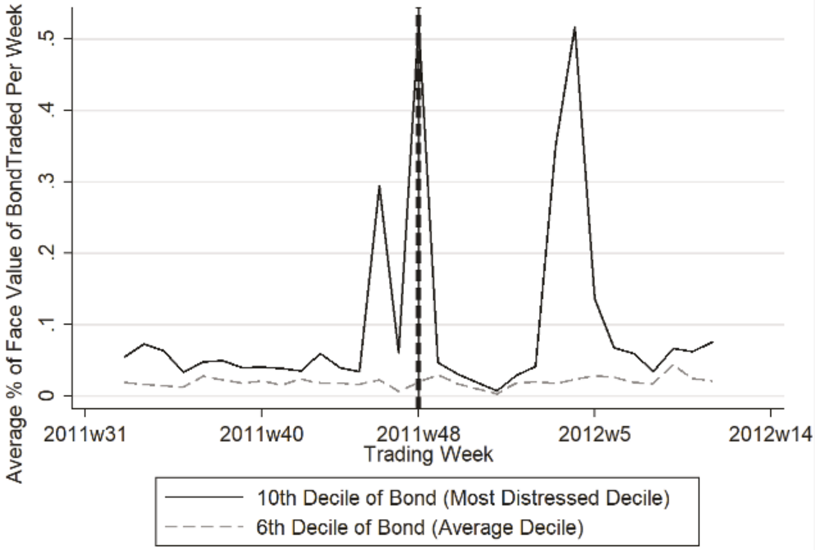

Figure 5 shows the average trading in the most distressed decile of bonds, as compared with the average bond, around the time that Rule 2019 was amended. The dotted line marks the week the new Rule 2019 came into effect. The identifying assumption in a difference-in-differences analysis is that the control group and the treatment group followed parallel trends prior to the rule change. Figure 5 shows the mean percentage of the bond issue trading in each week for the control decile, which is the 6th decile, representing bonds with average risk, and the treatment decile, which is the 10th decile, corresponding to the most distressed bonds in the market. As the figure shows, the two lines follow reasonably parallel trends until the new Rule 2019 came into effect, at which point a large number of very large trades in the most distressed decile meant that the two paths diverged. The sheer magnitude of the observed outlying trades suggests that caution is due in interpreting the results in this section, as a relatively small number of trades drive the result.

Table 1 shows the result of these specifications. I study two dependent variables: the percentage of the issue trading in each week, as a proxy for liquidity, and the estimated bid-ask spread as a proxy for the level of information in the market. I use three event windows, looking 15 weeks, 10 weeks and 3 weeks before and after the enactment of new

Rule 2019. Longer event windows raise the probability of confounding variables, while shorter event windows reduce the sample size.[80]

Table 1. The Impact of the Amended Rule 2019 on Trading in Distressed Debt.

	(1)	(2)	(3)	(4)	(5)	(6)
	Log Total Percentage Traded in Week	**Log Total Percentage Traded in Week**	**Log Total Percentage Traded in Week**	**Log Weekly Mean Bid-ask Spread**	**Log Weekly Mean Bid-ask Spread**	**Log Weekly Mean Bid-ask Spread**
1st Decile (Least Distressed Bond Decile)	0.233**	0.349**	0.458*	−0.253***	−0.247*	−0.383
	(0.113)	(0.142)	(0.268)	(0.088)	(0.133)	(0.301)
2nd Decile	−0.002	0.025	0.217	−0.352***	−0.407***	−0.360
	(0.089)	(0.110)	(0.221)	(0.074)	(0.108)	(0.285)
3rd Decile	−0.079	−0.088	0.104	−0.227***	−0.154*	0.051
	(0.072)	(0.092)	(0.176)	(0.058)	(0.079)	(0.183)
4th Decile	−0.069	−0.083	−0.038	−0.100**	−0.093	0.053
	(0.058)	(0.076)	(0.144)	(0.047)	(0.064)	(0.145)
5th Decile	−0.025	−0.014	−0.104	−0.045	−0.051	0.038
	(0.048)	(0.060)	(0.113)	(0.034)	(0.040)	(0.099)
7th Decile	0.163***	0.216***	0.280**	0.033	0.037	−0.141
	(0.052)	(0.061)	(0.113)	(0.037)	(0.048)	(0.106)
8th Decile	0.269***	0.277***	0.352**	0.109***	0.102**	−0.034
	(0.062)	(0.076)	(0.143)	(0.039)	(0.046)	(0.105)
9th Decile (Most Distressed Bond Decile)	0.385***	0.338***	0.719***	0.194***	0.244***	0.277**
	(0.074)	(0.090)	(0.182)	(0.045)	(0.053)	(0.120)
10th Decile (Most Distressed Bond Decile)	0.034	0.158	0.875***	0.194**	0.311***	0.301
	(0.107)	(0.138)	(0.271)	(0.080)	(0.079)	(0.186)
New Rule 2019 in Effect	0.093	0.089	−0.010	0.069	0.102	0.007

80 3 weeks is the narrowest window in which I observe the result displayed in Table 1.

	(1)	(2)	(3)	(4)	(5)	(6)
	Log Total Percentage Traded in Week	**Log Total Percentage Traded in Week**	**Log Total Percentage Traded in Week**	**Log Weekly Mean Bid-ask Spread**	**Log Weekly Mean Bid-ask Spread**	**Log Weekly Mean Bid-ask Spread**
	(0.087)	(0.091)	(0.109)	(0.070)	(0.072)	(0.080)
1st Decile × New 2019 (Least Distressed Bond Decile × New 2019)	−0.018	−0.039	−0.074	−0.040	−0.184***	−0.130
	(0.061)	(0.071)	(0.110)	(0.052)	(0.069)	(0.150)
2nd Decile × New 2019 (Second Least Distressed Bond Decile × New 2019)	0.018	−0.007	0.026	0.008	−0.048	0.018
	(0.063)	(0.075)	(0.117)	(0.045)	(0.057)	(0.097)
3rd Decile × New 2019	0.150**	0.132*	0.137	0.075	−0.036	−0.041
	(0.064)	(0.073)	(0.111)	(0.046)	(0.046)	(0.078)
4th Decile × New 2019	−0.006	0.004	0.136	−0.030	−0.117**	−0.020
	(0.058)	(0.069)	(0.113)	(0.045)	(0.054)	(0.085)
5th Decile × New 2019	0.050	0.059	0.159	−0.062	−0.118**	0.005
	(0.062)	(0.071)	(0.117)	(0.041)	(0.049)	(0.090)
7th Decile × New 2019	−0.049	−0.086	0.076	−0.033	−0.071	0.083
	(0.064)	(0.073)	(0.115)	(0.043)	(0.049)	(0.084)
8th Decile × New 2019	−0.166***	−0.108	0.100	−0.079*	−0.069	0.119
	(0.064)	(0.076)	(0.122)	(0.043)	(0.046)	(0.075)
9th Decile × New 2019	−0.273***	−0.156*	−0.143	−0.163***	−0.196***	−0.100
	(0.074)	(0.086)	(0.127)	(0.049)	(0.051)	(0.089)
10th Decile × New 2019	0.207**	0.240**	0.281**	0.206***	0.058	0.134
	(0.099)	(0.105)	(0.138)	(0.071)	(0.062)	(0.124)
R^2	0.06	0.08	0.10	0.01	0.01	0.01

	(1)	(2)	(3)	(4)	(5)	(6)
	Log Total Percentage Traded in Week	**Log Total Percentage Traded in Week**	**Log Total Percentage Traded in Week**	**Log Weekly Mean Bid-ask Spread**	**Log Weekly Mean Bid-ask Spread**	**Log Weekly Mean Bid-ask Spread**
N	68,547	45,723	14,913	59,726	39,935	12,975
Firms	1133	1108	1046	1127	1103	1025
Sample Range from Rule Change	± 15 weeks	± 10 weeks	± 3 weeks	± 15 weeks	± 10 weeks	± 3 weeks
Bond FE	Yes	Yes	Yes	Yes	Yes	Yes
Week FE	Yes	Yes	Yes	Yes	Yes	Yes
Financial Controls	Yes	Yes	Yes	Yes	Yes	Yes

* $p<0.1$; ** $p<0.05$; *** $p<0.01$

Table 1 analyzes the impact of the new Rule 2019 on trading in distressed debt, where the decile of the most distressed debt in the market is identified using the average bond price over the course of a week. The dependent variable for Models 1 to 3 is the aggregate percentage of debt that traded, where the aggregate amount of observed trading is scaled by the original amount of the bond outstanding, as identified in MergentFISD. The variable of interest is the 10th Decile v. New Rule 2019, which isolates the change in trading volume for the most distressed decile of bonds that correlates with the implementation of the New Rule 2019. The omitted decile is the 6th decile, making each decile dummy a comparison against trading in the average bond in the data set. For example, the results suggest that trading in the 10th decile in the three weeks before and after the rule change is 22% higher than trading in the average bond in the data set. Standard errors clustered at the firm level are in parentheses.

The results suggest that, while there appears to be no change in most deciles of the bond market after Rule 2019 was amended, trading volume appears to have increased, relative to the safest bonds, for the riskiest bonds. For example, in Model 3, trading increased about 32% for the riskiest decile of bonds. There are no consistent effects for any other decile in the sample. Additionally, the results from Models 4 suggest that the bid-ask spread also increased for the riskiest deciles, but I do not find the same result using the estimations in Models 5 and 6 and a shorter window.

Overall, the results support the view that changing the level of disclosure might affect the liquidity that the market provides to creditors. The most conservative interpretation of the finding is that traders may have cared enough about the rule change to delay buying and selling claims until after the disclosure risk had been eliminated. Given that the effect is driven by outliers, this interpretation seems reasonable.

5 Other Policy Concerns Raised by Claims Trading

There are at least three other concerns raised by claims trading that have not been the subject of major scholarly debate or judicial decisions. I raise each briefly.

First, bankruptcy courts have become experts in mediating disputes between warring hedge funds holding claims at different levels of the capital structure, which may limit the capacity of bankruptcy courts to handle situations with different problems. This expertise has become, in many ways, the primary thing that bankruptcy courts do, leaving bankruptcy judges at the mercy of market participants when it comes to evaluating a distressed situation. The ongoing bankruptcy of the Pacific Gas and Electronic Gas Corporation reveals some of the weaknesses in the institutional capacity of bankruptcy judges. PG&E is Northern California's main electrical utility, and it is filed for bankruptcy in January of 2019 after its equipment caused wildfires that decimated entire cities in California to the tune of more than $20 billion in damages. Despite the tools bankruptcy law might offer to PG&E to rehabilitate its business, most of its Chapter 11 case thus far has centered on the bankruptcy judge mediating the dispute between the hedge funds that own its debt and the hedge funds that own its equity. It is not obvious that bankruptcy judges could do better in a different universe, but the orientation of the bankruptcy industry as a whole to serving activist investors and resolving their disputes may have reduced its overall capacity to use other tools.

Second, and relatedly, as lenders often build their underwriting models around selling the claim when the firm falls into financial distress, there may now be a knowledge gap between the 'origination' side of lending and the 'distressed' side. For example, a major bankruptcy court decision may not be known by the investment banks preparing corporate loan documents. One example of this is the so-called 'J Crew maneuver', which exploited ambiguities in a collateral document that have not yet been fixed in the corporate lending market even years after the transaction shocked the market for corporate debt.[81] While there is no empirical evidence on this point yet, future research should investigate whether the speed of adjustment in the market for corporate finance has decreased as a result of the bankruptcy claims trade.

Third, the perception that bankruptcy courts are arenas for combat between warrior hedge funds may have reduced public confidence in the bankruptcy system. Again, the recent bankruptcy filing of PG&E provides an example. That case is currently

81 For a discussion of this problem, *see* Jared A. Ellias & Robert J. Stark, Bankruptcy Hardball, 108 Calif. L. Rev. 101 (2020). *See also* Rasmussen & Simkovic, *supra* note 49.

characterized by fights between hedge funds over who will make the most money even though issues of intense public concern – how California can reduce the risk of wildfires – loom very large. In the Toys R Us bankruptcy, the largest Toy Retailer in America was forced to liquidate after a fight between distressed hedge funds.[82] The bankruptcy system depends on public confidence in the fairness and integrity of the process. To the extent the public comes to believe that the bankruptcy system is full of mercurial hedge funds that care only about their own interest, it may damage public confidence in a process that nearly always imposes difficult losses on employees and, in many cases, pensioners.

6 Conclusion

This Report summarized the development of bankruptcy claims trading, the tactics and goals of activist investors and some of the policy questions claims trading and activists raise. While there can be no doubt that claims trading has dramatically changed bankruptcy practice, the evidence presented here suggests that, on average, bankruptcy judges and lawyers have been largely up to the challenges that claims trading has created, and American business writ large is likely better off for having a robust roster of experienced distressed investors wielding large pools of capital to rehabilitate distressed assets. I would encourage policy makers to continue down the road indicated by the new Rule 2019, by forcing additional disclosure into the marketplace of information about activist investors. It would be useful, for example, for more formal marketplaces to develop to provide public disclosure of pricing and trading volumes when a firm is in bankruptcy. In general, however, it is not obvious that radical changes are needed to the way claims trading is regulated, and the past three decades provide every confidence that bankruptcy courts will continue to be up to the challenges created by new financial innovations and business cycles.

82 *See* Gretchen Morgenson & Lillian Rizzo, Who Killed Toys 'R' Us? Hint: It Wasn't Only Amazon, Wall St. J. (23 August 2018), available online at https://www.wsj.com/articles/who-killed-toys-r-us-hint-it-wasnt-only-amazon-1535034401.

Appendix Table 1. Summary of Activist Investing Strategies

Assume: A Chapter 11 Debtor Can Reorganize in Transaction with a True Value of $650.

Financial Contract and Amount Owed	Financial Position	Potential Activist Investor Strategy	Dangers for Activist
$100: Revolving Loan with Lien on Receivables	Deeply in the money; limited value to activists	1. **DIP Finance Investing**. Earn Profits by Providing DIP Financing 2. **Exit Finance Investing**. Earn Profits by Providing the Firm with Financing to Leave Bankruptcy.	1. The First Lien Lenders may want to provide DIP Financing themselves and fund the Debtors' bankruptcy; the Revolving Lender may be refinanced against its wishes or will have to reduce the price of DIP Financing. The Second Lien Lenders may offer a defensive DIP Financing to block the First Lien Lenders from expropriating value. 2. Competition from First and Second Lien Lenders
$500: First Lien Debt with Blanket Lien	In the money; may control firm after bankruptcy case; attractive activist options that could be worth more than 100% of the First Lien Lenders' claim and downside is limited	1. **DIP Finance Investing**. Earn Profits by Providing DIP Financing 2. **Offensive Control Transaction**. Perhaps Use Covenants in DIP Financing to Buy Control of Bankruptcy Process; Steer Firm into Favored Transaction that Apprai-ses Firm at $650, leaving First Lien Lenders with $550 in value on first day after Chapter 11 3. **Defensive Control Transaction**. Perhaps Use Covenants in DIP Financing to Buy Control of Bankruptcy Process; Keep Second Lien Lenders from expropri-ating Value; Steer Firm into Fair Transaction that Underappraises Firm at Less than Market Value, leaving First Lien Lenders with more value than they deserve. 4. **Exit Finance Investing**. Earn Profit by Providing the Firm with Financing to Leave Bankruptcy.	1. May need to compete with Revolving Lenders, reducing the potential profits; Second Lien Lenders may seek to compete 2. As the firm can be reorganized in a transaction valued at $650, the Second Lien Lenders may try to obtain a judicial ruling blocking an expropriative plan or provide their own rival financing package, perhaps refinancing the First Lien Lenders and limiting their upside. 3. As above, potential competing, expropriative DIP loan from Second Lien Lenders who can at very least put pricing pressure on First Lien Lenders 4. Competition from Revolver and Second Lien Lenders

Financial Contract and Amount Owed	Financial Position	Potential Activist Investor Strategy	Dangers for Activist
$100: Second Lien Debt with Sub-ordinated Blanket Lien	Barely at the money depending on how the firm is appraised; attractive activist options, could try to acquire control of firm and earn return through operational improv-ements; can also litigate for side payments	1. **DIP Finance Investing**. Earn Profits by Providing DIP Financing 2. **Offensive Control Trans-action**. Perhaps Use Covenants in DIP Financing to Buy Control of Bank-ruptcy Process; Steer Firm into Favored Transaction that Appraises Firm at more than $650, expropriating value that would otherwise go to First Lien Lenders 3. **Defensive Control Tran-saction**. Perhaps Use Covenants in DIP Financing to Buy Control of Bank-ruptcy Process; Keep First Lien Lenders from Expro-priating Value; Steer Firm into Fair Transaction that Appraises Firm at Market Value. 4. **Exit Finance Investing**. Earn Profit by Providing the Firm with Financing to Leave Bankruptcy. 5. **Invest in Defensive Litigation**. Even if First Lien Lenders buy control of the firm with DIP Financing, invest in litigation to defend value entitlements. 6. **Invest in Offensive Litigation**. Use judicial process to try to obtain ruling or stall bankruptcy process to acquire bargain-ing power that compels First Lien Lenders to pay sett-lement that provides Second Lien Lenders with more than $50 in a recovery	1. Second Lien Lenders are typically in a poor position to outcompete First Lien Lenders for DIP Financing, although it does happen from time to time; bankruptcy code requires any DIP Financing that provides the lender with a priming lien to provide the First Lien Lenders with ‘Adequate Protection’. 2. As the Second Lien Lenders are likely to lose a comp-etition over providing financing, they will struggle to buy control of the Chapter 11 with DIP Finan-cing. 3. The First Lien Lenders or Unsecured Creditors are likely to fight back. 4. Competition from other creditors to provide exit fin-ancing. 5. Could lose in court. 6. Could lose in court.

Financial Contract and Amount Owed	Financial Position	Potential Activist Investor Strategy	Dangers for Activist
$1000: Unsecured bond debt	Out of the money; limited activist upside	1. **Litigate for Hold-Up Value.** Invest in litigation to create uncertainty for senior creditors to earn settlement as return on investment in litigation.	1. Evidence suggests that hold-up value settlements are not very valuable and legal services are expensive, which means this investment may not work out well. The bankruptcy judge may neutralize whatever litigation tactics the unsecured bondholders deploy
Equity	Out of the money; negligible value for activists	1. **Litigate for Hold-Up Value.** Invest in litigation to create uncertainty for senior creditors to earn settlement as return on investment in litigation.	1. As the shareholders are way out of the money, hold-up litigation will be an uphill battle unlikely to yield a return

Loan-to-Own Strategies, Valuation Uncertainty and Credit Bidding under Dutch Law

Sebastiaan W. van den Berg[*]

1 Introduction

In distressed or special situations, there are various investment strategies for creating value for investors, for example: (i) increasing the total enterprise value of the company and thereby increasing the value of an equity and/or debt instrument, (ii) increasing the value of the equity and/or debt instrument while the total enterprise value remains the same (and thus decreasing the entitlement or the value of other investors) or (iii) buying or selling mispriced financial instruments and speculating, or waiting, for a correction in the market values.[1]

The strategies mentioned under (i) and (ii) are more active investment strategies and assume some form of active involvement from the (distressed) investor.[2] One way of implementing those value-driven strategies is the *loan-to-own* strategy. Basically, such a strategy entails making a secured loan to a financially distressed firm – or, more likely, buying such a loan from an existing financing party at a discount – with the expectation that the firm will default under the secured loan, as a result of which (a) the secured lender can either initiate enforcement proceedings, or (b) insolvency procedures eventually follow. On the basis of those proceedings the assets can be sold to the secured creditor, in respect of insolvency proceedings either with a simple asset sale or a more complex reorganization plan, where the asset sale can be an element of the transaction.

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1 *See*: S.C. Gilson, *Creating Value through Corporate Restructuring: Case Studies in Bankruptcies, Buyouts and Breakups,* John Wiley & Sons, Inc., 2nd edition, 2010, pp. 20-21.

2 M.M. Harner, 'Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives', *ABI Law Review*, 2008, Vol. 16, No. 69, pp. 69-110: "The term 'distressed debt investor' generally refers to hedge funds, private equity firms, banks with proprietary trading desks and other non-traditional lenders. These investors typically do not have prior lending relationships with the company. Rather, they purchase the company's debt strictly as an investment opportunity. … Their investment strategies and workout approaches often differ from those of traditional lenders in the restructuring context."

Under U.S. law, in any of the aforementioned scenarios resulting in an asset sale, a secured creditor has, in principle, the right to credit bid the full amount of the secured obligation – thereby having the opportunity to compete with cash bids from third parties.

The economic rationale of such a strategy is relatively straightforward: the initial investment is a fraction of the full face value of the secured loan, while the full face value of the secured loan can be bid (in credit and not in cash) with the perspective of realizing a higher return once the underlying asset has (partly) recovered from the distressed situation and is sold again. Sometimes those distressed investors are called 'vultures',[3] but the downside of such a risky strategy is not insignificant, and therefore the risk-return trade-off differs from less distressed situations, which is not always highlighted when this investor group is being analyzed and framed.

In this article the loan-to-own strategy by means of a credit bid is investigated from a Dutch law perspective. More specifically, it is investigated how under Dutch law credit bidding can be carried out both in and outside of formal bankruptcy proceedings. As (Art. 57(1) of) the Dutch Bankruptcy Act (DBA) provides that security rights are not affected by insolvency proceedings, i.e. secured creditors "can exercise their security rights as if there were no insolvency proceedings" (unofficial translation) and the enforcement of security rights in bankruptcy, in principle, thus takes place no differently than the enforcement of security rights outside of bankruptcy, the difference between those situations is not emphasized in detail.

The board of the Netherlands Association for Comparative and International Insolvency Law (*Nederlandse Vereniging voor Rechtsvergelijkend en Internationaal Insolventierecht*) requested me to focus especially on loan-to-own strategies by means of credit bidding in order to create appropriate distance from ongoing discussions on the implementation of the Dutch Bill on the Confirmation of Private Plans (BCPP) (better known under its Dutch acronym 'WHOA').[4] Of course, loan-to-own strategies may also be executed by means of implementing reorganization plans – and thereby implementing a debt-for-equity swap.[5] Occasional references to the BCPP are inevitable, but the BCPP has deliberately not been put center stage in this Report.

The content of this article is as follows:

- Brief overview of credit bidding under U.S. (non)bankruptcy law;
- Dutch loan-to-own strategy: credit bidding under Dutch (non)bankruptcy law;
- Share pledge enforcement by means of a private sale;
- Introduction to distressed valuation methodologies;
- Analysis of credit bidding in respect of share pledge enforcements; and
- Summary and conclusion.

3 *See,* for example: H. Rosenberg, *The Vulture Investors*, John Wiley & Sons, Inc., 1992.

4 Informal translations of the BCPP can be found at https://resor.nl/dutch-scheme/.

5 S.W. van den Berg, W.G.M. Holterman and H.T. Haanappel, 'Reorganisation Value and the Dutch Bill on the Confirmation of Private Plans', *International Corporate Rescue*, November 2019.

2 Brief Overview of Credit Bidding under U.S. (Non)bankruptcy Law

2.1 The Policy Behind Credit Bidding

Credit bidding allows a secured creditor to compete with cash bids from third parties by allowing the secured creditor to bid up to the full amount of the secured obligation. As mentioned, the ability to credit bid exists under both U.S. nonbankruptcy law and U.S. bankruptcy law.[6]

In general, the advantages of credit bidding are deemed to be (i) the increase of the pool of potential bidders (thereby, in theory, increasing the amount and number of competitive bids), (ii) the discouragement of favoring 'white knights' or inside bidders[7] and (iii) the reduction of the costs to submit a bid, and minimization of transaction costs in general.[8] Thus, it provides a safeguard for secured creditors, by insuring against undervaluation of their collateral at an asset sale:[9]

> The ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price. It enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan.[10]

The argument that credit bidding protects the secured creditor from the risk of suffering a discount is based on the economic theory that suggests that a debtor might suffer a discount in connection with the sale of its assets, solely because of the fear of prospective buyers that they lack private information about the financial condition of the assets.[11]

On the contrary, it is also argued that credit bidding 'chills' bidding by third parties by permitting the secured creditor to 'overbid' with currency that may be of little or no value

6 *In re aRenne*, 55 F.Supp. 868, 873 (D. Neb. 1944) ("Orders for sale under the provisions of Title 11 … are normally analogous to decrees or orders for sale in foreclosure of real estate mortgages."); *See also*: D.S. Bernstein et al., 'The Logic and Limits of Credit Bidding by Secured Creditors Under the Bankruptcy Code', July 2011, p. 5; P.R. Hage et al., *Credit Bidding in Bankruptcy Sales: A Guide for Lenders, Creditors, and Distressed-Debt Investors*, American Bankruptcy Institute; 1st edition, 2015, p. 12.

7 'White knight' buyers are those that acquire a company, which is typically in financial distress or undergoing a hostile takeover, on terms favorable to the company or its management.

8 *See*: V.S.J. Buccola and A.C. Keller, 'Credit Bidding and the Design of Bankruptcy Auctions', *George Mason Law Review*, Vol. 18, No. 1, 2010, p. 100.

9 *In re Aéropostale, Inc.* No. 16-11275 (Bankr. S.D.N.Y. 26 August 2016), p. 72.

10 *RadLax Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2070 (2012).

11 G.A. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism', *The Quarterly Journal of Economics*, Vol. 84, No. 3, August 1970, pp. 488-500.

(namely, the secured creditor's deficiency claim).[12] This chilling effect may, however, not play a decisive role, as will be explored later on.

Outside bankruptcy proceedings, many U.S. state laws specifically authorize credit bidding at foreclosure sales involving real property.[13] Alternatively, the right to credit bid is also judicially recognized in some U.S. states. In addition, it is noted that Article 9 of the Uniform Commercial Code (a standardized set of laws for transacting business and fully adopted by most U.S. states) provides three basic methods for the enforcement of security interests after default: (i) collection and enforcement through a judicial process, (ii) repossession and disposition of the collateral through nonjudicial means and (iii) acceptance of the collateral in full or partial satisfaction of the obligation. Although it is concluded that the statutory text of Article 9 and the official comments thereto do not specifically refer to credit bidding at such a sale, according to Bernstein et al. (2012), secured creditors generally assume they can offer satisfaction of their claim as the consideration for a bid, a logical inference (given the secured creditor's right to the proceeds of sale) that has been accepted in courts as a matter of course.[14]

With respect to bankruptcy proceedings, we first have to explore the possibilities of selling assets in bankruptcy proceedings under the U.S. Bankruptcy Code. In what follows, it is briefly and generally explained how assets can be sold in a U.S. bankruptcy scenario, namely: (i) sales outside of the ordinary course of business but not pursuant to a Chapter 11 reorganization plan (section 363 of the U.S. Bankruptcy Code) and (ii) sales pursuant to a Chapter 11 reorganization plan (section 1129 of the U.S. Bankruptcy Code).

2.2 Credit Bidding in Section 363 Sales

Section 363 of the U.S. Bankruptcy Code provides that if certain conditions are met, encumbered assets may be sold outside the ordinary course of business, free and clear of liens, and without lender consent, provided that the creditors secured by the collateral are given (a lien on) the proceeds of the sale.[15]

Section 363(k) preserves a secured creditor's right to credit bid.[16] With respect to the question as to the amount such a secured creditor is entitled to credit bid, courts have

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12 *See*: D.S. Bernstein, B.M. Resnick and H. Dengel, *Credit Bidding in Chapter 11 after RedLAX*, New York University School of Law, 2012, p. 3.

13 *See*: *id.*, §1.

14 *See*: *id.*, p. 6.

15 *See*: *id.*, p. 8.

16 11 U.S.C. § 363(k) ("At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise, the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.").

interpreted section 363 to permit credit bidding of the entire face value of a secured creditor's credit.[17]

A court may, however, deny the right to credit bid 'for cause'. Such 'cause' is rarely found, but Bernstein et al. (2012) provided the following overview of circumstances where courts have denied the right to credit bid:

– A secured creditor acting in bad faith or colluding with the debtor or trustee.[18]
– A secured creditor failing to follow the sale procedures ordered.[19]
– A secured credit whose lien was subject to a bona fide dispute regarding its validity or priority.[20]
– Prejudice to other lienholders (particularly where senior or pari passu lienholders would be left uncompensated).[21]

In their *Final Report and Recommendations on the Reform of Chapter 11* (2014), the American Bankruptcy Institute (ABI) stated that disputing the bid chilling effect alone is not enough for a court to order for 'cause', as was also concluded in more recent case law: any alleged chilling effect is insufficient on its own to prevent secured lenders from exercising their credit bid rights with respect to their entire claims.[22] The following two examples, however show that the chilling effect was considered to be significant and that the credit bid was consequently capped.

In *In re Fisker Automotive Holdings Inc.,* the court found that

> [t]he evidence in this case is express and unrebutted that there will be no bidding – not just the chilling of bidding – if the Court does not limit the credit bid.

Without a cap on credit bidding "bidding will not only be chilled, bidding will be frozen".[23] The court ordered that the creditor's ability to credit bid was limited to the amount of the distressed purchase price that was actually paid for the debt.

More precisely, the secured outstanding senior loan facility debt ($168.5 million face amount) was purchased for $25 million, or approximately 15 cents on the dollar, by an investor called Hybrid. It was envisaged that Hybrid would buy the assets by means of a

17 *E.g.*, *Cohen v. KB Mezzanine Fund II, LP* (*In re SubMicron Sys. Corp.*), 432 F.3d 448, 459 (3d Cir. 2006) (explaining that § 363(k) "empowers creditors to bid the total face value of their claims").
18 *See*, *e.g.*, *In re Aloha Airlines, Inc.*, No. 08-00337, 2009 Bankr. LEXIS 4588, at *25-*26 (Bankr. D. Haw. 14 May 2009).
19 *See*, *e.g.*, *Greenblatt v. Steinberg*, 339 B.R. 458, 463 (N.D. Ill. 2006).
20 *See*, *e.g.*, *In re Akard Street Fuels, L.P.* (Bankr. N.D. Tex. 12 September 2001); *In re Akard Street Fuels*, L.P. (N.D. Tex. 4 December 2001).
21 *See*, *e.g.*, *In re Takeout Taxi Holdings, Inc.*, 307 B.R. 525, 536 (Bankr. E.D. Va. 2004); *In re Valley Bldg. Supply, Inc.*, 39 B.R. 131, 133 (Bankr. D. Vt. 1984).
22 *In re Aéropostale, Inc.* No. 16-11275 (Bankr. S.D.N.Y. 26 August 2016), p. 78.
23 *In re Fisker Automotive Holdings Inc.,* 510 B.R. 55 (Bankr. D. Del. 2014), p. 9.

private sale, thereby acquiring the assets in exchange for $75 million in the form of a credit bid. The committee of unsecured creditors opposed this proposed deal and endorsed an auction in which other parties could participate. One potentially interested strategic party, Wanxiang, refused to participate in any auction process unless the investor's ability to credit bid was capped at $25 million. After Hybrid's ability to credit bid was limited to $25 million, a competitive auction between Hybrid and Wanxiang ensued. Wanxiang prevailed, the aggregate value of its bid reported at $149.2 million, and thus being significantly higher than the $75 million.[24]

In *In re Free Lance-star*, the right to credit bid was capped at approximately 36% of the nominal value of the secured loan on the basis of the following arguments:

> The confluence of (i) Lender's less than fully-secured lien status; (ii) Lender's overly zealous loan-to-own strategy; and (iii) the negative impact Lender's misconduct has had on the auction process has created the perfect storm, requiring curtailment of Lender's credit bid rights.[25]

From the above two examples it must not, however, be concluded that the cap on credit bidding is always limited to the purchase price of the secured loan or another random figure as determined by the court.[26]

This is in line with ABI's recommendation on the process of credit bidding during section 363 sales:

> In a sale under section 363 of the Bankruptcy Code involving a secured creditor's collateral, the secured creditor should be permitted to credit bid up to the amount of its allowed claim relating to such collateral unless the court orders otherwise for cause. For purposes of this principle, the potential chilling effect of a credit bid alone should not constitute cause, but the court should attempt to mitigate any such chilling effect in approving the process. Section 363(k) should be clarified accordingly.[27] To conclude, the right of credit

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24 *See also*: B. Rosenblum, 'Delaware Court Finds "Cause" to Limit Credit-Bid to Facilitate Bankruptcy Auction', *Business Restructuring Review,* March/April 2014, p. 7.

25 *In re The Free Lance-Star Publishing Co. of Fredericksburg,* VA, 512, B.R. 798 (Bankr. E.D. Va. 2014).

26 Hage et al., *supra* note 6, p. 49; G.R. Warner, 'Slam Dunk for Credit Bid Cap', *GT Restructuring Review*, 19 February 2014, and G.R. Warner, 'Credit Bidding and the Clash of Old and New Bankruptcy', *GT Restructuring Review*, 5 February 2014: "the judge did not declare a new rule that the amount paid for the claim was the correct limit to place on the credit bid. The parties presented only three options: (1) allow credit bidding without restriction; (2) prohibit credit bidding entirely; or (3) limit it to the amount paid for the claim. The stipulated facts provided no support for denying the credit bid altogether, provided strong reasons for limiting it, and provided no factual basis upon which the judge could have picked a bid cap different from the amount paid for the claim."

27 Harner, Michelle M., 'Final Report of the ABI Commission to Study the Reform of Chapter 11' (2014), Book Gallery, Book 97, pp. 145-146.

bidding in section 363 asset sales is deemed considerably strong, although the right to credit bid can be restricted 'for cause'.

2.3 *Credit Bidding under a Chapter 11 Reorganization Plan*

Chapter 11 provides for the possible cramdown of a class of claimants, or capital providers, who did not accept the plan. In order to sanction such a plan, it must be demonstrated that the plan is 'fair and equitable' with respect to a dissenting class of claimants. In order to meet this condition, among other things, section 1129(b)(2)(A) of the U.S. Bankruptcy Code prescribes three requirements:

- Under the plan, the holders of secured claims retain the liens securing their allowed claims and receive deferred payments having a present value equal to the value of their collateral;
- The collateral is sold free and clear of the liens, with the liens attaching to the proceeds of such sale, so long as the secured creditor is permitted to credit bid; *or*
- The plan provides for the secured creditors to receive the 'indubitable equivalent' of their secured claims.

Briefly summarized, under section 1129(b)(2)(A), a plan is 'fair and equitable' only if it protects secured claimants by (i) leaving liens intact, (ii) permitting them to credit bid as under a sale on the basis of section 363, *or* (iii) giving them the 'indubitable equivalent' of their secured claims.

For a debtor who is trying to sell its assets under a reorganization plan, alternative (i) is not always attractive. This is because buyers do not want to risk having to redeem preexisting liens if the debtor fails to pay off the secured creditors. Consequently, a plan needs to either permit credit bidding, *or* provide secured creditors with the 'indubitable equivalent' of their secured claims.[28]

For a long time, there was a debate in U.S. courts and literature about the correct interpretation of section 1129(b)(2)(A). This credit bidding debate was centered on the disjunctive 'or'. As explained by Tabb (2012), the question was whether, when the collateral is being sold, the secured creditor is always entitled to make a credit bid, or whether alternatively the plan proponent can deny the secured creditor the right to credit bid and cram it down via the 'indubitable equivalent' third option, even in a sale.[29]

To put this discussion in perspective, one should bear in mind that the debtor and the secured creditors have conflicting interests. The secured creditors may desire to credit bid (if and when interested in the business), and the debtor and its shareholders may want to

28 *See*: Buccola and Keller, *supra* note 8, p. 108.

29 C.J. Tabb, 'Credit Bidding, Security, and the Obsolescence of Chapter 11', University of Illinois College of Law, 2012, p. 9.

prohibit credit bidding. Stakeholders are therefore interested in the question as to the conditions under which an asset sale plan prohibiting credit bidding nevertheless supplies secured creditors with the indubitable equivalent of their secured claims.

On 29 May 2012 the U.S. Supreme Court ruled in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 2012 WL 1912197, that a debtor may *not* confirm a Chapter 11 cramdown reorganization plan that provides for the sale of collateral free and clear of existing liens but does not permit a secured creditor to credit bid at the sale.

In the *RadLAX* case, the debtor purchased the Radisson Hotel at Los Angeles International Airport in 2007. The debtor also purchased lots adjacent to the hotel on which the debtor planned to build a parking structure. Within two years of obtaining financing for the refurbishment of the hotel and construction of the parking structure, the debtor had run out of funds. In August 2009, with more than $120 million outstanding, more than $1 million in interest accruing each month and no additional funds available to complete the project, the debtor filed for relief under Chapter 11. In 2012, the debtor proposed a Chapter 11 plan in which they would basically liquidate the company and sell substantially all of its assets through an auction to the highest bidder. There was a 'stalking horse bidder', a potential purchaser who was willing to start the bidding, and the proceeds of the auction were to be used to fund the Chapter 11 plan (*note for Dutch practitioners*: the U.S. reorganization plan can thus also have a liquidating nature, instead of one focused on the reorganization of the company),[30] primarily by repaying the secured creditors. The debtor proposed to sell its property free and clear of the secured creditor's liens and repay them with the sale proceeds. Rather than allowing the secured creditor to make a credit bid (i.e. option (ii) as indicated above), the debtor argued that the auction procedures satisfied clause (iii) above because by providing the secured creditor with cash (generated by the auction), the condition of providing the 'indubitable equivalent' was fulfilled.

The U.S. Supreme Court concluded that the debtor's reading of section 1129(b)(2)(A) – based on which clause (iii) would permit exactly what clause (ii) prohibits – was 'hyperliteral and contrary to common sense'. This was substantiated by considering as follows:

> [C]lause (ii) is a detailed provision that spells out the requirements for selling collateral free of liens, while clause (iii) is a broadly worded provision that says nothing about such a sale. The general/specific canon explains that the general

30 *See* in a Dutch context the Explanatory Notes to the BCPP, p. 77: "The plan could produce two scenarios: (1) the continuation of the activities of the business as a going concern; and (2) the discontinuation and wind down of the business outside bankruptcy. Another possibility is a combination. In a combination, some parts of the business are discontinued and others will continue."

> language of clause (iii), although broad enough to include it, will not be held to apply to a matter specifically dealt with in clause (ii).[31]

Thus, the U.S. Supreme Court determined that when the situation falls within the scope of both provisions, the specific provision presumptively governs. In reaching this conclusion, the U.S. Supreme Court noted that clause (ii) addresses a subset of cramdown plans and that clause (iii) applies to all cramdown plans, including all of the plans within the narrower description in clause (ii):

- is the rule for plans under which the creditor's lien remains on the property,
- is the rule for plans under which the property is sold free and clear of the creditor's lien, and
- is a residual provision covering dispositions under all other plans – for example, one under which the creditor receives the property itself, the 'indubitable equivalent' of its secured claim. Thus, debtors may not sell their property free of liens under §1129(b)(2)(A) without allowing lienholders to credit-bid, as required by clause (ii).[32]

2.4 *Closing Remarks on U.S. (Non)bankruptcy Law*

To summarize, credit bidding provides distressed investors with a tool for maximizing the proceeds of their secured claims. In U.S. bankruptcy proceedings, distressed debt investors may purchase and become owners of the collateral by means of an asset sale, either with or without a restructuring plan. For a debtor, in order to prevent a secured creditor from credit bidding, in respect of section 363 sales one has to argue to the court that the right to credit bid has to be limited for 'cause'. As indicated, such cause is difficult to prove, and so far the cases wherein creditors' rights were restricted on this basis are limited. In respect of a restructuring plan, a dissenting class has to be offered a substitute for its position, hence also called the 'substitution method'. This method entails that the dissenting class of creditors has to be provided with the 'indubitable equivalent' of its claim. Because of *RadLAX*, which is basically a victory for loan-to-own investors, providing – only – the indubitable equivalent is not sufficient, i.e. such a dissenting class retains its rights to credit bid. Consequently, such a debtor's approach for circumventing a credit bid strategy is no longer deemed successful. Also, in more recent jurisprudence, the focus is therefore on the question as to what qualifies as 'cause' (in order to argue that the section 363 asset sale may not be executed).[33]

31 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 2012 WL 1912197, p. 7.
32 *Id.*, p. 8.
33 *See*: B. Guy, B. Gardner and M. Hoberock, 'Best Practices for Loan-to-Own Strategies in the New World', *Journal of Corporate Renewal*, Vol. 6, 2016, pp. 18-25.

3 DUTCH LOAN-TO-OWN STRATEGY: CREDIT BIDDING UNDER DUTCH (NON) BANKRUPTCY LAW

3.1 Limiting the Scope

When analyzing loan-to-own strategies under Dutch law, a distinction can in theory be made between insolvency proceedings (under Dutch law suspension of either payments proceedings (*surseance van betaling*) or bankruptcy proceedings (*faillissement*)) and situations wherein the enforcement or foreclosure of Dutch security rights, i.e. enforcement proceedings, takes place.

There is, however, a parallel between enforcement proceedings and insolvency proceedings: under both scenarios the security holder can enforce its security rights and become the purchaser of the encumbered assets. Article 57(1) DBA provides that security rights are not affected by insolvency proceedings, i.e. secured creditors "can exercise their security rights as if there were no insolvency proceedings" (unofficial translation), and the enforcement of security rights in bankruptcy, in principle, thus takes place no differently from the enforcement of security rights outside of bankruptcy. Consequently, in the following paragraphs the distinction between the two situations is not always explicitly made.

It is noted that the current DBA does not provide a restructuring mechanism like a U.S. Chapter 11 reorganization plan. Under Dutch law, debtors can offer a compulsory composition plan to their creditors as part of formal proceedings, but this plan procedure is hardly used as it only binds unsecured creditors.[34] Consequently, the current Dutch plan proceedings are ineffective against shareholders or secured/preferential creditors.

This situation may change because of the proposed BCPP. The BCPP aims to introduce the Dutch scheme, which combines elements of the U.K. Scheme of Arrangement, such as the ability to implement a plan outside formal insolvency proceedings, with elements of the U.S. Chapter 11 reorganization plan, such as a (cross-class) cramdown mechanism. Because of the possibility to cram down out-of-the-money capital providers, more effective loan-to-own strategies will then become available to distressed debt investors. As the BCPP is still a bill (and not yet in force) and as indicated in the introduction, this article focuses mainly on loan-to-own strategies by means of credit bidding in Dutch enforcement proceedings/foreclosure scenarios.

34 A recent successful exception to this observation is the Oi case, where the debt restructuring in respect of the Dutch subsidiaries/financing vehicles Portugal Telecom International Finance B.V. (PTIF) and Oi Brasil Holdings Coöperatief U.A. (Oi Coop) was implemented by a composition plan in bankruptcy proceedings. The PTIF plan was approved by 100% of its creditors present at the meeting, representing 99.99% of the total claims of creditors that participated in the vote and representing 99.99% of the total debt of PTIF. The Oi Coop plan was approved by 92.82% of its creditors present at the meeting, representing 99.63% of the total claims of creditors that participated in the vote and representing 89.16% of the total debt of Oi Coop.

3.2 Introduction to Enforcement of a Right of Pledge and Mortgage Rights

The main types of security rights *in rem* under Dutch law are pledges (*pandrechten)* and mortgages (*hypotheken*). Pledges are established on movables, including claims and shares. Mortgages are vested on registered property, most notably land, and rights *in rem* on land. Mortgages and pledges are very similar in many respects.

Both rights of pledge and mortgages allow the secured creditor to enforce its security rights as soon as the debtor is in default, i.e. when there is an event of default pertaining to nonperformance of a secured monetary obligation, for example the failure to make interest or principal payments.

Under Dutch law various types of enforcement proceedings exist, which are not all applicable to both rights of pledge and mortgage:

– *Public auction (default rule for both rights of pledge and mortgage)*
  This route does not require court involvement. In principle, the sale has to take place in public in accordance with local rules and under the usual conditions (i.e. by auction in the presence of a notary or bailiff). The pledgee is entitled to participate in the auction. The pledgee is obliged to announce the sale. The notice period that must be observed between the announcement and the sale must be reasonable.
– *Private sale with court permission (alternative for both rights of pledge and mortgage)*
  In principle, both the pledgee and the pledgor can seek the required court permission. Very briefly stated (and to be elaborated on later), the process involves the pledgee (or the pledgor) agreeing a purchase price with the third party and then providing the court with a draft purchase agreement and requesting permission to sell in accordance with the proposed terms.
– *Private sale with consent of the pledgor (only applicable for rights of pledge)*
  This scenario does not require court involvement. Foreclosure can take place by means of a private sale instead of a public auction, with the consent of the pledgor. The pledgor can only give its consent after the right of the pledgee to seek enforcement has been triggered. If third parties have levied attachments or acquired rights *in rem* in the collateral, the consent of those third parties is also required.
– *Appropriation of the collateral at a value determined by the court (only applicable to rights of pledge)*
  This scenario does require court involvement. The pledgee can request the court to order that the collateral is sold to the pledgee at a price to be determined by the court.

As indicated previously, an insolvency proceeding does not prevent secured creditors from enforcing their security. The secured creditors can proceed with the enforcement proceedings as if no insolvency proceeding had been opened. However, the court can order a moratorium that prevents secured creditors from enforcing their security for a period of two months, which can be extended by another two months. Also, the bankruptcy trustee may set a reasonable time limit in which the secured creditor must foreclose on the collateral. If the foreclosure is not finalized within this time frame the bankruptcy trustee may sell the collateral. In practice, secured assets are also sold regularly by the bankruptcy trustee in agreement with the secured creditor.

3.3 Credit Bidding When Enforcing Rights of Pledge

Dutch law provides for the possibility to credit bid in an enforcement process of rights of pledge, e.g. share pledges or pledges on the debtor's accounts receivables.[35] Under Dutch law, the pledgee is, in principle, allowed to credit bid the nominal value of its secured claim. This is because pursuant to Article 3:253 (1) Dutch Civil Code (DCC), the pledgee is entitled to the proceeds, and there is no statutory law that prescribes that the proceeds first actually have to be paid to a notary or bailiff. Consequently, the pledgee can thus credit bid his secured claim since no liquidity is required for the purpose of the enforcement process, except for the enforcement costs.

Article 3:253 (1) DCC furthermore prescribes that any surplus is, in principle, paid to the pledgor. However, in the event that there are more interested parties (e.g. other pledgees or beneficiaries whose rights have ended as a result of the foreclosure or creditors who have seized the proceeds or the respective asset), the pledgee shall act in accordance with the provisions of Article 490b Dutch Code of Civil Procedure (DCCP). Briefly stated, Article 490b (1) DCCP prescribes that in case of enforcement proceedings, the net proceeds (i.e. the proceeds after payment of the enforcement costs) will be distributed to the pledgee and that in case of an excess (i.e. the proceeds are higher than the amount of the secured claim), the remaining amount will be allocated to pay the aforementioned other interested parties, if and when applicable, on the basis of ultimately a certain ranking (*rangregeling*) to be agreed on.

In order to obtain the court's permission for a private sale, it must be concluded that, given the respective circumstances, the proceeds of a public auction are not expected to exceed the sales price as realized in the private sales process. Further explanation is given in Section 4, but at least a robust valuation report is required to demonstrate that the proposed purchase price is fair. In addition, it is recommended that a (public) mergers and acquisitions (M&A) process be demonstrated to have been unsuccessful or not to have resulted in the respective reasonable price that can be realized pursuant to the requested private sale.

35 Since the execution of a right of pledge over a receivable is usually achieved by collection (*inning*) rather than by (private) sale of the relevant receivable, there is limited case law (*e.g.* Court of Amsterdam 26 July 2012, (unpublished) (*Uni-Invest*)) that pertains to the execution specifically by means of a court-approved private sale of a loan.

3.4 Credit Bidding When Enforcing Mortgage Rights

The legal system for enforcement sales of rights of mortgages is different compared with the enforcement of rights of pledges. Based on a formal or literal interpretation of Dutch law, one could argue that there is no possibility to credit bid in an enforcement process of mortgage rights.

Pursuant to Article 551 (5) DCCP and Article 3:270 (1) DCC, the purchaser is obliged to make the payment of the sales price to the accounts of the civil law notary who is executing the deed of transfer of the assets. Whereas in respect of private enforcement sales of rights of pledge the purchase price needs to be transferred to the selling pledgee (which basically provides for the possibility to 'set off' its secured claim against the obligation to make the respective payment),[36] this is – according to Article 3:270 (1) DCC – not possible in respect of enforcement sales of mortgage rights. In this situation, the purchase price needs to be wired to the (third party) accounts of the civil notary:

> A buyer who has bought mortgaged property at a public or private foreclosure sale must pay the agreed purchase price to the notary before whom the public sale has taken place or, respectively, who has executed the deed of transfer after a private foreclosure sale.

The notary will then first settle the enforcement costs and, if there are no other parties with any rights on the proceeds, subsequently transfer the proceeds to the mortgagee. Any possible remainder will be transferred into the bank account of the mortgagor (Art. 3:270 (2) DCC). In the event that more parties indicate that they are entitled to the proceeds, the notary will transfer the proceeds into the accounts of a custodian (Art. 3:270 (3) DCC), while an allocation of the proceeds, a 'ranking' (*rangregeling*), needs to be agreed on. If no ranking can be agreed on, it is not up to the notary to make a proper and fair allocation, but up to the (supervisory) judge to do so (Art. 3:271 (1) DCC and Article 552 DCCP). Also, the mortgagor can object to the (alleged) amount of the secured claim (Art. 3:271 (1) DCC and Art. 3:270 (5) DCC).

Article 3:270 (3) DCC explains the procedure in case there are more parties involved:

> When there are more mortgagees or when there are creditors or limited proprietors as referred to in the previous paragraph, then the notary immediately transfers the net sale proceeds of the foreclosure sale to a depository who meets the requirements of article 445 DCCP and who has

36 As a technical note, the pledgee is not actually setting off its claim but merely executing its security rights and receiving the proceeds to which the pledgee is entitled to. *See*: S.W. van den Berg, 'Herstructureringsmiddel voor distressed debt investors: credit bidding', *Ondernemingsrecht*, Vol. 61, 2016, p. 286, fn. 89.

> been appointed by the notary for this purpose. This transfer does not take place if the mortgaged property was sold by the first-ranked mortgagee who, before or on the payday, has handed over to the notary a declaration in which is specified which part of the net sale proceeds belongs to him by virtue of a debt-claim which is secured by his first-ranked mortgage or by other debt-claims that are secured as well on his behalf by one or more mortgages that are ranked immediately after his first-ranked mortgage, mentioning also the creditors whose debt-claims are ranked above his debt-claims. In that case the notary pays out directly to the first mortgagee what belongs to him according to the aforementioned declaration. This declaration must contain a note of the preliminary relief judge of the District Court in whose district the mortgaged property is located or is located for the most part, implying that he has briefly ('prima facie') examined the correctness of this declaration and has approved it. No appeal to a higher court and no other legal provisions are open against such an approval.

The scope of the test to be potentially made by the interim relief judge is rather limited. He must be able to assume that the secured creditor's claim is delivered correctly and in a well-organized manner. The notary making the request must declare that he has no suspicion that the secured creditor's claim is incorrect.

In order to conclude whether or not credit bidding is possible in respect of an enforcement sale of mortgage rights, a deviation from the literal provisions as previously indicated needs to be made. Provided all checks and balances are in place and thus no third parties' interests are possibly harmed, this would in my view – and despite the explicit paragraph (7) of Article 3:270 DCC indicating that it is not possible to derogate in the sale conditions as prescribed in Article 3:270 DCC – be possible.

Article 3:270(3) DCC does provide the possibility that the first-ranked mortgagee is excluded from a ranking, if and when such a ranking and subsequent allocation of the proceeds is required. The first-ranked mortgagee can already circumvent the longer formal route, namely by handing over to the notary the specification, or the declaration, that substantiates his secured claim. As previously cited, Dutch law prescribes that in such a scenario, the notary pays out directly to the first-ranked mortgagee what belongs to him according to the aforementioned declaration. A ranking system in respect of the remainder of the proceeds does not need to prevent an early payment to the first-ranked mortgagee.

If and when the first-ranked mortgagee can – on the basis of a substantiated declaration, approved by the notary and the interim relief judge – receive in cash his part of the proceeds that he is entitled to, then it is only a technical step to conclude that making a credit bid, which is 'set off' against the proceeds that he would be entitled to, is also allowed for.

Obviously, all checks and balances need to be in place. Although Dutch law prescribes that an approval from the preliminary relief judge, as described previously, is not mandatory, but is needed only if the notification does not meet the conditions of the test to be made by the notary, it is recommended that such an approval part of the enforcement process be made. Especially, if it is envisaged to credit bid, such an approval would be recommended in case the enforcement proceedings do not contain a request to the preliminary relief judge in order to approve the enforcement sale, for example, in the case of a public auction. In insolvency proceedings there is the safeguard of bankruptcy trustee's and supervisory judge's cooperation and supervision, respectively.

If the mortgagee opts for a private sale process, with a request to the preliminary relief judge to approve such a sale, the foregoing formalities are less relevant – since the element of court approval is already incorporated in the enforcement process. There are not many cases were credit bidding was applied in respect of the enforcement on mortgage rights. One example is the *Eurocommerce* case, which is briefly described in the following:[37]

In the *Eurocommerce* case, a consortium of banks financed (part of) the Eurocommerce group, one of the largest office builders of the Netherlands, until its bankruptcy. The bank financing was secured by first ranking rights of mortgage on the real estate of several legal entities.

The consortium had entered into consultations with the bankruptcy trustees about a transaction with the purpose of realizing as much value as possible. This approach led to the so-called 'silo construction' (*siloconstructie*), for the construction of which the bankruptcy trustee and the supervisory judges of the Eurocommerce companies granted their permission.

In this case, the silo construction contained the following steps: a newco was established with four special purpose vehicles, or 'silos'. The real estate on which the various banks of the consortium had (first and only) rights of mortgage was then sold and delivered to the silos. The banks did not receive share interests in the silos but had the (contractual) right to nominate a managing director for their 'own' silo. The purchase price to be determined on each respective silo was deducted from the respective secured claim. Also, possible higher proceeds resulting from a subsequent sale of the real estate by a respective silo under more attractive market conditions would be allocated to reduce the remainder of the debt of the company. In addition, the silos were jointly and severally liable up to a certain amount for the (remaining) debt of the companies. The purchase

37 Court of Amsterdam 27 November 2012, ECLI:NL:RBAMS:2012:BY4255; Court of Amsterdam 27 November 2012, ECLI:NL:RBAMS:2012:BY4256; Court of Amsterdam 27 November 2012, ECLI:NL:RBAMS:2012:BY4257; Court of Amsterdam 27 November 2012, ECLI:NL:RBAMS:2012:BY4258; Court of Amsterdam 27 November 2012, ECLI:NL:RBAMS:2012:BY4259; Court of Amsterdam 27 November 2012, ECLI:NL:RBAMS:2012:BY4260.

price to be paid by the special purpose vehicles (SPVs) was again financed by the various banks, for which the silos granted a first right of mortgage. Because it made little sense to only circulate funds (*kasrondje*) with no purpose, i.e. transferring the purchase price to the notary on behalf of the purchasing entity and subsequently receiving the proceeds in the capacity of executing first mortgagor, the consortium requested to 'leave these steps behind', and thus basically requested to credit bid on the real estate.

The economic rationale of this silo construction is that the consortium of banks deemed the value and the possible proceeds of the real estate at the time of the execution of the security rights too low, or suboptimal. There can be all kinds of reasons why at the moment of execution the value of the real estate was (considered to be) too low. For now, it is concluded that although the preliminary relief judge as a starting point considered that, on the basis of Article 3:270 DCC, the purchaser must, in principle, pay the purchase price into the accounts of the notary (as described previously) – and that another method of payment was not provided for under Dutch law – the preliminary relief judge ultimately concluded that since the bankruptcy trustees approved the contemplated credit bid under this silo construction (basically a variant of the loan-to-own strategy), there is no objection to the course of affairs proposed by the consortium provided that such a transaction is properly documented by the notary.

3.5 Conclusion

Because Dutch law does not prescribe that the proceeds of a private sale of goods encumbered by a right of pledge actually have to be paid to a notary or bailiff, the pledgee can credit bid his secured claim. On the contrary and on the basis of a literal interpretation of Dutch law, credit bidding in respect of enforcement proceedings of rights of mortgages is, in principle, not allowed for. A deviation from the literal provisions is needed in order to conclude that credit bidding is also possible in such a situation. Provided all checks and balances are in place and no third parties' interests are possibly harmed, I see little objection to credit bidding in respect of the enforcement of mortgage rights as well. Dutch lower case law also indicates that credit bidding is already allowed for.

In the last decade, various financial restructurings of (international) group companies have been implemented through Dutch share pledge enforcements by means of a private sale. In the next section, credit bidding in the case of share pledge enforcements proceedings by means of a private sale is discussed in more detail.

4 Share Pledge Enforcement by Means of a Private Sale

4.1 Introduction

As indicated previously, enforcement by means of a private sale can take place with the permission of the court. The purpose of such a private sale is the maximization of the proceeds. Briefly stated, the court will test whether the proceeds of a public auction do expectedly exceed the sales price as realized in the private sales process. The respective bid is accompanied by a share purchase agreement – only being conditional on the court's approval. The request should be supplemented by (at least one) robust valuation report on the enforced shares. Since a (unconditional) share purchase agreement needs to be presented to the court, this enforcement procedure can only be requested if there is a proposed buyer for the shares, ideally also following an extensive due diligence and thus a proper sales/M&A process where long and short listed potential purchasers were selected/contacted and so forth.

After filing the request for permission for a private sale, a hearing takes place at which third parties can intervene and place higher bids. This process is not an auction, but competitive bids can be presented in order to persuade the court to reject the request. As competing bids have to be unconditional and fully funded, which is difficult for third parties to realize without extensive due diligence and cooperation from the management team, competing bids are hardly effective/successful.

It is noted that only interested parties are entitled to object to the proposed enforcement sale. In the Dutch *Crossbow* case (2019),[38] the court allowed the (indirect) shareholders to participate and raise objections to the proposed enforcement sale.

The time required to obtain a court approved sale is, based on current experiences, normally approximately two to three months, depending on the factual circumstances (including whether the sale is opposed or there is any competing bidder) and the court's availability. Recent experience with the Netherlands Commercial Court (NCC) shows that an application before the NCC can result in a shorter period of about one month, subject to the NCC's agenda (and excluding preparation time).

The NCC was established on 1 January 2019 and provides swift and flexible proceedings while the entire proceedings are conducted in English (including the judgment). The main requirements are that (i) the Amsterdam District Court or Amsterdam Court of Appeal has jurisdiction, (ii) parties agreed to take the case to the NCC and to make English the language of the proceedings, (iii) the matter concerns an international dispute, and (iv) the action is a civil or commercial matter within the parties' autonomy.

38 Court of Amsterdam 8 March 2019, ECLI:NL:RBAMS:2019:1637.

In the *Crossbow* case (2019), the NCC held that it had jurisdiction to determine a request for leave to enforce through a private sale. The timing of this case was as follows: the request was filed on 11 February 2019, the first hearing took place on 18 February 2019, the second hearing on 26 February 2019 (so the interested parties could be heard at a hearing). This hearing was, however, canceled (on 25 February) because the aforementioned parties were not interested in being heard, and, ultimately, a judgment approving the private sale was rendered on 8 March 2019.

4.2 *A Decade after* Schoeller Arca*: Dutch Courts Apply a Holistic Approach*

Since the *Schoeller Arca* case in September 2009, various financial restructurings on the basis of a private sale have been implemented.[39] For the purpose of this article, I will not elaborate on each and every case but will only touch upon the elements of the cases that support the analysis of credit bidding under Dutch law.

4.2.1 Schoeller Arca (September 2009)

In this case, leave for the sale of the pledged shares was granted since the proposed sale was considered in order to realize the maximum proceeds at the moment of enforcement. The buyer's bid consisted of the following components: (i) cash purchase price of EUR 13,656,032 for the pledged shares; (ii) debt assumption of the company's debt under the senior facilities agreement for an amount of EUR 9,865,000; (iii) the remainder of the senior lenders' debt of EUR 129,204,051 remained payable by the (group of the) debtor, i.e. a 'debt rollover'. The proceeds from the pledged shares amounted to EUR 13,656,032 (element (i)). The other two elements, in particular (iii), are relevant for the assessment of the entire transaction. The continuation of the partial financing by the senior lenders is an important element because some senior lenders had indicated that they were not prepared to continue their loans after the execution process if the competing bidder became the buyer.

The court concluded that the default and the security (and enforcement) right was not disputed. With respect to the timing of the enforcement proceedings, it was explicitly considered that it is at the sole discretion of the pledgee to determine the timing of enforcement.

The Dutch court approved the private sale and concluded that

39 Court of Amsterdam 23 September 2009, ECLI:NL:RBAMS:2009:BJ8848 (*Schoeller Arca*); Court of Utrecht 30 March 2012, ECLI:NL:RBUTR:2012:BW0487 (*Selexyz*); Court of Amsterdam 26 July 2012, (unpublished) (*Uni-Invest*); Court of Amsterdam 23 August 2012, ECLI:NL:RBAMS:2012:BY1439 (*Ramblas*); Court of Rotterdam 17 November 2014, ECLI:NL:RBROT:2014:9408 (*Ambucare*); Court of Amsterdam 30 January 2015, ECLI:NL:RBAMS:2015:816 (*Svyaznoy*); Court of Amsterdam (Netherlands Commercial Court) 8 March 2019, ECLI:NL:RBAMS:2019:1637 (*Elavon/Crossbow*); Court of Amsterdam 30 July 2019, ECLI:NL:RBAMS:2019:6505 (*Vieo*).

> in circumstances where no unconditional and better offer is made than the offer of purchaser (i.e. Bidco), and the pledgee and pledgor are in agreement with the offer of purchaser, it cannot be determined that the proceeds for which the shares are being sold do not represent the maximum possible proceeds.

In its analysis, the court concluded that it can reasonably be assumed that compared with a private sale, a public auction will not result in a higher purchase price – taking into account the structure and complexity of the respective group of companies and the requirements of further financing thereof.

4.2.2 Crossbow (March 2019)

This first procedure before the NCC concerned the private sale of the pledged shares in the capital of I.P.S. B.V., which entity was part of the Airopack group, headed by Airopack Technology Group AG. This Swiss entity was listed on the Zurich stock exchange and held all the shares in I.P.S. Holding B.V., which held all the shares in I.P.S. B.V. Rabobank was the super senior lender (approximately EUR 15 million outstanding) and Apollo the senior lender (approximately EUR 147 million outstanding, including EUR 15 million as emergency liquidity facility). The collateral included various guarantees from the parent companies and pledges on shares in certain group companies and on receivables. The Airopack group got into payment problems and defaulted under the financing agreements at the end of 2018. The preliminary relief judge of the NCC was requested to approve the private sale of the pledged shares to Apollo. Alvarez & Marsal estimated the value of the company (enterprise value on a cash and debt-free basis) to range from EUR 100 – 125 million and, therefore, considered the equity value to be nil.

The transaction was constructed as follows: Crossbow, a special purpose vehicle founded by Apollo, would purchase the pledged shares against a purchase price of EUR 1 plus (i) the foreclosure costs that were owed to the pledgee and the lenders plus (ii) the amount due to Rabobank (insofar as Rabobank would not continue its financing, which was not yet known at the moment of enforcement). In addition, the senior lender undertook to release the borrower from a substantial part of its obligations under the credit agreement. This was constructed as follows: after the acquisition of the pledged shares, the senior lender would remain creditor and become the sole shareholder of the borrower. The senior lender would then either (a) contribute a part of the senior loan as a share premium contribution on the outstanding shares in the share capital of the borrower or (b) consider the debt (partially) as purchase price for new shares, to be issued by the borrower. Either way, the result was that the loan was canceled by operation of law. The aforementioned capitalization was an integral part of the sale and was an irrevocable and unconditional commitment of the senior lender that came into effect immediately after the share transfer.

The pledgee argued that in order to make a bid that is credible and better for the pledgor, an alternative bid should materially include, among other things, the following elements: (i) a cash amount of EUR 1 for the pledged shares; (ii) a cash amount equal to the enforcement costs and (iii) a cash amount needed to take out the senior lender in full, i.e. an amount of at least EUR 147,146,452.96 (plus another EUR 10,000,000 if the respective emergency liquidity facility was drawn in full) in order to pay off the payment obligations of the pledgor under the guarantee granted to the senior lender.

With regard to the transaction structure, the preliminary relief judge considered as follows:

> a reduction of Senior Debt may of course not be fully equivalent to cash in these circumstances. But having reviewed the parties' submissions and the documents in the record, I am convinced that in fact no shareholder value exists anyway. The debt owed to Apollo/Crossbow and Rabobank is such that the Swiss Parent shareholders are facing a bankruptcy/liquidation scenario with or without drastic measures such as the proposed transaction. No one has suggested a public auction would be a better option in any respect. In fact, the debt is such that no rival or alternative proposals have been received, despite sustained efforts. Nothing in the record suggests any such proposals may reasonably be anticipated anytime soon. In light of these points, the impact on the Swiss Parent shareholders is not an impediment to the proposed enforcement. … The reduction of Senior Debt is significant (whether or not it is roughly equivalent to the Enterprise Value calculated by A&M) and it is part of a business plan reviewed and tested by A&M. It holds out the prospect of future investment, which will be required soon. No one has identified any alternative way to move forward in the business and to secure such funding in timely fashion, other than the proposed transaction (followed by funding subject to certain conditions). The impact on the business does not warrant any delay or change in the proposed transaction.

Although the preliminary relief judge considered that a cash consideration is – from a Dutch law perspective[40] – not the same as a noncash consideration (e.g. debt reduction), the judge took a holistic approach by carefully considering the complete contemplated transaction, thus including all postenforcement steps, i.e. the recapitalization of the company. Combined with the fact that no alternative bidders were present – an alternative valuation report was not even presented – the court concluded that the

40 In *Saltri III Limited v. MD Mezzanine SA Sicar & Ors (Stabilus)*, [2012] EWHC 3025 (Comm), 7 November 2012, it was – from an English law perspective – considered that there was nothing in the intercreditor agreement (governed by English law) that prevented a sale or disposal being made for nominal consideration or being made for noncash consideration.

contemplated private sale would realize the highest proceeds and therefore to grant the requested approval.

4.2.3 Vieo (July 2019)

With regard to this private sale, the facts were as follows. Vieo B.V. (and ultimately with the Swiss investment company Palmarium AG) is the holding company of the Lebara group: a company that is involved in the sale of mobile telephone services. To finance the purchase of the Lebara group, Vieo issued bonds for an amount of EUR 350 million in mid-2017 (with Nordic Trustee as trustee for the bondholders). The shares in Vieo were pledged to the trustee. After the Lebara group became financially distressed and eventually a statutory default occurred, Nordic Trustee proceeded to execute the rights of pledge on the instructions of the bondholders. The subsequent request to the preliminary relief judge involved the sale of the pledged shares to a foundation (established by the bondholders) for an amount of EUR 1 but under the obligation to convert an amount of EUR 200 million from the debt of Vieo into share capital of Vieo, which would cause the outstanding debt under the bond loan to decrease by the same amount. It was argued by the bondholders/pledgee that there was little appetite in the market, and Duff & Phelps estimated the enterprise value (on a debt- and cash-free basis) to range from EUR 192.5 – 220 million. Given the debt position, the equity value of the pledged shares was, according to the pledgee, nil.

Vieo and its shareholders argued that the intended sale did not take into account the interests of Vieo as debtor, and the interests of the shareholders, since the proposed sale would allegedly not lead to the highest proceeds. In order to support this argument, a valuation report from Alvarez & Marsal was submitted, which estimated the enterprise value to range from EUR 385 – 440 million, based partly on certain market testing. Based on this valuation report, there would still be equity value.

In addition, it was argued that the proposed debt-for-equity swap was not part of the execution, since this conversion/recapitalization would not be part of the enforcement proceedings and the recapitalization would not lead to an actual return that would benefit the bondholders. It was argued that, after all, the bondholders would not receive a payment because of this recap.

The preliminary relief judge concluded in favor of the pledgee. It was considered that there had been no evidence of unconditional interest in the market at all. Furthermore, it was considered that the intended method of sale was, in fact, equivalent to a sale of the shares for an amount of EUR 200 million; the debt conversion/recap was unconditionally part of the sale, it was concluded. It was true that Vieo et al. argued that the request with a purchase price of EUR 1 was no better alternative than a public auction, but according to the preliminary relief judge that was something else, i.e. not the correct analysis. It was concluded that it was unlikely that a better return could have been obtained for the pledged shares by means of an auction or other bid. Thus, again, the preliminary relief judge applied a holistic approach when considering the proceeds of the requested private sale. Next to this and provided there was a statutory default, it was concluded that the timing of the enforcement was at the sole discretion of the pledgee.

4.3 Conclusion

The procedures very briefly summarized in the foregoing indicate that the Dutch courts are generally willing to cooperate with a request for a private sale, provided there is a statutory default, a realistic background is provided about the distressed situation of the company in general (and the market appetite because of that situation specifically), and an unconditional bid is presented that is supported by a robust valuation report. The valuation report should basically confirm the reasonableness of the bid price or, put another way, support the economic parameters of the deal structure. As also explained earlier, valuation has a central role in those situations, not only for providing the court with insight into the fairness of the proceeds that can be realized by means of the private sale, but also to show that the execution proceeds that will follow from the proposed transaction will (potentially) not result in any payment to other capital providers.

Consequently, a robust valuation report is needed in the process of the contemplated transaction, commencing with seeking leave from the preliminary relief judge. On the other hand, as illustrated by the *Schoeller Arca* and, recently, the *Vieo* cases, other interested parties can also file a valuation report, arguing that certain interested parties are still in the money and that the contemplated sale should not be approved since the value as presented in the alternative report could possibly also be realized by means of a market sale, as a result of a proper M&A process, or a process structured alternatively. Thus, valuation plays an important role in share pledge enforcement proceedings, more especially *distressed* valuation.

5 Introduction to Distressed Valuation Methodologies

In general, when analyzing the value of a company in distress, analysts can apply the same methods as when calculating the enterprise value of a company that is not in distress. Those methods include (i) the discounted cash flow (DCF) method (the income approach), (ii) the multiple (or market) approach and, to a lesser extent, (iii) the net asset value approach. However, various adjustments need to be made in order to take into account the effects of distress, as distress has a negative impact on the value for two general reasons: there is a lower expected future cash flow to the capital providers owing to the negative impact of distress on the business, for example because certain strategic investments cannot be made, growth is hampered, creditors are being paid too late, stakeholders (clients, suppliers, employees and capital providers) lose confidence in the company and the negotiating power of the company reduces. Secondly, a higher return on capital (both debt and equity) is required by the capital providers owing to the increased uncertainty. In order to take these effects into account, the common valuation methodologies need to be adjusted and this can be done as follows.[41]

First, the DCF approach could be adapted or modified for the effects or costs of distress as follows. Both the forecast of the expected cash flow and the discount rates can be amended in order to include the effect of distress. In respect of the expected cash flows, a model or forecast should include more (negative) scenarios, resulting in a thorough scenario analysis, including liquidation scenarios. It requires that every scenario (for example, a complete meltdown or shrinking revenues by a certain percentage) should be linked to a certain probability. It is noted that the respective input needs to be assessed periodically, for example each year, because the probabilities and cash flow expectations are likely to change from year to year. This also means that the adjustment for distress is cumulative and will, because of the related uncertainty, have a greater impact on the expected cash flows in the later year. As Damodaran (2009) explains, if the probability of distress is, for example, 10% in year 1, the expected cash flows in all subsequent years have to reflect the fact that if the firm ceases to exist in year 1, there will be no subsequent cash flows.[42] But if the firm survives the first year and the probability of distress remains the same, there is now only an 81% chance that the firm will have cash flows in year 3.[43] Next to the subjectivity of such a scenario analysis, the estimation of the discount rate is also vulnerable to several errors. Briefly stated, both the calculation of the cost of equity and the cost of debt and the appropriate debt to equity level are arbitrary.

Secondly, and as an alternative to the modified DCF approach as presented earlier, it is possible to separate the going-concern assumptions and the value of the company being in distress. Consequently, the firm value is the cumulative value of the probability of distress times a (distressed) sale value and the probability that the company will not become more severely distressed times the going-concern value. The probability of distress could be estimated with a statistical approach (for example, the Altman Z-score),[44] or be based on bond ratings or bond prices.

Thirdly, and as another alternative to the DCF approach, the *adjusted present value* (APV) method could be used. This method starts by calculating the firm without debt (i.e. the value of the unlevered firm); subsequently, the value is adjusted for the positive and negative effects of debt. It is assumed that the primary benefit of debt is a tax benefit

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41 *See*: A. Damodaran, *Valuing Distressed and Declining Companies*, New York University – Stern School of Business, June 2009.

42 *See:Id.*, p. 36.

43 Probability of surviving into year 3 = $(1-0.1) \times (1-0.1) = 0.81$.

44 E.I. Altman, 'Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy', *Journal of Finance*, 1968, Vol. 23, No. 4, pp. 589-609. For a more updated version of the Altman Z-score and its relationship to default probabilities reference is made to E.I. Altman, *Corporate Financial Distress and Bankruptcy*, John Wiley & Sons, 2nd edition, 1993.

(i.e. tax deductibility) and that the most significant price of borrowing is the risk of bankruptcy. When applying this method, especially with distressed companies, there is the advantage that the cost and probability of distress can be analyzed in greater detail. The present value of expected bankruptcy cost consists of the probability of a bankruptcy scenario (which could be calculated as indicated above) times the present value of bankruptcy costs. Almeida and Philippon (2005) suggest a variation of this APV method, arguing that the measure of distress cost understates its magnitude because it does not factor in the reality that distress costs are often systematic. They present two ways of adjusting distress costs to reflect this systematic risk. First, they derive probabilities of default from corporate bond spreads, and, secondly, they derive the risk adjustment from historical data on distress probabilities and asset-pricing models. They conclude that the expected bankruptcy costs are substantial and have a large impact on value.[45]

Fourthly, and since this method is used a lot in practice, a brief remark about distress in relative (multiple) valuation is also made. When applying the multiples valuation method, one is comparing the value, or price to be paid, with the value, or price paid, for comparable transactions or companies. That similar assets should sell for similar prices is the underlying presumption of this approach. However, certain transactions or companies, especially distressed transactions or distressed companies, are extremely case sensitive and therefore difficult to compare. Comparing transactions is, in general, deemed more arbitrary, because with this method most of the time going-concern valuations are applied to a distressed company. A brief description of only the comparable companies method, also known as trading multiples, is provided here.

As has been said, the comparable companies method is based on the concept that businesses with similar characteristics should have similar valuation parameters. Therefore, the approach starts by identifying a relevant peer group and a relevant multiple, such as EV/EBITDA.[46] When identifying the relevant peer group, which is generally difficult because there is limited data available for privately held companies, financial and business characteristics are considered (e.g. revenues, profitability, return and growth rates, or capital structure). Since a company's value equals the present value of the future cash flow, it is recommended to use forward-earning multiples, instead of backward-looking multiples. In particular, normalized earnings (or EBITDA levels) estimates better reflect the reasonable expectation of long-term cash flows. According to Koller et al. (2015),[47] forward-looking multiples generally also have a much lower

45 H. Almeida and T. Philippon, *The Risk-adjusted Cost of Financial Distress*, SSRN Working Paper, 2005.
46 Enterprise Value/Earnings Before Interest, Taxes, Depreciation And Amortization.
47 T. Koller, M. Goedhart and D. Wessels, *Valuation: Measuring and Managing the Value of Companies*, John Wiley and Sons, 6th edition, 2015, p. 355.

variation across peer companies. That forward-looking multiples tend to be more accurate predictors of value than historical ones is also shown in empirical evidence.[48]

To further substantiate these remarks, it is noted that in periods of stable growth and sustainable profitability, using a short-term financial forecast can be a realistic and therefore sufficient indication of the value of the company. However, when a company is in (severe) economic or financial distress, short-term forecasts are expected to be (extremely) volatile and therefore uncertain by nature. For companies generating those volatile or uncertain financial results, stabilized financial projections should be used for multiples valuation.[49] When applying forward multiples and using forward numbers, possible adjustments need to be made because of the uncertainty, and the chance of failure, embedded in such a forecast, i.e. the estimated value needs to be corrected because of the chance of 'bad things' happening to the firm over the ensuing years.[50]

6 Analysis of Credit Bidding in Respect of Share Pledge Enforcements

In the foregoing analysis, it is concluded that under Dutch law credit bidding is, in principle, possible in the process of executing security rights, especially rights of pledges. In practice, credit bidding is used mainly when enforcing share pledges. Various Dutch cases are highlighted wherein a loan-to-own strategy was executed by means of credit bidding the purchase price in a private sale. Sometimes this practice of credit bidding was not merely *direct* credit bidding (i.e. actually 'setting off' the secured claim against the purchase price) but one of *indirect* credit bidding: the use of the secured debt position in general in order to realize the contemplated transaction. In the *Vieo* case, for example, the release of debt post closing was considered to be part of the consideration, or the purchase price to be paid by an alternative bidder.

During the last decade, it was in Dutch legal literature on the basis of the respective court judgments concluded that when executing a loan-to-own strategy the optimization of proceeds fulfilled a central role. In order to receive court approval, the contemplated private sale needs to realize the highest proceeds, as compared with the alternatives (most of the time considered to be a public auction). Despite the validity of such a conclusion, in my view the preparation of the enforcement proceedings, and especially market testing, has not been given as much attention. Although the respective preliminary relief judges all included in their judgment whether or not a statutory default (*verzuim*) was in place (which was in most cases simply a given),[51] next to the valuation outcome also the timing of the execution process in combination with the market testing carried out is of the

48 B.C.N. Greenwald, J. Kahn, P.D. Sonkin, and M. van Biema, *Value Investing: From Graham to Buffett and Beyond*, John Wiley & Sons, 2001.

49 Koller et al., *supra* note 46, p. 356.

50 *See*: Damodaran, *supra* note 41, p. 20.

51 *See* for an exception: Court of The Hague, 7 March, ECLI:NL:RBDHA:2019:2196.

essence for the purpose of the question as to whether or not the outcome of the enforcement proceedings is or should be considered to be fair, i.e. is in the interest of all parties involved.

What essentially happens when a capital provider, i.e. a secured loan party, enforces the share pledges (on the shares in the company that is also being financed) by means of a private sale to that respective party – or a third party/special purpose vehicle related to the capital provider (from an economic perspective this does not make a difference) – is a mutation in the capital structure. Out-of-the-money capital providers are wiped out and in-the-money capital providers continue the enterprise. Provided the value breaks somewhere in the debt and a debt-for-equity swap is implemented, such a loan-to-own strategy leads to a postenforcement scenario where the former debt provider is the new equity holder.

Although under Dutch law the pledgee (or mortgagee) has the right to enforce whenever a default is in place, logically, this will most likely occur when the company is facing severe economic and/or financial distress. Under those distressed circumstances, again, logically, the (enterprise) valuation outcome is relatively low. In a situation where the pledgee is continuing the underlying business – and thus assumes the company to have a viable going-concern perspective – by means of executing the loan-to-own strategy, such a strategy boils down to the adage ‘buy low, sell high’. Under extremely uncertain and volatile circumstances, it can be questioned whether such a scenario is reasonable for all capital providers involved. In particular, when the pledgee has private information but other market parties potentially only have limited public information and, predominantly, not enough time to execute a proper due diligence process (in cooperation with the management), the valuation outcomes can deviate significantly.

Ideally, and in order to safeguard independence, the party/advisor providing the valuation for the pledgee should not be the same party as the one that is testing the market and setting up the M&A process. Although this perhaps seems to be less efficient, it also prevents interested parties from arguing that there was a conflict of interest (i.e. for the purpose of a successful loan-to-own strategy the pledgee wants to have a relative low valuation outcome and an unsuccessful M&A process with not many interested buyers).

Unconditional competitive bids will most of the time only be made on the basis of a robust financial analysis and proper due diligence, but current case law does not yet indicate in detail the extent to which such an M&A process has been carried out. Obviously, there is not much time, and with severely distressed companies time is of the essence, but without a proper sales process it is unlikely that professional investors will place unconditional competitive bids. Consequently, the outcome is likely to be an approval for the requested private sale by the preliminary relief judge. Notwithstanding the absence of competing bids, it is thus possible that parties credit bidding the private sale price are buying at undervalue. This speculation effect is strengthened if one considers that distressed debt investors already buy the secured claim against x% of its face value, while the full nominal value of the secured claim can be used for credit bidding the private sale price.

In the *Eurocommerce* case, which was discussed earlier, this undervalue problem was acknowledged by the respective financing banks involved. As indicated, their solution was to – temporarily – place the real estate in certain silos (a silo/SPV per financing bank with its own chosen real estate) and wait for a better economic climate and subsequent real estate valuation. Although the request for the private sale was based on an initial sales prices, it was also agreed that the financing banks would, to a certain extent, remain liable for the remainder of the debt of the bankrupted companies. This remainder of this debt would, eventually, be decreased if and when the real estate were sold by the respective silo. Consequently, there was basically a 'subsequent sale' clause agreed upon, acknowledging that the timing of the enforcement was suboptimal.

An alternative to such a 'subsequent sale' clause is a simple purchase price adjustment on the basis of another valuation, to be made within a certain period of time after the enforcement. If and when the value of the company (on a stand-alone basis) or the enforced shares increases, such an increase of proceeds could be used to decrease the remaining debt of the pledgor. The effect would be that although certain capital providers were considered to be out of the money, they are actually still (partly) in the money and should be (partly) compensated accordingly.

Alongside the former methods based on a subsequent event, i.e. the 'subsequent sale' clause and the 'subsequent valuation and purchase price correction' clause, it might also be possible to correct for a change/increase in the underlying value of the pledged assets at the moment of the enforcement. Out of the money can then be provided with a certain option value, or with the calculated value of a call option, as was also suggested by ABI (2014) in respect of composition plans in the context of financial restructurings.[52]

In this respect, it is noted that options are a component of every investment instrument.[53] For example, in a straightforward structure, equity can be viewed as a call option on the firm, as there is the ability to terminate the rights of the debt investor by paying him off (which thus basically creates an option on the company's assets), i.e. the right to buy a particular position at a fixed price.[54] Every call option on any asset has a strike price and an exercise date. The strike price is simply the amount owed to the debt

52 *See*: B. Wessels and R. de Weijs, 'Proposed Recommendations for the Reform of Chapter 11 U.S. Bankruptcy Code', *Ondernemingsrecht,* Vol. 37, 2015, pp. 210-220; S.W. van den Berg, '(Rechtsvergelijkende) beschouwing over waardeallocatie bij herstructureringen', *TvI,* Vol. 42, 2015, pp. 277-289.

53 *See*: F. Black and M. Scholes, 'The Pricing of Options and Corporate Liabilities', *Journal of Political Economy*, Vol. 81, No. 3, 1973, pp. 637-654.

54 *See*: R.A. Brealey, S.C. Myers and F. Allen, *Principles of Corporate Finance*, McGraw-Hill, 10th edition, 2011, pp. 590-591.

(or senior) investor. The exercise date sets the time when the holder of the option must decide whether to exercise the option.[55] The impact of such option value is not yet developed in great detail in Dutch case law or Dutch legal literature.

7 Summary and Conclusion

A loan-to-own strategy contains the practice of buying (at a discount) or making a secured loan to a financially distressed firm and speculating on a default, as a result of which enforcement proceedings can be initiated, or insolvency procedures eventually follow. In the course of both proceedings, the assets can be sold to the secured creditor. Under U.S. law, a secured creditor then has, in principle, the right to credit bid the full amount of the secured obligation – thereby having the opportunity to compete with cash bids from third parties. Unlike U.S. law, Dutch law does not explicitly allow for credit bidding. Under Dutch law it is, however, not mandatory that the proceeds of a private enforcement sale of goods encumbered by a right of pledge are paid to a notary or bailiff. This implies that the pledgee can credit bid his secured claim. On the contrary and on the basis of a literal interpretation of Dutch law, credit bidding in respect of enforcement proceedings of rights of mortgages is, in principle, not allowed for. A deviation from the literal provisions is needed (and in my view possible) in order to approve credit bidding, as demonstrated by lower Dutch case law.

Over the last decade, loan-to-own strategies in respect of international group companies have, under Dutch law, been executed by means of share pledge enforcements. This is partly because financial restructurings are difficult to implement under the existing law, but also because the Dutch courts facilitate swift share pledge enforcement proceedings.

Provided there is a statutory default and the proceeds of a public auction are not expected to exceed the sales price as realized in the private sales process, the pledgee can request the preliminary relief judge to grant a leave for the enforcement. Not only can the pledgee provide for a valuation report (and thereby substantiate that the purchase price results in the highest possible proceeds), but interested parties can also present a competing bid, supported by another valuation report, arguing that the value breaks at a different level, that certain other capital providers are theoretically still in the money and that the contemplated sale should not be approved. Thus, valuation, more specifically *distressed* valuation, plays an important role in share pledge enforcement proceedings. Because valuation is subjective and arbitrary by default, it is essential that all legal checks and balances are in place (e.g. clear confirmation that there is a statutory default under the finance documents and valid security rights).

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55 *See*: D.G. Baird, 'Priority Matters: Absolute Priority Rule, Relative Priority, and the Costs of Bankruptcy', *University of Pennsylvania Law Review*, Vol. 165, No. 4, March 2017, p. 793.

In my view the preparation of the enforcement proceedings, and especially the market testing, or the M&A process upfront, has not been given as much attention as needed. In a situation where the pledgee is executing the loan-to-own strategy and continuing the underlying business – and thus assumes the company to have a viable going-concern perspective – there is no incentive for a proper M&A process (or high valuation). In particular, when the pledgee has private information but other (market) parties potentially only have limited public information and, predominantly, not enough time to execute a proper due diligence process (in cooperation with the management), valuation reports presented by the pledgee and other interested parties can deviate significantly. Notwithstanding the absence of competing bids, it is possible that parties credit bidding the private sale price are buying at undervalue.

This article demonstrates a couple of alternatives for balancing the effects of the aforementioned valuation uncertainty. Those technical correction mechanisms, such as a 'subsequent sale' clause or a 'subsequent valuation and purchase price correction' clause, may possibly result in a more well-balanced outcome and can, possibly, correct for the suboptimal timing of the private sale – and especially the lack of thoroughness of the executed M&A process – as initiated by the distressed debt investor.

The German Legal Framework for Loan-to-Own Strategies

Tim Florstedt[*]

1 Introduction

Following the financial crisis of 2007-2008, new restructuring laws have emerged in legal systems throughout Europe. The German reforms of the so- called Insolvency Plan procedure are considered a covert model for the Directive on Preventive Restructuring Frameworks. This report describes the German legal framework as has emerged. It focuses on the question of whether the German legal framework provides a well-balanced approach to the interests of creditors and owners or whether the law produces unjustified redistribution effects.

In her book *The Code of Capital*, Katharina Pistor impressively describes the worldwide primacy of Anglo-American law.[1] German law differs in many ways from this model and is regularly considered outdated and deficient in US-American journals. The new Shareholder Rights Directive (EU 2017/828) basically follows the English law (Stewardship Code, Say on Pay and Related Party Transactions) and binds all members of the EU. Against this background it is astonishing that a completely different perception seems to prevail as to insolvency law. The Directive on Preventive Restructuring Frameworks reads almost as if the German ESUG has been the model.

The following quote points out that distressed debt investors can also in practice benefit substantially from German law:

> We have assisted a number of investors in executing loan-to-own strategies. Although subject to execution risk and often vulnerable to a number of external factors, the entry price for the investor is often significantly less than what the investor would have paid in a conventional M&A process.[2]

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1 *Pistor*, The Code of Capital, How the Law Creates Wealth and Inequality, 2019, p. 158 ff.

2 *Debtwire*, European Distressed Debt Market Outlook, 2014, p. 31 and also 2017, p. 26.

In academic discussions, however, the specific challenges that arise in the field of distressed debt investing are not even considered. Even within the discussion about the ESUG reform this has, surprisingly, not been an issue.

2 The Fragmented German Restructuring Law

German law, like most legal systems, does not have a single coherent restructuring law. Insolvency Plan law, which is modeled on Chapter 11, is only one segment. For simplicity's sake and in order to understand the entire field, one can speak of a triad. In addition to the reformed Insolvency Plan procedure (sections 217 et seq. German Insolvency Code (Insolvenzordnung – InsO)), other effective instruments for coping with a crisis have been available since 2009 in the German Stock Corporation Act (Aktiengesetz – AktG)[3] and the German Act on Debt Securities (Schuldverschreibungsgesetz – SchVG).[4]

Although fragmented, the most important piece of legislation is certainly the internationally known reform of the Insolvency Act/Insolvenzordnung, the so-called ESUG[5] of 2012. With the possibility of a debtor remaining in control of his assets and the inclusion of a debt-for-equity swap in the Insolvency Plan, the law provided important impulses for the restructuring practice. The Insolvency Code also provides for the much anticipated so-called Protective Shield Procedure. This procedure enables the debtor to prepare a plan in cooperation with an appointed and supervising practitioner in the field of restructuring within a three-month period. However, the hopes and expectations of this Protective Shield Procedure have remained partly unfulfilled.

The second important piece of legislation in the field of corporate reorganization is a preinsolvency law for the out-of-court restructuring of bonds found in the German Act on Debt Securities, the SchVG 2009. A comparable bond law exists only in Switzerland.[6] Although the SchVG is considered inadequate in academic literature,[7] in the Distressed Debt Practice it has become an important instrument.

The third large piece completing the puzzle of the German legislative framework is constituted by the 2009 reform of Stock Corporation Law. This reform has considerably weakened the individual protection of shareholders when implementing the restructuring

3 Introduced by the Act on the Implementation of the Shareholders' Rights Directive of 30 July 2009 ('ARUG'), BGBl. I 2009, p. 2479.

4 Introduced by the German Bond Restructuring Act of 31 July 2009, BGBl. I, p. 2512.

5 ESUG is the commonly used acronym of Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen, which can be translated as Law on further facilitation of Corporate Reorganization.

6 *See* Florstedt, RIW 2013, 719 ff.

7 *See* only the comments on the decision of the Higher Regional Court Frankfurt on the Main, ZIP 2012, 725 ff., as well as Paulus, BB 2012, 1556; Weiß, in: Baums (ed.), Das neue Schuldverschreibungsrecht, 2013, p. 25 ff.

of capital increases. The judges were left to decide how to resolve the tension between the goal of restructuring and the fair protection of shareholders.[8] The requirements are applied by the courts at the expense of the shareholder minorities, making the capital increase considerably easier.

3 Experience with the German Legal Framework: Case Studies

The interplay of these different legal building blocks can best be illustrated by conducting case studies.[9] There are numerous examples of distressed debt takeovers, and it is useful to analyze these before assessing the German legal framework.

3.1 The Period Prior to the Entry into Force of the ESUG (2012)

The new peak phase of takeovers in Europe begins in 2011 with the distressed debt takeovers of Findus Group, Travelodge, Biffa and Klöckner Pentaplast, whose reorganization in 2011 shows the typical process of a market-organized takeover. Here the case of Klöckner Pentaplast will be analyzed.

3.1.1 Klöckner Pentaplast Case

3.1.1.1 Facts

Klöckner Pentaplast was acquired for the first time in 2001 and then at the peak of the acquisition market, in May 2007, for the second time by private equity investors, this time by Blackstone for EUR 1.3 billion (secondary buyout). The financing consortium of banks syndicated the loans, sold them mainly to collateralized loan obligations (CLO) funds, which came under pressure during the financial crisis and resold the loans at high discounts, in 2008 among others to the current owners.[10] The company, which was highly leveraged by the buyouts, was unable to maintain the financial ratios that were still geared to the market environment before the crisis.

The subsequent reorganization process is reminiscent of a takeover battle. A coalition of senior creditors and shareholders was formed. The financial investor Oaktree, who was involved in the senior Lien, and Blackstone, as the former owner, wanted to push through a debt relief. The counter-coalition in the junior Lien, led by Strategic Value Partners,

8 With regard to the difficult task of developing the law, especially in the SchVG, *see* Florstedt, ZIP 2012, 2286 ff.

9 All information is taken from publicly accessible sources and is, to the best of my knowledge, correct.

10 According to information from the market, discounts of more than 40% for the senior tranches will be realistic during this period; at the beginning of 2012, senior loans were traded at 85%, subordinated loans at 25% and mezzanine papers at 15%, Handelsblatt, 13 February 2012.

opposed the plan, threatened to call in the loans and was finally able to take over the company. It is common practice that financing agreements enable subordinated creditors to replace the senior creditors and to collect the pledged shares in the company, and this is included in the standardized agreements of the LMA. Strategic Value Partners (SVP) thus succeeded in acquiring control. With own funds of EUR 190 million and a loan from the investment bank Jefferies of over EUR 650 million, they paid off the senior creditors in full and had the pledged shares transferred to them. Following the acquisition in May, Klöckner Pentaplast issued an 11%-interest-bearing PIK bond for EUR 225 million, which was used to repay the SVP's own funds.

3.1.1.2 Conclusion

The procedure shows how the unsupervised reorganization of operationally successful companies continues to be market organized. The formal legal instruments of judicial reorganization are not applied at all when there is a change of control during a company crisis. One should bear in mind that the case described previously is the norm, when considering the necessity of further reforms.

3.2 Preference for Out-of-Court Restructuring Even under the ESUG

Even after the ESUG entered into force, creditors primarily tried to avoid a formal Insolvency Plan procedure.

3.2.1 The SolarWorld Case

The reorganization of SolarWorld AG shows particularly well that, in addition to the reformed Insolvency Plan procedure, there is a legal framework for the preinsolvency restructuring of shares and bonds that is quite workable.

3.2.1.1 Facts

Before the restructuring, founder A held a stake of approximately 28%; the remaining shares were in free float. After the restructuring, the company's shares were to be allocated to Itom Investment S.àr.l.[11] (46.5%) and Qatar Solar S.P.C. (29%) – two vehicles of financial investors – furthermore to A (19.5%) and the other existing shareholders, whose stakes would be reduced by 95%.[12] The distressed debt takeover

11 A special purpose vehicle declared as a settlement agent; the owner is a foundation under Dutch law. The identity of the investors is not disclosed.

12 The reaching of the control threshold through joint action by A and Qatar Solar S.P.C. triggered the obligation to make an offer pursuant to sections 29, 35 German Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz – WpÜG); pursuant to sections 36, 37 para. 1 WpÜG in conjunction with sections 8, 9 No. 3 WpÜG offer Regulation, the BaFin granted an exemption on 30 January 2014, available at www.bafin.de.

shows an atypical form, as it is not a financial investor that takes over the company, as in the case of Klöckner Pentaplast (above), for example, but the value of the restructured company – prosaically speaking: the 'restructuring cake' – is divided between three groups.

Simplified, the restructuring was to be carried out in two steps: (1) The outstanding liabilities of approximately 945 million euros were to be reduced to approximately 440 million euros. They consisted essentially of

- a loan of EUR 52.5 million,
- five promissory note loans of EUR 90 million, EUR 50 million, EUR 97 million, EUR 65 million and EUR 50 million, which were largely bought up by 'alternative financial investors',
- two listed bonds for EUR 387 million (maturity 2010-2017; annual interest rate of 6.125%) and for EUR 139 million (maturity 2011-2016, annual interest rate of 6.375%).

Creditors should accept a debt relief of approximately 40% (loans) and 55% (promissory notes and bonds).[13] A bond with a nominal value of 1000 euros should be exchanged for purchase rights, first, to new shares and, second, to a secured bond with a nominal value of approximately 440 euros.[14] (2) The share capital was to be reduced to 744,800 euros at a ratio of 150:1 and increased to 14,896,000 euros against the contribution of the promissory note loans and bonds – excluding subscription rights. The share of all existing shareholders would be reduced to approximately 5%.

The virulent core of the 'transaction structure' was, on the one hand, the complete exclusion of shareholder subscription rights and, on the other hand, the fact that loan and bond creditors were of equal rank but were treated unequally. Bondholders were granted purchase rights to subscribe to 16.46 new shares, just as the creditors of the promissory note loans. However, they were certain to acquire only 7.31 shares, as A and Qatar Solar S.P.C. had priority rights to acquire a total of 48.5% of the new shares at a total price of around EUR 46 million. These acquisition rights were directed only against the bond creditors, not against the loan creditors.

13 The background to the more favorable treatment of the European Investment Bank loan is its collateralization in October 2012; *see* the report of the common representative of 29 July 2013, p. 23, available at www.solarworld.de.

14 Optionally, a cash settlement was to be made. In addition, the bondholders received a compensation payment of 57.84 euros per 1,000 euros nominal value.

The necessary resolutions were passed at general meetings and creditors' meetings with low attendance and the required majorities.[15] Legal action was taken against the resolutions under stock corporation and under bond law, inter alia, by 'professional plaintiffs', i.e. private individuals who have specialized in the (ab)use of rights of action and who cashed in on the nuisance value of such actions.[16] With its decision of 13 January 2014, the Higher Regional Court of Cologne granted clearance, and the measures could be implemented.

3.2.1.2 Conclusion

The out-of-court restructuring consisted essentially of two steps, firstly, a capital reduction and, secondly, changes in the bond terms and conditions. Both steps warrant a further analysis.

First Step: Reorganizing Capital Structure. The court first had to decide whether the capital reduction decided by a majority could be implemented. In Germany, this is undertaken in two proceedings, a review of the resolution for formal or substantive errors and an additional proceeding alongside the normal and lengthy action for deficiencies in the resolution.[17] The subject of this solely decisive summary procedure is only whether the resolution may be implemented. If a resolution is validated by the court, its implementations shall no longer be affected by the actions of the opponent of the company.[18] The law, however, does not stipulate which exact circumstances constitute a 'particularly serious violation' in restructuring matters. In its assessment, the Cologne Higher Regional Court also took into account the threat of insolvency in favor of the company. The Court therefore ruled in its favor. The senate argued that if the financial investors who take over the distressed company demand that the existing shareholders exit the company largely without receiving compensation, this demand should be sufficient to validate the resolution.[19]

Second Step: Changes to the Terms and Conditions of the Bonds. The case also illustrates how simple it is to retrospectively amend the terms of the bonds under the SchVG with mandatory effect for all bondholders. To this end, section 5 SchVG gives a majority extensive powers. Pursuant to section 5 para. 3 sentence 1 SchVG, for example, the amount of the principal claim or of interest claims (nos. 1-3), the ranking of claims

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15 The General Meeting adopted the resolutions with over 99% of the votes cast, with around 30% of the share capital represented; at the (repeated) creditors' meetings, the measures were approved with approval rates of around 95% and an attendance rate of around 35%; the first meetings on 8 and 9 July 2013 had failed to achieve the minimum presence required by section 15 SchVG; *see* the resolutions and results of the GM, available at www.solarworld.de, and the creditors' meetings, available in the electronic Federal Gazette; *see also* Heitker, Börsen-Zeitung of 7 August 2013, p. 11; Becker, Börsen-Zeitung of 6 August 2013, p. 7.

16 The comparable parties were so-called predatory professional plaintiffs; *see* Baums/Drinhausen/Keinath, ZIP 2011, 2329, 2334.

17 Section 264a AktG.

18 Section 264a para. 4 AktG.

19 *See* the decision from Cologne's Higher Regional Court, ZIP 2014, 263, 266.

(no. 4) or even the exchange of bonds for company shares (no. 5) can be decided. Pursuant to section 5 para. 4 sentence 1 SchVG, a simple majority is generally sufficient for resolutions on the amendment of the terms and conditions of the bonds. Material changes to the terms and conditions of the bonds require a qualified majority of at least 75%, section 5 para. 4 sentence 2 SchVG. Pursuant to section 15 para. 3 SchVG, an attendance of 50% of the nominal value of the total bond is required for a quorum; if this quorum is not reached, 25% attendance at a second creditors' meeting is sufficient for material changes.[20]

The specific case on which the Higher Regional Court of Cologne had to decide demonstrated that legal protection for dissenting creditors is weak. The bondholders are granted a right to contest in accordance with the German Stock Corporation Act.[21] If a resolution of the bondholders is contested, it may be implemented – as in Stock Corporation Law – only if a court finds, on petition by the company, that the bringing of the action does not prohibit the implementation of the resolution.[22] As in Stock Corporation Law, execution is prevented only if it would be unbearable due to a 'particularly serious breach of law'.[23] A violation of elementary rights, which is certainly a hardship for the individual, is not sufficient; the violation must rather call for cassation according to its nature and extent. The Court was unable to identify such a particularly serious breach. Here, too, it is noticeable that the guarantees typically provided for by insolvency law are not granted in the preinsolvency period.[24] What is even more serious is that bondholders in the protective proceedings cannot object that other classes of creditors or shareholders are better off in comparison with them. The priority rule under insolvency law apparently is not applicable in preinsolvency.[25]

3.2.2 The Jack Wolfskin Case

The example of Jack Wolfskin shows that, even after the ESUG reform, practice still favors the English Scheme of Arrangement for the restructuring of companies that are viable in their core business but are overindebted.

3.2.2.1 Facts

In 2010, Jack Wolfskin generated sales of 304 million euros with around 430 employees. In 2011, Blackstone purchased Jack Wolfskin for EUR 700 million, of which EUR 485 million was debt-financed by Morgan Stanley, Bank of America, Merrill Lynch, UBS and

20 Major changes can therefore theoretically be enforced with effect against all bondholders with an approval rate of only 18.75%; *see* Balz, ZBB 2009, 411; Schmidtbleicher, Die Anleihegläubigermehrheit, p. 207 ff.; *see also* Florstedt, RIW 2013, 583, 586; Florstedt, WiVerw 2014, 155, 161.

21 Section 245 AktG, section 20 Abs. 2 SchVG.

22 Section 20 Abs. 3 S. 4 SchVG.

23 *See* the explanatory memorandum of the draft bill (RegE), BR-Drucksache 847/08, p. 63.

24 From the outset, the court limited the creditors' interest only to a comparison with liquidation values.

25 Cologne's Higher Regional Court, ZIP 2014, 268, 269 f.

IKB, and ultimately imposed on Jack Wolfskin itself. This included a seven-year loan of EUR 350 million, a revolving credit facility (RCF) of EUR 80 million and a second Lien loan of EUR 45 million, which bore interest at 9.5% above Euribor. Since then, an unsuccessful internationalization strategy had placed an additional burden on the company so that by mid-2015 the debt burden for Jack Wolfskin was too high and had to be renegotiated with the financing banks. In return for an additional capital injection by Blackstone in the amount of EUR 75 million, the term of the working capital line was extended, and the agreed leverage covenant was increased from 5× to 6.4× EBITDA.

Finally, at the beginning of 2017, there were reports that Blackstone had offered to invest EUR 25 million in new capital in order to retain a majority stake in the company if the creditors waived half of their EUR 300 million debt in return.

In mid-2017, the hedge funds Bain Capital Credit, HIG/Bayside Capital and CQS finally acquired 50% of the shares. The remaining shares were acquired by more than ten other funds. To this end, the hedge funds had consistently bought up debt capital at significant discounts in order to exchange it for shares in the form of a debt-equity swap, as had been intended from the outset.

The restructuring plan implemented in accordance with the English Scheme of Arrangement included a debt cut from EUR 365 million to EUR 110 million, whereby EUR 210 million was transferred to the Hold-Co, EUR 45 million was waived and EUR 110 million remained with the Op-Co with an extended term until 2020. In addition, a further EUR 25 million in new capital was introduced by the hedge funds. Blackstone was expelled as a shareholder and lost its equity stake of EUR 300 million completely.

3.2.2.2 Conclusion

The functioning of the Scheme of Arrangement cannot be described here; of interest is only why German companies prefer this approach in view of the far-reaching alternatives under German law.

It will simply be a matter of avoiding the so-called insolvency stigma. Since the legislature had decided against the introduction of a preinsolvency restructuring law in 2012, German restructuring practice has so far had to contend with the typical problems of insolvency proceedings – piecework disruption, termination of control agreements/possibilities, problems with covenants in financing and supply agreements as well as effects on customer relations and image cultivation.[26] In this respect, it is also perceived as a problem that the so-called protective shielding procedure in section 270b InsO (discussed briefly earlier) is part of the formal Insolvency Plan procedure.[27]

In Germany, the confirmation decisions on a Scheme of Arrangement of the English courts are still subject to Article 2 lit. a in conjunction with Article 36 Regulation (EU) No

26 Madaus, NZI 2017, 329, 333.
27 *Id*.

1215/2012. Following Brexit, at least the material effects on claims subject to English law would still have to be recognized under the Rome I Regulation. In Germany, confirmation decisions could also continue to be recognized under section 328 of the German Code of Civil Procedure (Zivilprozessordnung – ZPO), even if there is a 'close connection' under German law, particularly if the debtor's COMI is located in England.[28] 'Forum shopping', as in the case of Jack Wolfskin, will therefore most likely continue to occur after Brexit.

The negative consequences of 'forum shopping' have been sufficiently described by others[29] and cannot be discussed in more detail here.[30]

3.3 Loan-to-Own Procedure According to the ESUG (2012)

The procedure of debt-based company takeovers under the ESUG can be illustrated by looking at the first and largest takeovers to date by distressed debt investors.

3.3.1 Pfleiderer AG Case

The case of Pfleiderer AG concerned the first distressed debt takeover under the new Insolvency Plan law introduced into the Insolvency Act by means of the ESUG.

3.3.1.1 Facts

The wood-processing company, with 3000 employees and a consolidated turnover of over one billion euros in 2009, achieved a loss of over 700 million euros in 2010, partly because of write-downs on recently acquired investments. Since 2008, One Equity Partners, a private equity firm, had been the largest shareholder of Pfleiderer AG, initially holding 15% and later 27%. During the corporate crisis, numerous hedge and debt funds took over claims of approximately EUR 372 million. In July 2009 and later, interest payments on a EUR 260 million hybrid bond[31] issued in 2007 were suspended.

The takeover was preceded by a failed attempt at out-of-court restructuring. A restructuring plan drawn up with creditor banks in May 2011 provided for a simplified capital reduction to less than 1% of the subscribed capital, a cash capital increase excluding existing shareholders' subscription rights and the exchange of the hybrid

28 On the recognition of the English Scheme of Arrangement in Germany post Brexit, *see* Sax/Swierczok, ZIP 2017, 601.

29 For this *see* Frind, NZI 2019, 699, 699 with further evidence.

30 Among the negative consequences are the relaxation of standards to avoid conflicts of interest, a reduced enforcement of liability standards vis-à-vis managing directors and insolvency administrators, a lack of prosecution for delay in filing for insolvency, the increased settlement of old liabilities despite prohibition ('critical vendor') and, finally, a significant decline in successful restructurings. The latter is attributed mainly to the fact that unsustainable restructuring solutions are approved too easily.

31 By Pfleiderer Finance B.V.

bond for shares. The distribution key was to give existing shareholders a 1% stake in the restructured company, hybrid creditors a 4% stake and senior creditors 80%.

The existing shareholders could have subscribed to the new shares at EUR 5.11, the senior creditors at EUR 1.37. The proposed resolution, which was strongly criticized by investor protection associations, was approved by the hybrid creditors with 88.2% of the votes cast, although the minimum attendance was only just reached; at an extraordinary general meeting, the capital measures were approved, with 93.3% of the votes cast, including those of the main shareholder, a private equity fund.

The resolutions of the creditors' meeting were challenged by professional plaintiffs, among others; settlement negotiations failed. The Frankfurt Higher Regional Court did not grant the validation of the resolution of 27 March 2012.

Upon application of Pfleiderer AG on 28 March 2012, the insolvency proceedings were initiated on 17 April 2012. The Insolvency Plan, submitted on 3 August 2012, now provided for a capital reduction to zero and a subsequent capital increase in cash and kind. Remarkably, subscription rights of the existing shareholders were completely excluded. In the vote on the plan on 12 September 2012, the creditor groups approved the plan, with a total of 99.46% of the votes cast and existing shareholders with 99.19%. No appeals were lodged, and the plan was registered on 27 November 2012. On completion of the capital restructuring, the listing of Pfleiderer shares on the stock exchange also ended; an application for admission to listing of the new shares was not filed. The new shares were taken over by an acquisition company, the Luxembourg-based Atlantik S.A. The true investors hid their identity behind trust structures. Only after the plan was registered in December 2012 was the trustee taken over by Blackstone Group LP.

3.3.1.2 Evaluation

The case shows how the reformed insolvency law changes the method of restructuring by providing a quick and workable alternative for the failed out-of-court reorganization (see Section 3.2 above). The procedure and the distribution key, which no longer takes into account the subordinate groups, have model character. For preinsolvency reorganization, however, it is evident that lawsuits against companies by 'professional plaintiffs' are a common phenomenon.

The Insolvency Plan provided for a capital restructuring, namely a capital reduction to zero and a capital increase with the complete exclusion of subscription rights for existing shareholders. As a result, the financial investors were able to acquire 100% of the new shares. The case of Pfleiderer AG was the first demonstration of the efficiency with which restructuring capital measures could be implemented after the introduction of the ESUG and showed that even individual creditors were able to exclude not only reluctant shareholders, but all shareholders – including those willing to make new cash contributions – without relatively great difficulties.[32] In the protective proceeding for the existing shareholders, which is intended to make a value assessment possible, it became apparent here – as in the SolarWorld case – that the existing creditors could all easily be referred to the otherwise occurring insolvency.[33]

3.3.2 The IVG Immobilien Case

In the case of larger companies, the negotiation situation is characterized by a much larger number of financial investors facing each other, as the example of IVG Immobilien AG shows.

3.3.2.1 Facts

With annual sales of 438 million euros in 2012, the company had made a loss of 100 million euros and, in the spring of 2013, was in a precarious situation as a result of too rapid growth between 2006 and 2008 and subsequently owing to Basel III and the turnaround of energy politics in Germany. Of the debts of EUR 4.23 billion at the end of 2012, EUR 3.5 billion were due by 2014 and a debt reduction of EUR 1.75 billion was necessary. Package shareholders reduced their holdings; banks had already started to sell loans to hedge funds such as Apollo and TPG in the autumn of 2012. The hedge fund Aurelius Capital Management had collected 30% of the 400 million euro convertible bond, but hedge funds had also bought into the other credit classes.

The reorganization plan provided for the syndicated loans (Syn Loan II) and the property financing to be extended, a partially syndicated loan (Syn Loan I), the low collateralized convertible bonds and the unsecured hybrid bond to be exchanged for shares.[34] As a result, these creditors would have held a 96% stake in the company, but in return would have waived repayment of EUR 1.75 billion. This was opposed by Aurelius Capital Management.[35] In the negotiations, which are said to have resembled a game to some of the parties involved, no agreement could be reached by the deadline negotiated with the banks (29 July). In August, the company filed for insolvency and continued to pursue the restructuring plan under the protective shielding procedure.

Finally, insolvency had to be notified while the protective shielding procedure was still in progress, as it was not possible to reach a provisional deferral agreement for financial

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32 *See* Karsten Schmidt, ZIP 2012, 2085, 2086; Decher/Voland, ZIP 2013, 103, 104 f.

33 *See* Decher/Voland, ZIP 2013, 103, 110.

34 As a reaction to the decision of the Frankfurt Higher Regional Court on Pfleiderer AG, the convertible bond, to which the SchVG is not applicable under this decision, was to be restructured using the English Scheme of Arrangement. The hybrid bond was to be restructured using the SchVG, *see* Becker, IVG has to reduce debts by €1.75 billion, Börsen-Zeitung of 4 June 2013, p. 10.

35 Based on a 'revised' calculation, Aurelius demanded the bonds to be settled at 73% (instead of 41%); the lenders should then receive only 39 to 52% instead of 46 to 55%, *see* Rottwilm, Spekulanten zocken um die IVG, ManagerMagazin of 6 August 2013.

liabilities falling due. However, the type of procedure was not changed in view of the threat to standstill agreements.[36]

As creditors, the plan had to take into account two syndicated, in some cases fully secured, loans of approximately EUR 2.5 billion, property financing secured by mortgages of EUR 400 million, high-interest, unsecured and subordinated bonds with an indefinite term and a nominal amount of EUR 400 million (convertible bond), and due guarantee obligations for subsidiaries, in particular from a convertible bond, of approximately EUR 630 million.[37]

The Insolvency Plan provided for a capital relief including a cash capital increase and debt-equity swap at a rate of 60%. Quota-increasing conversion options were provided for, if necessary against the surrender of collateral for the creditors of the first syndicated loan and the convertible bonds. Creditors of the second and fully collateralized loan should only have to accept a deferral. The plan was accepted by all groups, with only one dissenting vote. Among the shareholders, the plan was approved by an overall majority of 56%. Subordinated creditors did not vote.[38]

3.3.2.2 Evaluation

In the continuation of the dispute with a convertible bond creditor about the recoverability of the claim and participation in the plan distribution, which had already been conducted before the insolvency, the insolvency court finally followed the assessment of the debtor and rejected the application for minority protection.[39] It is sufficient to note at this point: the larger the company is and thus attracts the attention of the financial investors, the more difficult become the consensus-based solutions and the more probable becomes the way through an Insolvency Plan procedure with a lowered majority requirement and prohibition of obstruction (cramdown). The failure of out-of-court restructuring due to large disparities in objectives and interests, when a large number of hedge funds are involved, could become typical for larger reorganizations.

36 ESUG-Report, BT-Drucks. 19/4880, p. 274.

37 *Id.*

38 *Id.*

39 The newly amended validation procedure in section 253 InsO also came into effect for the plan confirmation. According to the model of the procedure pursuant to section 246a AktG, the practitioner can request the court to reject the complaint against the plan. Pursuant to section 253 para. 4 sentence 1 InsO, the interest in enforcement must prevail over the complainant's interest in postponement. The weighing of interests is, however, limited to economic interests, with the result that an overriding enforcement interest must be assumed even if the reorganization plans are seriously jeopardized or finally frustrated. In the case of a particularly serious breach of law, i.e. in the case of an obvious and intolerable unlawfulness, the court will reject the application for validation, section 251 para. 4 sentence 3 InsO.

4 Some Conclusions

4.1 Overall Picture of Out-of-Court Restructuring

The case studies allow for some conclusions. On the positive side, the market is generally coping well with the out-of-court restructuring offers of German law. Restructuring under 'clearance law' is seen as a genuine alternative to the Insolvency Plan procedure. The SchVG and the restructuring company law functionally take the position of the US Chapter 11 proceedings. Disputes with shareholders and bondholders can often be settled within a legally prescribed three-month period.[40] The English Scheme of Arrangement is a further alternative.

From a more critical perspective, the absence of guarantees and protective mechanisms typical of insolvency law is striking. The lack of such protection does lead to redistribution effects.

4.1.1 No Guarantees Typical of Insolvency Law

German law acquires its functional capacity only by reducing legal protection. Bondholders and shareholders can only (1) reprimand 'violations of particular seriousness', the existence of which is theoretical; (2) not achieve a substantive review of the entire restructuring plan; (3) not prevent being forced out of the company as owners or bondholders without full compensation and legitimate satisfaction of their interests.[41]

This also means that the guarantees typical of insolvency law are completely suspended in the preinsolvency period: (1) There is no value control as to whether the value allocations made in the plan unfairly disadvantage other groups; (2) bondholders may arbitrarily be treated less favorably than creditors of equal rank; (3) the value allocation to distressed debt investors is de facto not even limited by the nominal amount of the claims.

4.1.2 No Protection against Manipulation, e.g. through Voting Bans

Owing to conceptual weaknesses, the German bond law is subject to a constant risk of manipulation. According to the SchVG, 18.75% of the voting shares may be sufficient for a majority resolution. A qualified majority, e.g. through an additional head majority, is not required. In the case of the Pfleiderer AG, the first resolutions by bondholders were not adopted owing to the lack of sufficient attendance of bondholders at the meeting,

40 Section 246a para. 3 sentence 6 AktG in conjunction with section 20 para. 3 sentence 4 SchVG, for deadline compliance *see* Baums/Drinhausen/Keinath, ZIP 2011, 2329, 2342 ff.; Bayer/Hoffmann/Sawada, ZIP 2012, 897, 907 ff.

41 II. 2.3., 3.3.

until one of the distressed debt investors involved simply bought enough hybrid bonds and voted in favor of the lenders for an almost complete waiver of claims by bondholders.[42]

The law hardly provides any defense against such behavior. In particular, voting bans or a withdrawal of voting rights for recently acquired claims are not provided for. In fact, financial investors can 'buy' the necessary consensus unnoticed and without legal control. A 'bought' consensus cannot justify compulsory intervention.

4.1.3 No Protection for Founders and Existing Shareholders

The justification for the weak legal protection in the preinsolvency area is the assumption that the shares are worthless in the event of an underbalance sheet, which is already too undifferentiated for formal insolvency.[43] This has recently been thoroughly and convincingly criticized[44] and will not be expanded upon here.

4.1.4 No Effective Court Proceedings

Under current law, the judicial review of a restructuring plan as the basis for preinsolvency forced solidarity is implemented in too many procedures. Bond and Stock Corporation Law main proceedings and interim proceedings are conducted; these are followed by value compensation proceedings.[45] Despite this multitude of court proceedings, the principal task of insolvency law – i.e. the assessment and distribution of the value of the restructured company[46] – is not solved.

4.2 The ESUG as a Model for the Directive on Preventive Restructuring Frameworks

The German legislature based the ESUG amendment on the US Chapter 11 proceeding, without addressing the criticism that had previously been voiced by the ABI Commission.[47] In the opinion of the ABI Commission, the Chapter 11 procedure, when it was created in 1978, offered a flexible basis for an appropriate balance of

42 Godenrath, Grünes Licht für Pfleiderer-Sanierung, Börsen-Zeitung of 21 July 2011, p. 10.
43 *See* only instead of numerous Decher/Voland, ZIP 2013, 103, 108; Landfermann, WM 2012, 821, 829. Thole, ZIP 2013, 1937, 1940.
44 Convincing Schäfer, ZIP 2013, 2237, 2239 f.
45 Concerning the possibility of converting the action against the resolution into an action for damages after a release has been granted *see* Decher, AG 1997, 390.
46 This regulatory problem is not dependent on the disputed primary objective of the insolvency plan proceedings (continuation or realization of liability). Instructive on typical problems related to insolvency *see* Bebchuk, A new approach to corporate reorganizations, 101 Harv. L. Rev. 775, 777 ff. (1987-1988).
47 Siemon, ZInsO 2013, 1861, 1861.

interests. Today, however, it has become – like its German counterpart – a takeover playing field for the big players.[48]

The ESUG was originally conceived as an attractivity-enhancing measure for early restructuring as an alternative to the English Scheme of Arrangement. The central components were to be the strengthening of creditors' rights and the facilitation of debt-for-equity swaps.[49] A key question in insolvency law is to what extent the debtor can remain in possession of his assets and the operation of his business. The ESUG chooses an intermediate route that is of importance for distressed debt investing: the court needs to review the plan; the debtor, however, remains authorized to dispose of assets[50] and remains the master of both the company and the reorganization proceedings; the 'practitioner' only serves as the debtor's 'controlling body' and monitors the structuring of the proceedings (section 274 para. 3 InsO);[51] the role of the creditors' committee is also limited to a controlling function.[52]

However, this division of tasks is accompanied by structural problems. Here is just one example: The court and also the dissenting creditors simply do not have enough information to properly assess the plan. In Germany, information is procured in self-administered insolvency proceedings via the debtor's report to the creditors' meeting, which the practitioner partly reviews and comments on, section 281 InsO. This gives the debtor (and also the practitioner, but already less so) a sovereignty of information that endangers an appropriate balance of interests.[53] According to the basic structure of the Insolvency Code, the court and the insolvency practitioner form a symbiosis[54] in that the court is dependent on the appointed practitioner's procurement of information.[55] Against the background of the position of the insolvency administrator, there is therefore a blatant gap in the case of self-administration. This is aggravated by the fact that the court is put under time pressure by suppliers and customers in view of a progressive loss of confidence in the debtor's operative business and thus often has to assume that the information given is correct.

In the Protective Shield Procedure, the appointed practitioner in the field of restructuring that assists the debtor is often 'brought along' by the debtor, i.e. proposed by the debtor, and is to be appointed by the court with the exception of obvious inappropriateness, section 270b para. 2 sentence 2 InsO.

48 *See also* Siemon, ZInsO 2014, 172; *id*.
49 *See* Government draft on ESUG of 4 May 2011, BT-Drucks. 17/5712, p. 1.
50 *See* further Siemon, ZInsO 2012, 2009, 2014.
51 Siemon, ZInsO 2013, 1549, 1557.
52 *Id*.
53 Siemon, ZInsO 2013, 1549, 1558.
54 Vallender/Zipperer, ZIP 2013, 149, 151.
55 Siemon, ZInsO 2013, 1549, 1559.

5 Outlook for the German Implementation of the Directive on Preventive Restructuring Frameworks

There is currently no German draft of the Restructuring Directive,[56] which came into force on 16 June 2019. In view of the considerable leeway that the Directive leaves to the member states, only a few key issues are highlighted below.

5.1 Judicial Control

Unlike the Chapter 11 proceedings[57] and the Scheme of Arrangement,[58] the Directive does not provide for a judicial control of the restructuring process itself. The participation of governmental authorities (judicial or administrative) is mandatory only on plan confirmation,[59] and judicial review is compulsory only in appeal proceedings.[60]

The lack of judicial control is problematic, on the one hand, in view of the unclear scope of application ('probable insolvency') of the Directive, while, on the other hand, it creates room for abusive arrangements, such as the purposeful formation of creditor classes in order to artificially create majorities (gerrymandering).[61] The cases described previously indicate that in the case of preinsolvency, the lack of control to date is likely to lead to redistribution effects. The distribution issues typical of insolvency are only marginally examined in summary proceedings under company law or bond law. For insolvency proceedings it is a much discussed problem that the practitioner is in fact selected by the debtor, whose interests are also pursued, as was indicated previously in the IVG case. The requirements of the Directive on the selection and independence of the restructuring officer leave a number of issues unresolved.[62] It is foreseeable that such implementation will provide little remedy for the aforementioned difficulties.

56 Directive (EU) 2019/1023 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt (Directive on restructuring and insolvency), 'RD'.

57 11 U.S.C. § 1125(b).

58 Sec. 896(1) Companies Act.

59 Art. 10 para. 1 RD.

60 Art. 16 para. 1 RD.

61 For example, creditors with the same interests can be divided into different classes (so-called *class gerrymandering*) or a class with minimal impairment can be formed (so-called *artificial impairment*) to ensure that at least one class agrees to the plan, thus enabling a cramdown. The weak level of judicial control is also surprising because the Commission itself had stated that the protection of property rights requires sufficient judicial control, European Commission, Commission Staff Working Document Accompanying the Proposal for a Directive on preventive restructuring frameworks, 22 November 2016, SWD (2016) 357 final, p. 56.

62 Cf. Arts. 26, 27 RD and in detail *Morgen*, Kommentar und Handbuch zur Richtlinie über präventive Restrukturierungsrahmen, Christoph Morgen (ed.), 2019, Art. 5 para. 93 ff.

5.2 Specialization of the Courts

The specialization of the competent courts was also considered by the commission to be important in order to be able to decide quickly and competently on any time-critical legal and valuation issue that might have to be clarified.[63] The Directive does, however, not require a concentration of jurisdiction – as can be observed in Chapter 11 proceedings – which leads to specialization and expertise of the courts. The tendency of the German restructuring practice to initiate expensive and complex scheme proceedings, as in the Jack Wolfskin case, is partly attributable to the lack of expertise of German courts. The problem is sufficiently well known in Germany, and the evaluation report on the ESUG commissioned by the Federal Government states "a clear need to concentrate insolvency proceedings".[64] Whether this will happen remains to be seen. However, the cases also indicate that, irrespective of the concentration of jurisdiction, there is a lack of knowledge on the questions that are typical in distressed debt investing. In Germany, the topic has thus far been considered almost exclusively by practitioners involved in the field and has not been picked up by legal scholars or in the training of judges. The major reform report by an expert commission had devoted 192 pages to the reform of the ESUG but excluded distressed debt investing as being irrelevant.[65]

5.3 Majority Requirements

It is noteworthy that the Directive provides only for a mandatory upper limit on the majority required for voting on the plan;[66] conversely, a simple majority of the voting creditors is sufficient.[67] A quorum for a minimum participation in the plan voting is merely optional under the Directive.[68] Against this background, the German experience is a reminder. The quorum required for the attendance of 25% of the outstanding bonds in the SchVG has produced highly questionable results, when the bonds are purchased shortly before the meeting by creditors of other classes, who then vote in the interest of another class of creditors, as the Pfleiderer case illustrates.[69]

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63 Commission Staff Working Document (Fn. 62), p. 22.

64 Research report on the evaluation of the law to further facilitate the restructuring of companies (ESUG) of 7 December 2011 ("ESUG – Evaluation Report"), pp. 235-239.

65 *Id*.

66 Art. 9 para. 6 RD.

67 By comparison, the Scheme of Arrangement requires a majority of 75% of the nominal value of the voting creditors in each class, sec. 899(1) Companies Act 2006; the Chapter 11 proceedings require a majority of two-thirds of the nominal value of the voting claims and a simple majority in relation to the number of voting class members, 11 U.S.C. § 1126 (c).

68 Recital 47 RD.

69 *See* above.

5.4 Creditors' Interest and Plan Content Review

A cramdown across classes is provided for by Article 11 para. 1 Directive, even if only one class agrees, which would have received a payment or retained a share if the debtor were to be valued as a going concern using the normal ranking order.[70] The corrective factor here is the criterion of *creditor interest*:[71] it is necessary that creditors who reject the plan would not be placed in a worse position than in the event of liquidation or the next-best-alternative realization. The compulsion for a further assessment is new in Germany. Whether this will have the desired protective effect can be doubted. It will also be decisive whether the creditor minorities receive the necessary information to verify the liquidation value and the next-best-alternative scenario (Art. 2 para. 1 (6) Directive). Furthermore, no specifications are given for the method of valuation. This rule is unlikely to change the distribution problems described above for the IVG, the Pfleiderer or the SolarWorld cases.

A similar picture emerges with regard to court control: unlike the Scheme of Arrangement[72] and the Chapter 11 proceedings,[73] the Directive does not provide for a fairness control of the restructuring plan. This is unsatisfactory, especially in comparison with the current Insolvency Plan procedure, which, among other things, contains an important corrective in the form of the integrity test pursuant to section 250 no. 2 InsO. This, too, underpins the problem of the lack of information for minority creditors and the fact that such a plan control has so far only been provided for insolvency but not for the out-of-court restructuring types.

5.5 Relative Priority Rule

It is obvious that the relative priority rule introduced at the very end of the legislative process in Article 11 para. 1 lit. c) Directive, but optional, poses considerable risks to the efficiency of the procedure. This can be illustrated very well by the IVG case. Even under the absolute priority rule a negotiated solution with more than 100 financial investors is unlikely. If, however, the absolute priority of the order of precedence is abandoned, the negotiating positions will only become more diverse and an agreement even less likely than under the absolute priority rule under German law.[74]

70 One of the prerequisites for this is that the plan must meet the requirements of Art. 10 para. 2, para. 3 RD, Art. 11 para. 1 lit. a) RD.
71 Art. 11 para. 1 lit. b) (ii) RD.
72 The deciding court has a judicial discretion in this respect.
73 11 U.S.C. § 1129(a)(3).
74 Section 245 para. 1 No. 2 in conjunction with para. 2 No. 2 InsO.

6 Outlook

In German legal policy, the assessment of the German legal framework and the prospects for reform are naturally very different. For many, there is an opportunity for a further reduction of obstacles to restructuring, even if this is at the expense of the former owners and dissenting creditors. For others, forced solidarity cannot do without an upgrading of the protection of minorities; they see the chance to restore the value-based legitimation of preinsolvency forced solidarity through a coherent system of preinsolvency.

6.1 First View: For More Efficient Restructuring

The demand for a 'restructuring-friendly' continuation of German law becomes plausible against the background of the case studies. A value-preserving preinsolvency corporate reorganization often fails owing to the (too) difficult consensus-building process of the parties involved, the (too) strong protection of shareholders and creditors from drastic measures and – partly identical to this – the (too) extensive possibilities of blocking by individuals: Pfleiderer AG or IVG Immobilien AG[75] were forced into formal insolvency proceedings by dissenting creditors. From here it is understandable if, for example, a weakening of the veto rights of individuals in a debt-for-equity swap is demanded or, more precisely, if rules on the simplified exclusion of subscription rights, expansion of the scope of the authorized capital are demanded. In the case of bonds, for example, the exclusion of content review under general terms and conditions law, the amendment of the resolution control (no rights of contestation for bondholders) or the possibility of restructuring across bonds are demanded and are now proposed as part of the implementation of the Directive.

6.2 Second View: For More Minority Protection

According to a different view of the restructuring processes outlined previously, the opposite is the case, namely that the majority finds it too easy to implement restructuring measures at the expense of structurally weak creditors. Basically, in all cases it is evident that small investors or minority creditors have little to gain against arbitrary assumptions in restructuring plans and statements on company valuation. This leads to redistribution effects. From this point of view it is consistent to demand a strengthening of the judicial review of content of the plan,[76] especially in cases of restructuring with considerable creditor interventions without effective judicial control

75 *See* above.
76 The control threshold of 'very serious violation' is practically never reached, *see* above.

(as is the case with SolarWorld AG). In this area, guarantees typical of insolvency law are largely lacking. The result is also striking that the preinsolvency restructuring attempts, namely Pfleiderer AG, IVG Immobilien AG, Q-Cells AG, Praktiker AG, Deikon GmbH, Strenesse GmbH, Centrosolar Group AG, Rickmer Holding, MS 'Deutschland' and Solar World AG all ended in insolvency. It has not yet been discussed whether the companies were simply unable to continue as a going concern because of their operating business or whether the considerable costs of the preinsolvency procedure have made a partial contribution to the ultimate failure of the restructuring. But also the question of judicial cost control has so far – wrongly – hardly been raised.