



**Improving the chances of a plan being
adopted while protecting creditors in
cross-class cram-down plans**

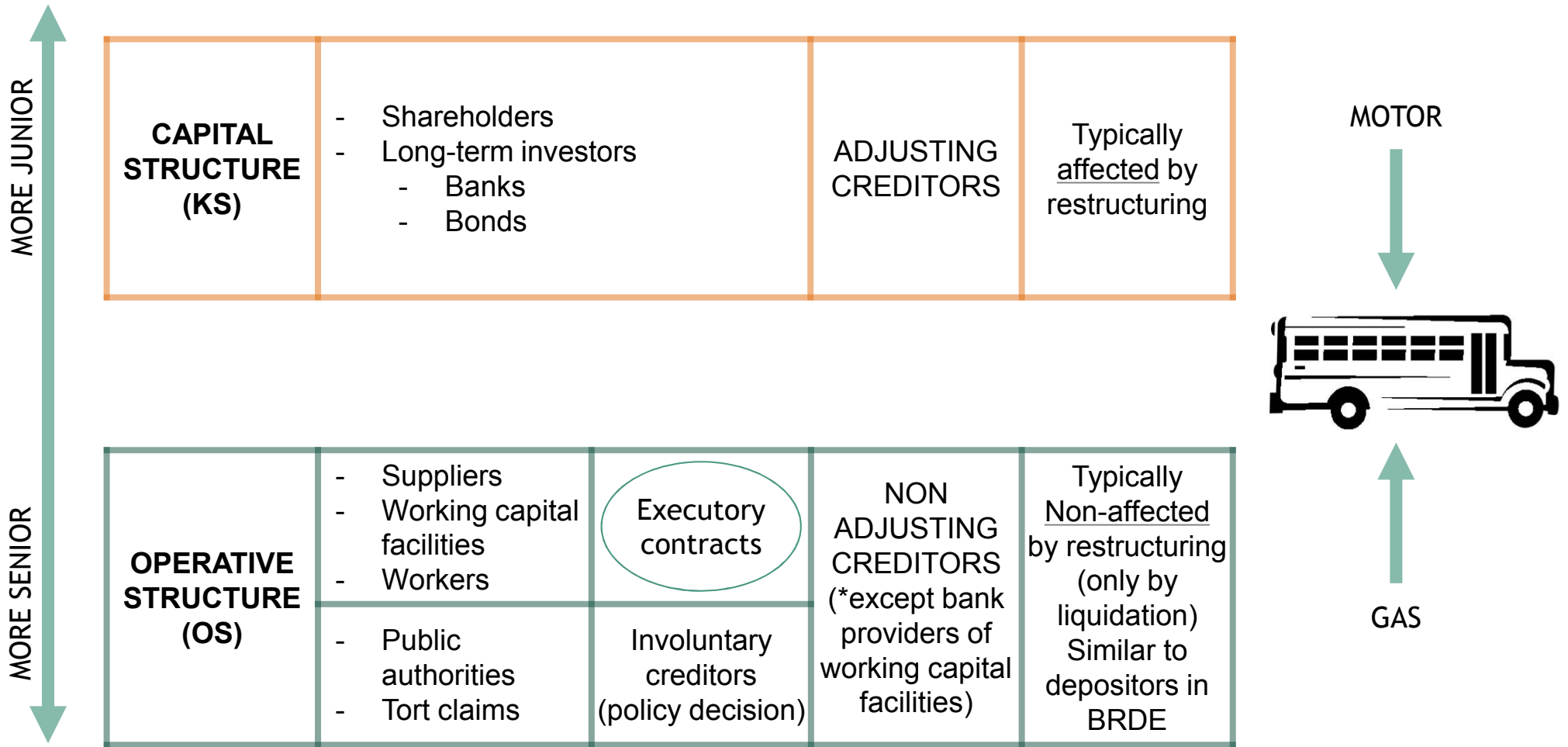
GARRIGUES

Adrian Thery

Varna, May 18th 2018

I. Capital Structure vs. Operative Structure

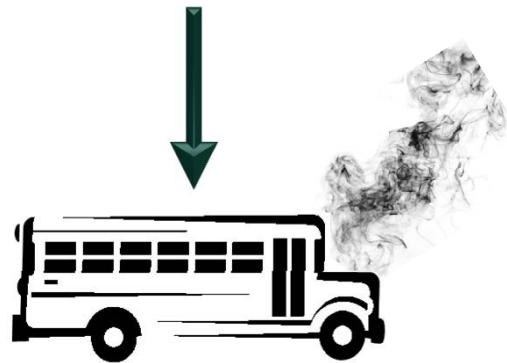
Liabilities



I. Capital Structure vs. Operative Structure

Non-adjusting (N/A) creditors affection: policy decision: for MS?

Driver-owner (capital investors) pays: MOTOR



Passengers (operative creditors) pay: ticket=GAS

Alternatives:

1. Investors are the only ones obliged to repair the bus: passengers can opt for ticket refund and exit the bus (passengers must not share burden of repair losses).
 - Capital structure **different** from operative structure (operative creditors unaffected by restructuring)
 - Daily *business preserved*: operative creditors support
 - *Neutralizes stigma* associated to restructuring
 - Operative creditor un-affection: *no need for viability test*

OR

2. Investors + Passengers: both obliged to contribute value to repair the motor. Passengers cannot exit the bus until the repair is finished and do not get priority ticket refund.
 - Capital structure **confused** with operative structure (restructuring affects operative creditors)
 - Daily *business jeopardized*
 - Restructuring *stigma* appears
 - High risk of restructuring non-viable businesses
 - Enhanced need to adopt an *entry viability test*
 - No ICA between KS and N/A creditors: *APR complexity*

II. Cross-class Cram-down (CCCD)

TYPICAL EUROPEAN VIEW OF CREDITOR'S CLASSES

HORIZONTAL VIEW

Capital structure or financial creditors



EU - No CCCD (yet) to approve a non-consensual Plan:

- Need for **each and every class** to meet the requisite majority for plan confirmation.
 - Each class has a **veto right** over the plan:

{

irrespective of whether

- The class is affected by the plan or not
 - The class is in or out-of-the-money
 - **Hold-up** of junior classes:
 - Junior blackmail senior classes as a condition not to veto plan and jeopardize senior's recoveries

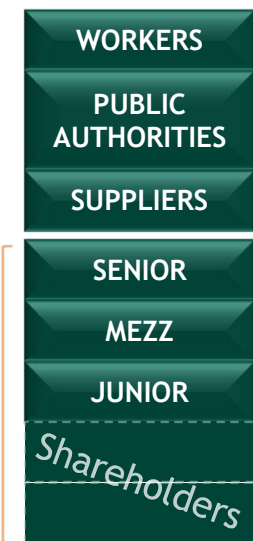
MODERN USA APPROACH TO CREDITOR'S CLASSES (ALSO ADOPTED BY DRAFT DIRECTIVE)

VERTICAL VIEW

More senior



Capital structure or financial creditors



N/A creditors:
Typically unaffected

Stratification of financial creditors according to preexisting entitlements, namely inter-creditor agreements (ICA)

Prerequisite for APR (only preliminary hearing)

II. Cross-class Cram-down (CCCD)

VALUATION IS CRITICAL FOR AN EFFECTIVE CCCD:

VALUATION: [Enterprise Value]

- Determines *where the value breaks*: who paid, fulcrum & wipe-out
- All classes have **right to vote** (even underwater). Otherwise:
 - Reduced chances of consensual plan
 - Valuation not to be performed ex-ante - but ex-post, if challenged
- Plan must respect “Absolute Priority Rule” (**APR**) **and its corollary**:
 - APR: no junior class can see a penny if seniors are not fully repaid
 - APR corollary: no senior class can be paid more than its claims



VALUATION

CCCD SHALL NOT RELY ON A MAJORITY OF CLASSES TEST (AS IN GERMANY) BUT ON VALUATION (AS IN USA)

- Foundation of majority vote relies in “**commonality of rights**” between members:
 - Concurs within creditors of one class but not amongst different classes
- Number of classes and its members is **random**:
 - No logic in majority of classes rule (majority may be underwater) and *ripe for abuse*
 - In *example* above, underwater classes control the plan (& get higher recovery)

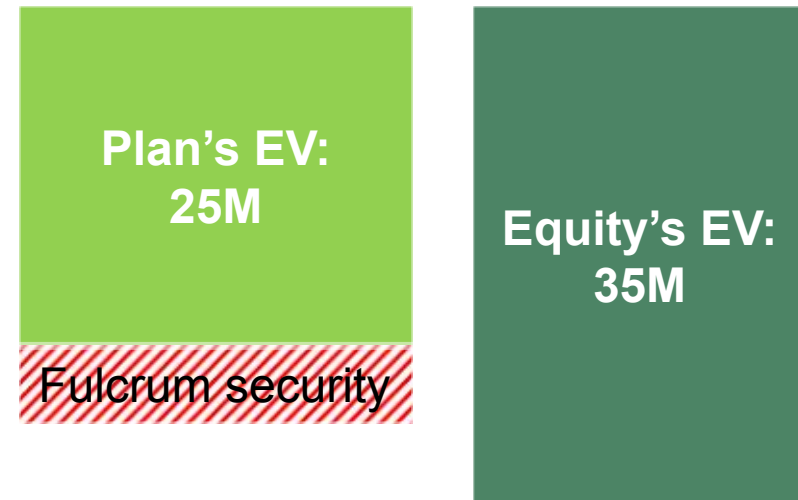
A) Capital structure (Total: 30M)

Classes top-down by seniority ranking

10M	Senior
10M	Mezzanine
10M	Junior
	Equity

B) Enterprise valuation (EV)

After: Plan proposer (25M) & Equity (35M)



1) APR and BIC often confused

- Best Interest of Creditors test (BIC)
 - Responds to Bankruptcy Decision (Liquidation or Restructuring) and
 - Liquidation Value (LV: higher between piecemeal or as a going-concern) compared with Restructuring Value (RV)
- Absolute Priority Rule (APR)
 - Responds to distributional issues between stakeholders: how to fairly distribute RV
 - Fairness test = APR + principle of no unfair discrimination between classes ranking pari passu

2) APR and BIC only have in common possible consequences of their infringement: either set aside the Plan, or challenge to obtain compensation from Plan supporters

3) Under Plan, distribution of EV/RV (LV+ Restructuring Premium): according to contractual/legal waterfall (APR)

- EV is usually DCF: future flows that are redistributed by means of the debt instruments issued through the Plan
- Net Present Value of debt instruments under the Plan to coincide with actual EV

II. Cross-class Cram-down (CCCD)

IMPORTANCE OF CCCD BASED ON APR/VALUATION (USUALLY IDENTIFIED WITH THE “FAIRNESS TEST”)

1) ADEQUATE INCENTIVES FOR EFFECTIVE DELEVERAGING

2) DEBT-TO-EQUITY PREDICTABLE CONVERTIBILITY CREATES NPL VALUE FOR BANKS

3) CONTROL RIGHTS REALLOCATION BENEFITS CORPORATE GOVERNANCE

- Class where value breaks (“*fulcrum*”) gets equity post-restructuring as a consideration for the short-fall in the recovery of its claims: adequate alignment of interests for corporate governance purposes
- Post-restructuring equity will have the adequate incentives to best manage the company:
 - New equity will manage the company without either taking too much risk (no “gambling for resurrection”) nor too little risk (as would happen should equity be allotted to secured creditors)

4) VALUATION: RESTRUCTURING ONLY IF RESTRUCTURING PREMIUM (RV > LV)

Otherwise, enforcement or liquidation are more efficient

ENFORCEMENT: NPL's & AECE DIRECTIVE

- Enforcement regime shall streamline clean business transfers, i.e. *share pledge enforcement* (which de-leverage the business): moratorium only on piecemeal enforcement of necessary assets for the business
- Restructuring and CCCD in the absence of share pledges (*public corporations*)

LIQUIDATION: RESTRUCTURING TO BE COMPLETED WITH ADEQUATE LIQUIDATION REGIME (SME's)

- When no Restructuring Premium \Rightarrow liquidation (difference between RP and GCS)
- Entrepreneurs shall be allowed to *participate in the auction* (participation forbidden in several member States, like France or Spain)
- Importance of courts/IP's having the ability to *transfer businesses as going-concerns*:
 - (i) Business sales shall be *free and clear of debt* (i.e. acquirer pays price for business and acquires no liabilities with minimum exceptions - price distribution according to ranking)
 - (ii) to *assign executory contracts* in favor of acquirer (i.e. with no veto rights by debtor's counterparty)

II. Cross-class Cram-down (CCCD)

CCCD as a means to assure debt deleveraging and as a Corporate Governance instrument

- Debt-for-equity swaps promote change of control and best available management in benefit of stakeholders & community

	1 No CCCD	2 CCCD with APR	3 CCCD with majority of classes
DEBT OVERHANG			<p>SAME PROBLEM AS UNDER</p> <p style="text-align: center;">1</p>
CONTROL RIGHTS	<ul style="list-style-type: none"> No corporate change of control <ul style="list-style-type: none"> Same shareholders in control “Gamblings for resurrection” <ul style="list-style-type: none"> Attempt to increase EV (to be in the money again) through excessive risk-taking (casino) Aggravated if no directors liability for breach of duty to minimize losses (vs. preserving value; at all costs?): policy decision 	<ul style="list-style-type: none"> Control rights (post-restructuring equity) allocated: <ul style="list-style-type: none"> Either to whom all the classes agree (consensual plan); OR Either, in case non-consensual plan, to the class where value breaks (<i>fulcrum</i>) <ul style="list-style-type: none"> Best Risk Mix (neither excessive non insufficient for most efficient management) Plus: creates market for corporate control increasing value of NPL’s 	<p>In lack of consensual plan, Control Rights (CR) not allocated to best possible class (<i>fulcrum</i>)</p> <ul style="list-style-type: none"> But randomly (to whom majority of classes say) or to senior secured creditors (risk averse – inefficient management)