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Pre-insolvency procedures in the Netherlands: addressing hold out behaviour prior to formal insolvency proceedings

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Outline

- What is the hold out problem the Directive seeks to address?
  - How is the hold out problem different from other insolvency law problems? Such as *Insolvenzanfechtung (Deckungsanfechtung)*?
- Leverage and the problem of diverse creditors
  - Financial creditors vs trade creditors
- What is happening in the Netherlands?
  - Legislation: current and proposed
  - Practice

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Reorganisation procedures

- US: 'Chapter 11'
- UK:
  - Scheme of Arrangements
  - Company Voluntary Arrangement (CVA)
  - Administration procedure
    - Usually a combination of Administration with either Scheme or CVA
- Germany:
  - Within normal insolvency procedure, possibility of an 'Insolvency Plan Procedure'
- Netherlands:
  - Two procedures: Bankruptcy Procedure and Suspension of Payment
  - Not yet a pre-insolvency procedure, but currently developed
  - Possibility of a reorganisation plan (composition plan) in both Bankruptcy and Suspension of Payment Procedure.

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Understanding hold out behaviour from a theoretical perspective

Why do we have insolvency laws in the first place?

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What would happen without insolvency laws?

Destructive race by the creditors

Also understood as
'a tragedy of the commons'

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Common Property

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Tragedy of the Commons

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Oceans as a common pool

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Tragedy of the commons II

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Insolvency and common pool problems

The limited assets of the debtor function as a common pool to which an abundance of creditors try to take recourse

Seizing assets individually destroys going concern value

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Why do we

Destroy the fields?
Plunder the pond?
Kill the goose that lays golden eggs?

AND

Individually seize assets?

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Tragedy of the commons explained by the prisoners' dilemma

Rather detailed setting from game theory.

Basic lesson: whatever the other prisoner does, a prisoner can always improve its position by ‘ratting the other out’

Cooperating (remaining silent): both to prison for 1 year
Both ‘ratting out’: both to prison for 5 years

Although parties would collectively have been better of by cooperating, they can improve their individual position by not cooperating

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Insolvency rules explained by wish of overcoming tragedy of the commons

- Collective procedure
- Automatic stay
- Preference Law (*Deckungsanfechtung*)

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Dominant Insolvency Law Theory:

Insolvency laws impose a collective regime in order to prevent a tragedy of the commons

BUT….

What happens when we replace a free for all by a pure collective regime?

If 100% consent required, solutions are not likely to come about because of holdout problems

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What does hold out look like?

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Holdout behaviour indicative not of a common pool problem, but of an anticommons problem

What happens when we replace the common pool regime with a collective regime in which

everyone

has to agree?

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Back to the pond: What if everyone has to agree to someone fishing?

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Different conceptual frameworks

Common pool problem

Nobody can block the use by others

Normally leads to overuse

'Anticommons Problem'

Everyone can block the use by others

Everyone is given a veto-right

Holdout behaviour leads to underuse and suboptimal outcomes

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Anticommons and holdout in insolvency

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Clearest example: reorganisation plans

Creditors' holdout

In order to overcome hold out, majority rules

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Conceptual differences

Holdout normally not a prisonners' dillema

but

a game of chicken

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The crash in insolvency

No reorganisation plan, although everybody would have been better of.

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Rules on accepting a plan

- Germany:
  - more than 50% in number representing more than 50% of the amount
- US:
  - Majority of two-third in amount and a majority in number
- UK:
  - Scheme: more than 75% in value and 50% in number
  - CVA: more than 75% in value
- The Netherlands
  - more than 50% in number representing more than 50% of the amount

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Additional rules on creditor democracy

- What checks and balances do we need?

- Step 1: Offer a plan
- Step 2: Creditors vote and can accept plan by majority

Would this be sufficient?

- Step 3: Court confirmation and protection by means of 'no creditor worse off rule'
- Possible step 4 and 5: Cram down and APR

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Different creditors

&

Why is there so much debt?

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Balance sheet with 100% equity

ASSETS		EQUITY & LIABILITIES	
BUILDING	150	EQUITY	1000
MACHINES	350		
STOCK	500		
TOTAL	1000	TOTAL	1000

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Balance sheet partly bank financed

ASSETS		EQUITY & LIABILITIES	
BUILDING	150	EQUITY	650
MACHINES	350	BANK	350
INVENTORY	500		
TOTAL	1000	TOTAL	1000

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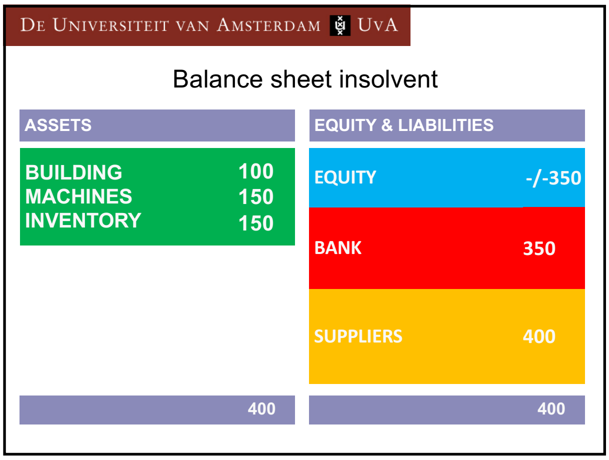
Balance sheet with both bank and suppliers finance

ASSETS		EQUITY & LIABILITIES	
BUILDING	150	EQUITY	250
MACHINES	350	BANK	350
INVENTORY	500	SUPPLIERS	400
TOTAL	1000	TOTAL	1000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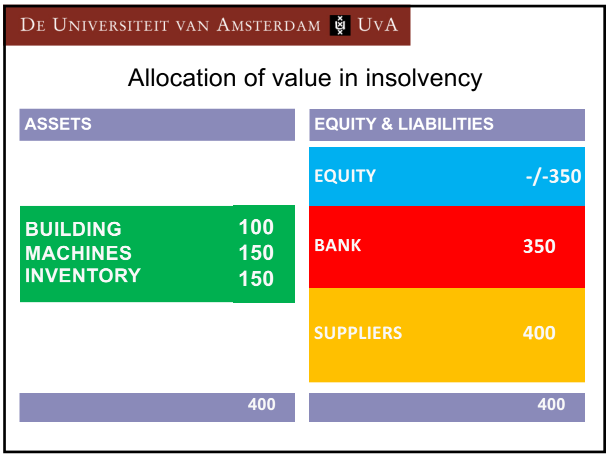
Balance sheet insolvent
ASSETS
EQUITY & LIABILITIES
BUILDING 100
MACHINES 150
INVENTORY 150
EQUITY -/-350
BANK 350
SUPPLIERS 400
400
400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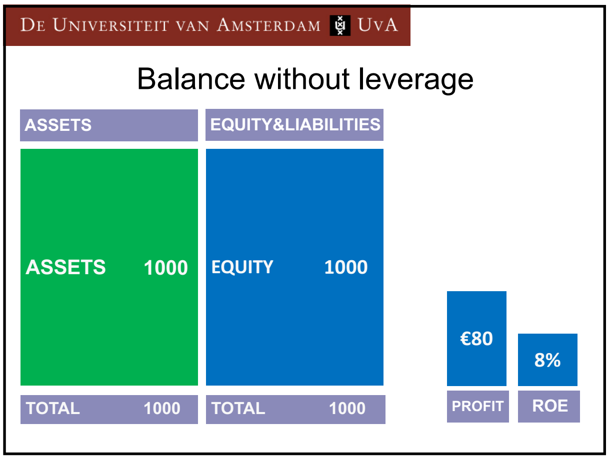
Allocation of value in insolvency
ASSETS
EQUITY & LIABILITIES
EQUITY -/-350
BUILDING 100
MACHINES 150
INVENTORY 150
BANK 350
SUPPLIERS 400
400
400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Balance without leverage
ASSETS
EQUITY&LIABILITIES
ASSETS 1000
EQUITY 1000
€80
8%
TOTAL 1000
TOTAL 1000
PROFIT
ROE

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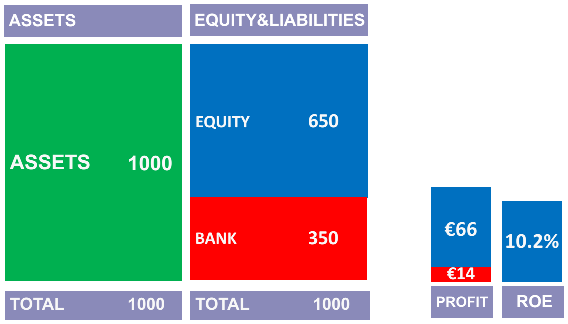
Leveraged finance (I)



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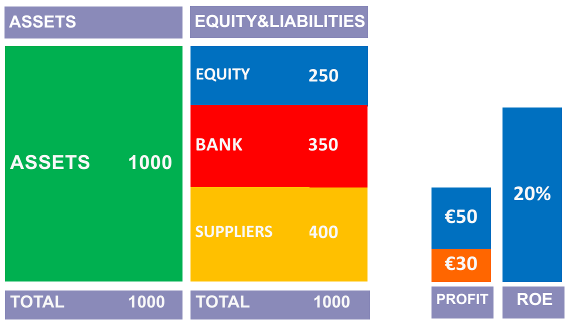
Leveraged finance (II)



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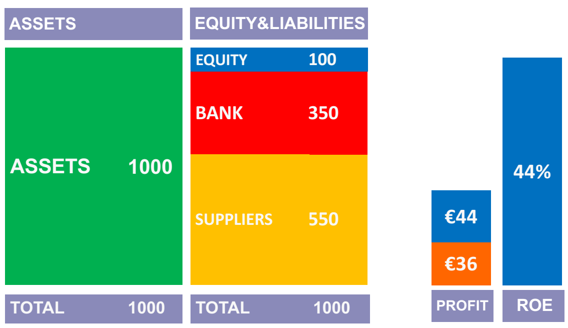
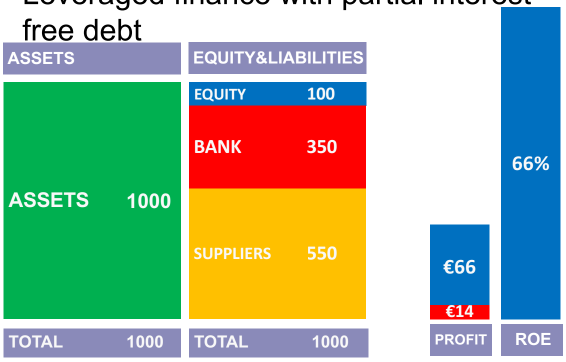
Leveraged finance (III)



Leveraged finance with partial interest free debt



Reactions

Legislative response
Late Payment Directive
(within 30/60 days)

&

Societal Response
Betaal me nu
Pay me now: http://www.supplierfinancing.org/pay-me-now/

Goal of insolvency law

Value Maximization

Capture the higher going concern value

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Insolvency: liquidation value

ACTIVA		PASSIVA	
			-/-
BUILDING	100	BANK	350
MACHINES	150		
INVENTORY	150		
		SUPPLIERS	400
	400		400

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going concern value

ACTIVA		PASSIVA	
			-/-
BUILDING MACHINES INVENTORY	700	BANK	350
		SUPPLIERS	400
	700		700

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Additional rules on creditor democracy

- Step 1: Offer a plan
- Step 2: Creditor majority rule
- Step 3: Court confirmation and protection by means of ‘no creditor worse off rule’

Do we want more? What if an entire class holds out?

- Step 4: Court cram down
- Step 5: Check on court cram down by means of APR

Possible step 4: cram down

- What if creditors hold out as a class?
- Imagine a plan, that provides for a pay out of 15%, while in case of liquidation, creditors would only get 12.5%?
- Plan complies with no creditor worse off rule
- Composition plans provide for majority rule, whereby creditors can overrule other creditors.
- Should the court be given the opportunity to overrule an entire class of creditors (also known as cram down?)
- Directive contains possibility of 'cram down'

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Liquidation with 12.5% pay out

ASSETS		EQUITY & LIABILITIES	
		EQUITY	-350
BUILDING	100	BANK *PAY OUT 100%*	350
MACHINES	150		
INVENTORY	150		
		SUPPLIERS *PAY OUT 12.5%*	400
TOTAL	400	TOTAL	400

Reorganised balance sheet with 15% pay out

ASSETS		EQUITY & LIABILITIES	
		EQUITY	
BUILDING MACHINES INVENTORY	410	BANK	350
		SUPPLIERS: 15%	60
TOTAL	410	TOTAL	410

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ASSETS		EQUITY & LIABILITIES	
		EQUITY	
BUILDING MACHINES INVENTORY	410	BANK	350
		SUPPLIERS	60
TOTAL	410	TOTAL	410

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Restructured balance sheet

ASSETS		EQUITY & LIABILITIES	
BUILDING MACHINES INVENTORY	700	BANK	350
		SUPPLIERS	60
TOTAL	700	TOTAL	700

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Allocation of equity after reorganisation

ASSETS		EQUITY & LIABILITIES	
		EQUITY *Who?*	290
BUILDING MACHINES INVENTORY	700	BANK	350
		SUPPLIERS	60
TOTAL	700	TOTAL	700

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ASSETS		EQUITY & LIABILITIES	
		EQUITY	290
BUILDING MACHINES INVENTORY	700	BANK	350
		SUPPLIERS	60
TOTAL	700	TOTAL	700

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APR in Directive

Art. 11 Directive

Similar to art. 245 InsO
Obstruktionsverbot

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Preventive restructuring addresses too much debt

Risk taken by financial creditors against compensation
Trade creditors often not compensated

What if value breaks above trade creditors?

Do ‘the’ shares go to second security holder?
Are trade creditors wiped out?

Who should share in the pain of allocation of losses?

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The Netherlands: current legislation

- Current possibilities in Bankruptcy Code
  - Composition plan in bankruptcy and suspension of payment
  - Relevant thresholds:
    - more than 50% in number representing more than 50% of the amount
  - No possibilities to force shareholders to give up their shares
  - Only 'debtor' can offer the plan
  - No APR
  - No pre-insolvency composition
- Composition plans in bankruptcy and suspension of payment do not limit the rights of secured creditors
  - No equivalent to German value preservation rules
- Suspension of payment does not effect secured or preferred creditors

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The Netherlands: legislative proposal

- Current proposals for Continuity of Enterprise Act II
  - Pre-insolvency procedure
  - Debtor remains in possesion
  - *Higher thresholds: 50% in number and 66% in amount*
  - Possibility to bind secured and preferred creditors but with value preservation principle
  - Protection of DIP-financing against transaction avoidance
  - Cram down, but …..no APR
- Current proposal will need to be amended to comply with Directive, most notably APR

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The Netherlands: Practice

- Reorganisation plans
  - Although currently no APR…
  - …..commercially driven reorganisations commonly provide for restructuring debt at level of financial creditors alone.
  - But, more litigious reorganisations do not provide for rule that creditors should get 'the shares'.
    - Also in practice trade creditors occasionally left with liquidation value.
- Pre-packs or other asset sales
  - Increase in insolvency procedures with secured shareholder loans
  - If a system allows for secured shareholder loans, true reorganisations will be rare.
  - Why try to reorganise, if shareholder can also acquire the assets out of an asset sale without putting in fresh money (credit bid)?

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Conclusions Netherlands

The Netherlands will (have to) change current proposals for preventive restructuring in order to comply with Directive

Trade creditors are needed during and post reorganisation

This can, however, proof to provide too limited protection in case of reorganisation

Reorganisation will not be attractive if shareholders can easily buy out of pre-pack by means of credit bid

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Questions

What is the problem and what are symptoms?

Is hold out the problem or the symptom?

Could overleverage be the problem?

To what extent do preventive restructuring frameworks address symptoms but feed an underlying problem of leverage?

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