

Reorganization: a system of all for one?

A close look into the value entitlements and the position of secured creditors under U.S., EU, Dutch and German legal systems

Abstract

The distribution of value in reorganization is in principle based on the outcome of the negotiations between creditors and shareholders involved in such procedures. Nevertheless, reorganization rules play an influential role in determining the outcome as they have ex ante impacts on the bargaining and the controlling powers of the negotiating parties. A contentious issue concerning the distribution of the reorganization value relates to cases where all prepetition assets of a debtor are encumbered. In such a case, the question is whether reorganization is still a collective procedure in the sense that it operates to maximize the collective return to all creditors, or it is a system of the winner, the secured creditor, takes all the value. An overview of the legislation and the legislative history of reorganization regimes suggests that legislators consider reorganization as a system that operates for the interest of the entire body of creditors and are against the distribution of the full reorganization value to secured creditors. This is, however, insufficient to guarantee the intended outcomes that are envisaged by the legislators. As demonstrated in the present paper, the regulation of the value entitlements and the position of secured creditors have impact, *inter alia*, on the distribution of value and the overall reorganization proceeding. The analyses in this paper demonstrate that the lack of sufficient legislative responses and high degree of flexibility as to the application of reorganization rules related to the value entitlements and the position of secured creditors would increase the chance of the diversion of practice from the objectives of the legislators. Furthermore, reorganization rules that regulate the position of secured creditors may function as double-edged swords. In principle, some reorganization rules are introduced to uphold the core features of security interests on the one hand, and facilitate reorganization procedures, on the other. However, in the absence of full-fledged mechanisms, the application of such rules may result in potential undeliberate consequences and put hurdles on maximization of value for the interest of all creditors.

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1 Introduction

Reorganization is an insolvency law proceeding tool¹ that allows distressed firms to capture higher going concern value (aka reorganization value) in excess of the liquidation value. A rich body of literature has been dedicated to whether in cases where all assets of a debtor are encumbered, secured creditors are entitled to the full reorganization value, or whether some value is to be left for distribution among other creditors.² Supporters of allocating the full reorganization value to secured creditors mainly raise arguments on the basis of parato efficiency³ or the freedom of contract and the importance of facilitating access to (secured) financing.⁴ A contrary viewpoint is the asset-based approach, based on which priority rights of secured creditors is tied to distinctive assets and cannot be extended to the full reorganization value.⁵ The asset-based approach challenges the allocation of the full reorganization value to secured creditors by addressing the existence of gaps in coverage of blanket security interests mainly because some of the postpetition value is not traceable to collateral or is generated thanks to the existence of soft variables that cannot be encumbered with security rights.⁶ Literature related to this second school of thought generally discusses the (limited) scope of security rights. In this respect, the assessment in literature by and large revolves around the question whether in a reorganization law regime, mainly in the context of U.S. law, there is a

¹ In this paper, the terms ‘insolvency’ and ‘bankruptcy’ are used interchangeably. Also, there are different viewpoints as to the legal nature of (preventive) reorganization proceedings. The discussion on the legal nature of reorganization proceedings is out of the scope of the present paper. For more elaborated discussions see Nicolaes Tollenaar, *Pre-Insolvency Proceedings: A Normative Foundation and Framework* (Oxford University Press 2019) paras 1.22- 1.31; Stephan Madaus, ‘Leaving the shadows of the US Bankruptcy Law: A proposal to divide the realms of insolvency and restructuring law’ (2018) 19 *European Business Organization Law Review* 615; Riz J Mokal, ‘What is an Insolvency Proceeding? Gategroup Lands in a Gated Community’ (SSRN, 7 June 2022) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4128352> accessed 15 June 2022. The present paper adheres to the conventional standpoint and considers reorganization proceedings as insolvency law tools. See, in particular, Thomas H Jackson, ‘Bankruptcy, Non-Bankruptcy Entitlement, and the Creditors’ Bargain’ (1982) (5) 91 *Yale Law Journal* 857. Jose M Garido, ‘Out-of-Court Debt Restructuring’ (World Bank Study 2012) para. 103 notes that formal and informal restructuring “procedures are not separate from each other but, rather, they exist in a continuum of different degrees of formality and court intervention.” In addition, in the legal systems that are the focus of the present paper either reorganization rules are stipulated within the respective insolvency law acts (the U.S. Bankruptcy Code and the Dutch Bankruptcy Act) or the design of the reorganization system is in line with insolvency law traits (Germany); As to German restructuring scheme see Stephan Madaus and David Ehmke, ‘Special Issue Preventive Restructuring 4. Germany: Still Waiting for the Revolution in Restructuring to Come?’ (HERO 2022/W-004) <https://www.online-hero.nl/art/4351/special-issue-preventive-restructuring-4-germany-still-waiting-for-the-revolution-in-restructuring-to-come#_edn51> accessed 28 June 2022.

² See for instance, Douglas G Baird, ‘The Rights of Secured Creditors After ResCap’ (2015) *The University of Illinois Law Review* 849, 856 and 858 noting that “[o]n the one hand are those who believe that when stock is taken in bankruptcy, no one should be able to enjoy the assets to the absolute exclusion of other stakeholders. On the other hand, are those who believe that stakeholders have a place in line, and the bankruptcy reckoning should respect it.”

³ For more elaboration regarding this viewpoint and the opposite standpoint see Charles W Mooney, ‘The (Il)Legitimacy of Bankruptcies for the Benefit of Secured Creditors’ (2015) *University of Illinois Law Review* 735.

⁴ Jay L Westbrook, ‘The Control of Wealth in Bankruptcy’ (2014) 82 (4) *Texas Law Review* 795, 827-852 provides a comprehensive analysis regarding contractualism. See also Barry E Adler, ‘Priority in Going-Concern Surplus’ (2015) *University of Illinois Law Review* 811, 816; Barry E Adler, ‘Finance’s Theoretical Divide and the Proper Role of Insolvency Rules’ (1994) 67 *Southern California Law Review* 1107; Alan Schwartz, ‘A Contract Theory Approach to Business Bankruptcy’ (1998) 107 *Yale Law Journal* 1807; Lynn M LoPucki, ‘The Case for Cooperative Territoriality in International Bankruptcy’ (2000) 98 *Michigan Law Review* 2216, 2243-2245. Steven L Harris & Charles W Mooney Jr., ‘How Successful Was the Revision of UCC Article 9: Reflections of the Reporters’ (1999) 7 (4) *Chicago-Kent Law Review* 1357, 1359 suggest that the Article 9 revision was motivated by “increase[d] awareness that the principal beneficiaries of secured credit” are borrowers *and* third parties. The additional argument in favor of allocating the entire going concern value to secured creditors is provided by Christopher W Frost, ‘Secured Credit and Effective Entity Priority’ (2019) *Connecticut Law Review* 420. Frost argues that “(...)the firm is a closed system in which the firm creates cash flow during bankruptcy solely through the use of secured creditor’s pre-bankruptcy collateral.”

⁵ For more explanation see Baird (2015) (n 2); Frost (n 4).

⁶ Melissa B Jacoby and Edward Janger, ‘Tracing Equity: Realizing and Allocating Value in Chapter 11’ (2018) 96 *Texas Law Review* 673; Michelle M Harner, ‘The Value of Soft Assets in Corporate Reorganizations’ (2015) *University of Illinois Law Review* 509,540; Edward Janger, ‘The logic and limits of liens’ (2015) (2) *University of Illinois Law Review* 589; Stephan Madaus, ‘Is the Relative Priority Rule right for your jurisdiction? A simple guide to RPR’ (WP-2020-1).

possibility to extend prepetition security rights to the excess value that is captured in reorganization (aka the surplus value).⁷

The present paper addresses the question as to whether secured creditors are entitled to the full reorganization value from a different perspective, which is less addressed in literature.⁸ The focus of this paper is mainly on the legislator's approach as to regulation of the value entitlements of secured creditors in reorganization and the value that secured creditors may receive in practice. To this end, the analysis in the present paper is not confined to the discussion on reorganization rules related to the value entitlements of secured creditors and the distribution rules. This paper takes a step further and assesses additional rules that have impact on the position of secured creditors and, hence, their actual value recovery in reorganization. In this way, there would be a possibility to gain deeper insights as to the roots of the disparity, if there is any, between the legislative view on secured creditors' value entitlement and the actual value that they capture in reorganization.

The position of secured creditors in reorganization proceedings can have far-reaching economics implications.⁹ For instance, the rights of secured creditors in reorganization has ex ante consequences on the availability of credit and the secured creditors' monitoring incentives.¹⁰ The other concern regarding the regulation of the position of secured creditors in reorganization relates to its interconnection with the overall objective of insolvency law regimes. Insolvency law regimes are in principle aimed at "saving financially distressed firms that are economically efficient and shutting down financially distressed firms that are economically inefficient."¹¹ On the one hand, undermining the core features of security rights in reorganization can result in secured creditors' bias against such proceeding. In that case, inefficient liquidations followed by fire sales of assets can be anticipated. On the other hand, affording too much protection to secured creditors in reorganization may eventually result in a situation where secured creditors exercise pervasive control in such proceedings.¹² In such a case, the secured creditors' bias towards reorganization can be expected whilst reorganization is not necessary nor efficient. In an effort to strike a balance between the degree of secured creditor protection inside and outside of reorganization regimes, legislators additionally take into account the possible trade-offs

⁷ Jacoby and Janger (n 6); Ralph E Brubaker, 'The Post-RadLAX Ghosts of Pacific Lumber and Philly News (Part I): Is Reorganization Surplus Subject to a Secured Creditor's Pre-Petition Lien?' (2014) *University of Illinois Law Review* 1; Ralph E Brubaker, 'Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11' (2012) 34 (7) *Bankruptcy Law Letter* 1.

⁸ Jacoby and Janger (n 6) and Brubaker (2014) (n 7) touch upon this matter to some extent concerning the U.S. Chapter 11 Bankruptcy Code.

⁹ Tomas Rydl, 'The Impact of Insolvency Law on Financial Stability' (CNB Financial Stability Report 2005); Jean-Charles Bricongne et al, 'Economic Relevance of Insolvency Frameworks in a High-debt Context: An EU Perspective' (European Commission research project, discussion paper 032, June 2016); Michelle Harner, 'Final Report of the ABI Commission to Study the Reform of Chapter 11' (2014) Book Gallery <<http://digitalcommons.law.umaryland.edu/books/97>> accessed 20 May 2022 (hereinafter ABI).

¹⁰ Based on empirical evidence, the degree of creditor right protection has a positive association with the availability of credit while it has a negative association with the monitoring incentive of lenders. For further elaboration on this matter see Rafael LaPorta et al, 'Law and Finance' (1998) 106 (6) *Journal of Political Economy* 1113; Reiner Haselmann, Katharina Pistor and Vikrant Vig, 'How Law Affects Lending' (Columbia Law and Economics working paper 285, 2005).

¹¹ Michelle J White, 'The treatment of secured credit in bankruptcy: a unified model' in Barry E Adler (ed), *Research Handbook on Corporate Bankruptcy Law* (Elgar 2020) 211. See also Gerard McCormack and Wai Y Wan, 'Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges' (2019) 19 (1) *Journal of Corporate Law Studies* 69.

¹² See for instance, Kenneth M Ayotte and Edward R Morrison, 'Creditor Control and Conflict in Chapter 11' (2009) 1 (2) *Journal of Legal Analysis* 511; Eckbo B Espen, Kai Li and Wei Wang, 'Rent Extraction by Super-priority Lenders' (2019) Tuck School of Business Working Paper No 3384389 <https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=3384389> accessed 16 June 2022.

between facilitating reorganization proceedings and upholding the key features of security interests in such procedures. The reason for this is that the existence of several tools that are deemed to facilitate reorganization proceedings—such as the possibility of imposing a stay on individual enforcement actions, the right of the debtor in possession to use or sell (encumbered) assets and attract interim financing— may result in restrictions on rights that secured creditors could enjoy outside reorganization.

1.1 Research focus and questions

The determination of the value entitlements of secured creditors in reorganization is a contentious issue. First, in contrast to liquidation proceedings, where secured creditors have priority over other creditors with respect to the proceeds of the sale of assets, reorganization may not necessarily entail the sale of assets.¹³ Second, although there may exist statutory rules regarding the value entitlement of secured creditors, ambiguities as to the interpretation of the rules may still be present, which would lead to different distribution results. Thirdly, in order to determine the value entitlements of secured creditors in reorganization, a distinction should be made between the value that secured creditors can claim based on the legislation and the value that they may effectively obtain on account of their position in reorganization. It may very well be the case that the actual outcome of value distribution to secured creditors would be against the intent of the legislator.

Against this backdrop, the research question in this paper is *“in a case where the entire prepetition assets of a debtor are encumbered with security rights, can secured creditors claim entitlement to the full reorganization value?”*

The analysis in the present paper is broken down into three questions. The first question is:

- I) What is the value entitlement of secured creditors in reorganization where there are security rights on all prepetition assets of a debtor?

In order to gain insights into the actual value that secured creditors obtain in reorganization, the paper discusses the position of secured creditors in reorganization. For this reason, it focuses on two additional aspects related to the regulation of rights of secured creditors, namely the concepts of “adequate protection of secured creditor” and “priming under interim financing” leading to the following two questions.

- II) Are the interests of secured creditors adequately protected against potential negative impacts of imposing restrictions on their individual enforcement rights?
- III) Do legal systems recognize the concept of “priming”, which is the possibility of creating a security right that is higher in rank than a prepetition security right, in the context of interim financing?

The focus in this paper is on U.S., EU, Dutch and German legal systems. The U.S. Chapter 11 Bankruptcy Code has been an important source of inspiration for the introduction of

¹³ In reorganization, rather, the survival of the legal entity and the continuation of the business during and after the procedure may allow the distressed corporation to retain a higher value than the liquidation value.

reorganization in a number of jurisdictions.¹⁴ In addition, since the reform Act of the U.S. Chapter 11 in 1978, reorganization constitutes a considerable portion of corporate defaults in the U.S.¹⁵ Hence, the experience of the U.S. Chapter 11 as to the position of secured creditors in reorganization would be insightful even though, as it will be discussed in this paper, this is still a matter of ongoing judiciary and scholarly contention in the U.S.

In contrast to the U.S., in Europe, the concept of reorganization has only recently attracted a widespread attention among member states. The introduction of the 2019 EU Directive on Preventive Restructuring Frameworks (hereinafter the Directive),¹⁶ strongly inspired by the U.S. Chapter 11, marks the initial steps of the EU legislator towards harmonization of restructuring practices. The Directive, however, only provides for minimum harmonization.¹⁷ Hence, national legislators are conferred with a considerable degree of discretion concerning the regulation of many aspects of reorganization proceedings, including the entitlements of secured creditors.¹⁸ For this reason, the present paper delves, in particular, into the implementation of the Directive under Dutch law—Wet homologatie onderhands akkoord (hereinafter the WHOA)—and German law—Gesetz über den Stabilisierungs- und Restrukturierungsrahmen für Unternehmen (hereinafter the StaRUG). The Netherlands has traditionally been recognized a secured creditor-friendly jurisdiction. By introduction of the WHOA, Dutch legislators envisaged to attract financially distressed firms in order to become a restructuring hub.¹⁹ The reason for choosing Dutch law in this paper is to assess how the legislator responded to the trade-off between upholding strong secured creditors' rights in reorganization on the one hand, and facilitating such procedure, on the other. This paper also provides an in-depth analysis as to the value entitlements and the position of secured creditors under German law as Germany is the most important jurisdiction in Europe, especially after the Brexit.

1.2 Paper structure

This paper proceeds as follows. Section 2 highlights the core features of security rights and provides an overview of the basic entitlements of secured creditors under the legal systems that are the focus of the present paper. Section 3 conceptualizes the problematic issues surrounding security rights in reorganization proceedings. In particular, the focus is on the three substantial issues identified above, namely I) the possible value entitlement of secured creditors; II) the extent to which secured creditors are adequately protected against curtailing their outside of

¹⁴ McCormack and Wan (n 11).

¹⁵ U.S. Congressional Research Service, 'United States Bankruptcy Courts: Caseload Statistics for the 12-Month Period Ending December 31, 2020' (March 2021) <<https://crsreports.congress.gov>> accessed 06 May 2022.

¹⁶ Directive of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2017/1132/EU ((EU) 2019/1023, L 172/18).

¹⁷ Emilie Ghio, Gert-Jan Boon and et al, 'Harmonizing Insolvency Law in the EU: New Thoughts on Old Ideas in the Wake of the Covid-19 Pandemic' (2021) 30 (3) *International Insolvency Law Review* 9 noting that the Directive "(...) merely offers a menu, rather than a truly harmonised framework, based on the codification of best practices already in place in some of the Member States' preventive restructuring regimes". See also David Ehmke et al, 'The European Union Preventive Restructuring Framework: A Hole in One?' (2019) 28 (2) *International Insolvency Law Review* 18.

¹⁸ Ghio, Boon and et al (n 17) 9 noting that the Directive "(...) merely offers a menu, rather than a truly harmonised framework, based on the codification of best practices already in place in some of the Member States' preventive restructuring regimes". See also Ehmke et al (n 17).

¹⁹ See for instance, Marc Molhuysen and Olmo Weeshoff, 'WHA! New Dutch Scheme set to position the Netherlands as a restructuring hub' (DLA Piper, 20 December 2019); Gerrit-Jan De Bock, Ruud A G De Vaan, 'Rapidly Implemented Amidst COVID Crisis, New Dutch Restructuring Procedure Offers Relief to Businesses and Organizations Struggling with High Debts' (2021) 18 (3) *European Company Law* 106.

formal insolvency procedures rights; and III) the possibility to create a priming lien to raise interim financing. Subsequently, section 4 delves into the approaches of the U.S., EU, Dutch and German legal systems concerning the addressed three core issues. Section 5 concludes.

2 The core features of security rights and basic entitlements of secured creditors

All creditors seek to prevent or minimize losses related to a debtor's default. Creating security rights is the most best-known strategy to avoid losses as a creditor. Security rights are basic building blocks of the financial system. Security rights in general have three key characteristics,²⁰ which are not always distinguished: I) the first feature is a priority right over the proceeds of the encumbered assets;²¹ II) the second common feature is a distinct procedure to foreclose on the assets, often with very little and sometimes no court involvement;²² III) the third critical element of security rights, which emanates from the first two key features, is the control function of secured creditors over assets of a debtor.²³ While the first feature of security rights deals with the question of distribution, the second and the third functions enable secured creditors to take control over the assets through monitoring and controlling the recovery process.

Security rights are a domain between contract and property. These legal modules can potentially create wealth by enabling owners to encumber their land or other assets to obtain investment capital.²⁴ Legal systems, where debt financing plays a fundamental role in their economy, such as the U.S., the Netherlands and Germany generally provide for the possibility to create security interests on a broad range of existing and future assets.²⁵ In light of the changes to the nature of firms, a security right can be vested not only on tangible, but also on

²⁰ It should be noted that any of the mentioned characteristics may be present in arrangements that are not security. In addition, the arrangement that does not have the features may still be characterized as a security. Lynn M LoPucki, 'The Unsecured Creditor's Bargain' (1994) 80 *Virginia Law Review* 1887, 1921 notes "[s]ecurity offers the user some combination of three features, which I will refer to as priority, encumbrance, and remedy. None of the three is present in every arrangement that qualifies as security; any of the three features can be present in arrangements that are not security." See also, Riz J Mokal, 'The Search for Someone to Save: A Defensive Case for the Priority of Secured Credit' (2002) 22 *Oxford Journal of Legal Studies* 687. LoPucki and Mokal address an additional feature of security rights, which is encumbrance. In his paper, Mokal notes the following: "the collateral is also encumbered, in that the debtor loses the right to convey to third parties' rights inconsistent with those of the secured."

²¹ John Armour, 'The law and Economics Debate about Secured Lending: Lessons For European Law Making?' (2008) in Horst Eidenmüller and Eva-Maria Kieninger (eds), *The Future of Secured Credit in Europe* (2008) 1, 22; LoPucki (1994) (n 20) 1921; Teemu Juutilainen, *Secured Credit in Europe: From Conflicts to Compatibility* (Bloomsbury Publishing 2018) 1.

²² Eric Dirix, 'Remedies of Secured Creditors outside Insolvency' in Horst Eidenmüller and Eva-Maria Kieninger (eds), *The Future of Secured Credit in Europe* (2008) 223; Armour, (n 21) 19; Moritz Brinkmann, 'The Position of Secured Creditors in Insolvency' in Horst Eidenmüller and Eva-Maria Kieninger (eds), *The Future of Secured Credit in Europe* (2008) 249; LoPucki (1994) (n 20) 1921.

²³ Westbrook (2014) (n 4) 805 notes as follows: ("(...) the vast and sophisticated literature of secured-credit and bankruptcy law has focused almost exclusively on questions of priority, rather than on the problem of control of the process by which seizure, sale, and distribution are achieved."); See also, Gerard McCormack, *Secured Credit under English and American Law* (Cambridge University Press 2004) 7.

²⁴ Katharina Pistor, *The Code of Capital: How the Law Creates Wealth and Inequality* (Princeton Press 2019).

²⁵ In EU legal system, there is not harmonized field of security rights. There are initiatives concerning the harmonization of secured transactions, among which the Draft of a Common Frame of Reference (DCFR) is a well-known source. See for more detail Wolfgang Faber, 'Proprietary Security Rights in Moveables-European Developments: A Spotlight Approach to Book IX DCFR' (*Juridical International*, 22/2014) <https://www.juridicalinternational.eu/article_full.php?uri=2014_22_27_proprietary-security-rights-in-movableseuropean-developments> accessed 10 April 2022.

intangible (i.e. intellectual property) transferable assets.²⁶ As a result of this, the encumbrance of all or almost the entire assets of a corporation is a common practice.²⁷

Once a debtor defaults, secured creditors' control of the process of recovery and their priority over proceeds of encumbered assets may depend on whether the attempt thereto by the secured creditor takes place inside or outside of a formal insolvency procedure.

Outside of a formal insolvency procedure, secured creditors have strong control over the recovery process. Upon the debtor's default, secured creditors are commonly entitled to enforce their security interests through a public sale auction or private sale of collateral. U.S., Dutch and German legal systems require only minimal or no court involvement in such procedures.²⁸

Inside of formal insolvency procedures, there may be restrictions on secured creditors' control of collateral and the remedies they could invoke outside of such proceedings. Depending on the enforcement procedure, there might be alternations on how secured creditors can enforce their security rights and take control over the recovery process. Liquidation is a collective formal insolvency procedure. The general goal of collective insolvency proceedings is to maximize the firm's value for the interest of the entire body of creditors.²⁹ In order to achieve this goal, insolvency proceedings may override the remedies of individual creditors outside of a formal insolvency procedure.³⁰ U.S. and German legal systems impose restrictions on individual enforcement actions of secured creditors in liquidation proceedings. In these legal systems, the trustee/administrator plays a key role in selling the entire assets, either as a piecemeal or going concern.³¹ Under Dutch law, however, secured creditors are entitled to independently exercise their preferential recovery rights as if there is no liquidation proceeding.³² Alternatively, it is possible that the secured creditor and the trustee agree that the latter sells the collateral and pays the sale price to the secured creditor.

Next to the liquidation proceeding, the other collective insolvency law mechanism is reorganization. Due to the distinguished nature of reorganization proceedings that is discussed in the subsequent section (§ 3), the position of secured creditors may considerably differ from their position outside of a formal insolvency proceeding and in liquidation.

²⁶ See for instance, as to U.S. law, articles 9-204 and 9-109 the Uniform Commercial Code (UCC); Jason Fu, 'Floating Charge and Blanket Liens' (2019) *International Corporate Finance E-Journal*. As to German law see Sections 1273 et seq. *Bürgerliches Gesetzbuch* (hereinafter BGB).

²⁷ The discussion as to the requirements to make a security interest enforceable against the debtor and third parties is out of the scope of this paper.

²⁸ As to U.S. law, see in particular part 6 of Article 9 UCC. As to Dutch law see Section 3:248, Section 3:251 (1), Section 3:250, Section 3:268 (5) *Burgerlijk Wetboek* (hereinafter BW). As to German law see Section 1228 BGB, Section 1246 BGB, Section 1147 BGB; Section 15 *Zwangsversteigerungsgesetz* (hereinafter ZVG).

²⁹ Jackson (n 1); For more elaborate discussion see also, Rolef J de Weijts, Aart Jonkers and Maryam Malakotipour, 'Imminent Distortions of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority' (RPR)' (2019) *Tijdschrift voor Belgisch Handelsrecht* 477.

³⁰ Douglas Baird and Thomas H Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 (1) *University of Chicago Law Review* 97, 101.

³¹ While in the U.S., secured creditors are entitled to the full proceeds from the sale of collateral, under German law, certain costs and administration expenses that are related to the disposition of the encumbered asset or a claim shall be credited before the distribution of the sale proceeds to the creditor. Sections 170 and 171 German Insolvency Code, *insolvenzordnung* (InsO) and Section 10 ZVG.

³² Section 57 (1) *The Dutch Bankruptcy Act, Faillissementswet* (Fw). The Dutch Bankruptcy Code imposes only few conditions in this respect. See also Sections 58, 101 and 176 Fw.

3 Conceptualization of main issues surrounding security rights in reorganization

The general framework of reorganization proceedings under U.S. Chapter 11 Bankruptcy Code, the EU Directive, the WHOA and the StaRUG is comparable. The existence of several tools in reorganization allow firms to retain a higher going concern value in excess of the liquidation value. The common examples of such tools are the possibility to impose a stay on individual enforcements, continuation of business during the proceeding, the right of the debtor to remain in possession of assets, interim financing; the possibility to use, sell, or lease assets, a debt for equity swap, and the possibility to enforce a reorganization plan against the dissenting vote of a voting class (“the cross-class cramdown”). In this light, a reorganization procedure, in order to be effective in achieving its goal, may demand curtailing the rights of creditors. Among creditors, secured creditors may be affected the most.

In view of some scholars, “bankruptcy law necessarily overrides the remedies of individual investors outside of bankruptcy, for those “grab” rules undermine the very advantages sought in a collective proceeding.”³³ The other side of the coin is how can the core features of security interests—the priority right over proceeds of collaterals and effective enforcement of security rights—be upheld in reorganization proceedings?³⁴

This section focuses on three main tensions in context of the regulation of security rights in reorganization procedures. Two points concern the concept of adequate protection of secured creditors and priming under interim financing. These two matters address the tension between the facilitation of reorganization and a possible negative impact on value recovery of secured creditors. The third point is the value entitlement of secured creditors. This point focuses on the tension between maximization of reorganization value for the interest of the general body of creditors and the determination of the value entitlement of secured creditors. These two are most heavily debated, but the third is the most important and will also precede the other two. Therefore, in addressing these three questions, the following order will be applied: I) what is the possible value entitlement of secured creditors in reorganization proceedings? II) are the interests of secured creditors adequately protected against potential negative impacts of imposing restrictions on their individual enforcement rights? III) do legal systems recognize the concept of priming? The remainder of this section highlights the theoretical debates and issues with respect to the three core issues surrounding security rights in reorganization proceedings.

3.1 The value entitlement of secured creditors in reorganization

Reorganization proceedings facilitate the possibility to capture a higher value for distribution among creditors involved in such proceedings. Where there are no distributional rules in place in reorganization proceedings, the maximization of the total value through such procedures would be detrimental to the parties that could have realized a higher value in liquidation or through alternative possibilities. In this light, it is not uncommon in reorganization regimes to

³³ Baird and Jackson (1984) (n 30) 101. See also Bob Wessels and Stephan Madaus, *Instrument of the European Law Institute Rescue of Business in Insolvency Law* (European Law Institute 2017) para 376 (hereinafter, ELI Report)

³⁴ Reinhard Bork, *Rescuing Companies in England and Germany* (Oxford University Press 2012) para 14.19 notes, “the economic sustainability of the secured creditor’s legal position forbids his rights being curtailed, set aside, or placed at the mercy of a majority vote.”

guarantee each stakeholder the realizable value from a hypothetical liquidation proceeding. Based on the benchmark “no creditor worse off principle”,³⁵ each creditor can insist on receiving at least as much under the plan as they would receive in a liquidation case or the next best alternative scenario. While the benchmark no creditor worse off principle sets the recovery floor, it may not be an indicative norm as to the value entitlement of secured creditors in reorganization proceedings. In principle, the possible value entitlement of secured creditors in a reorganization procedure can be classified into four main categories.³⁶

- i) The piecemeal liquidation value
- ii) The going concern liquidation value
- iii) The fair market value of encumbered assets³⁷
- iv) The full reorganization value

The *piecemeal liquidation value* entitlement (scenario i) provides secured creditors with a priority right over other junior stakeholders as to the sum of the value of the respective encumbered assets in a liquidation proceeding. Generally, the piecemeal liquidation entitlement generates lower proceeds compared to the other three categories. The main reason is that the individual value of assets may not be worth as much as they would generally be valued when they are sold together.

The *going concern liquidation value* of encumbered assets (scenario ii) is the value of the assets to a prospective owner that is willing to purchase the business as a going concern in liquidation.³⁸ The common element between the two approaches lies in the fact that the sale of assets is assumed to take place in a hypothetical liquidation proceeding. When a distressed company’s assets are sold in a liquidation proceeding, the property is exposed to the relevant markets for a shorter than the normal timeframe, with minimal advertising and less time to assure the highest bid is received.³⁹

³⁵ “The best interest of creditors” test may be used as an alternative term to no creditor worse off principle.

³⁶ Sebastian van den Berg, ‘de Waarde van het onderpand onder de WHOA (on)terecht gebaseerd op liquidatiewaarde?’ (2020) 31 Tijdschrift voor Insolventierecht.

³⁷ See for instance, Jay E Fishman, Shannon P Pratt, and William J Morrison, *Standards of Value: Theory and Applications* (2nd edition, John Wiley & Sons, 2013). On p. 22 the authors note that the most common valuation definition of fair market value is “[...] the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” According to Garner, *Black’s Law Dictionary*, 1587, fair market value is defined as “the price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm’s length transaction; the point at which supply and demand intersect.” For other sources of definition of market value of assets see for instance, Tollenaar (2019) (n 1) 104. Tollenaar states that the market value of assets is “the highest price in cash that would be agreed between a willing hypothetical buyer and a willing hypothetical seller who are sufficiently and similarly informed in an open and unrestricted market (in which all potential buyers are approached) and are under no compulsion to buy or sell.”

³⁸ Fishman, Pratt, and Morrison (n 37) use the terminology of “investment value”. On p. 24, they note that investment value “considers the owner’s (or prospective owner’s) knowledge, abilities, expectation of risks and earning potential, and other factors. Investment value often considers synergies available to a specific purchaser.” It should, however, be noted that the terminology of investment value is not specifically used to refer to value of assets in liquidation proceedings.

³⁹ Michael Crystal and Riz J Mokal, ‘The Valuation of Distressed Companies: A Conceptual Framework’ (SSRN 2006) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=877155> accessed 05 February 2022; Crystal and Mokal note that the market value of asset reflects the value “when assets are individually exposed to the relevant markets through a suitably lengthy and extensive process of advertising, where reasonable efforts are made to identify potential purchasers, and where an appropriate level of negotiations is carried on with the identified parties in order to obtain the best price.” It should be noted that some legal systems provide for pre-package sale of underlying assets, generally a sale of the business, which changes the timing of events in an assets sale. In a pre-package sale, the debtor has the right to privately make an agreement with a potential buyer for the sale of underlying assets prior to the filing for a liquidation proceeding. The sale, however, would be executed after opening insolvency by the administrators. The pre-package sale of business is meant to provide for a more

As opposed to the first two categories, the *fair market value* entitlement of secured creditors (scenario iii) assumes that the sale of underlying assets takes place in an orderly course of business, with normal exposure at their appropriate secondary market.⁴⁰ Secured creditors may be granted with a higher priority entitlement compared to the first two concepts, which both assume the sale of assets in an insolvency proceeding.

Finally, according to the *full reorganization value entitlement* of secured creditors perspective (scenario iv), where all assets are encumbered, secured creditors would have a priority right as to the entire reorganization value of the business, up to the amount of their claim. The reorganization value is the enterprise value of the business on the promise that the business is continued as a going concern in accordance with a proposed reorganization plan. The reorganization value of a business would typically yield a higher value compared to the other three described values due to the distinct mechanism in reorganization. The most important legal consequence of reorganization is that the legal entity remains in place. As a result, the value of contracts or soft assets that cannot be sold or transferred to a buyer when the debtor is declared insolvent would be preserved in reorganization. Clear examples of soft asset that can be kept only if the legal entity itself is kept in place are landing rights for airlines or permits for selling certain goods on licenses to operate a business. Reorganization may also provide for the possibility to retain a higher value in cases where there is an illiquid market to sell assets.⁴¹ This excess value that can only be created in reorganization is generally referred as the reorganization surplus value.⁴²

The discussions as to the value entitlements of secured creditors become more clear where the entire (prepetition) assets of a debtor are encumbered. The hypothetical example in the subsequent section demonstrates the competing approaches and possible outcomes.

3.1.1 Possible value entitlement of secured creditors in a hypothetical case

Assume a viable high-tech firm is in financial distress and files for a reorganization proceeding. A secured creditor has a total claim of 20 against the debtor and she holds security interests on all (prepetition) assets of the firm. In addition, unsecured creditors, including bondholders and suppliers hold a total claim of 26 against the debtor. The reorganization value of the firm is

orderly sale of assets to generate higher returns for creditors. Nevertheless, the direct costs of insolvency such as the administrator's fee may result in receiving lower priority entitlement compared to the other two approaches, namely the fair market value of encumbered assets and full reorganization value entitlements.

⁴⁰ See for instance, Fishman, Pratt and Morrison (n 37) 29; Tollenaar 2019 (n 1) 105.

⁴¹ Lucian A Bebchuk, 'A New Approach to Corporate Reorganizations' (1988) 101 Harvard Law Review 775, 776.

⁴² There is a lack of a harmonized approach as to the determination of the reorganization surplus value. For the purpose of this paper the reorganization surplus value refers to a value that can be only realized in a reorganization proceeding through the distinct mechanism of reorganization and cooperation of stakeholders. In some literature, however, the surplus value reflects the difference between a piecemeal liquidation value of assets and the expected going concern value in reorganization. See, for instance, Aart L Jonkers and Robert van Moorsel, 'WVOA voor iedereen, verdeel de bankbonus' (2019) 17 Ondernemingsrecht 944; Adler (2015) (n 4). Another approach is to consider the difference between a going concern liquidation value and a going concern value in reorganization as surplus value. See for instance, Douglas G Baird and Thomas H Jackson, 'Bargaining after the Fall and the Contours of the Absolute Priority Rule' (1988) The University of Chicago Law Review 738, fn. 33; van den Berg (n 36)

expected to be 25. The figure below illustrates the interim balance sheet of the firm based on its (going concern) reorganization value, before imposing haircuts and debt-equity swaps.⁴³

Interim balance sheet in reorganization

ASSETS	EQUITY & LIABILITIES
25	Secured creditor 20
	Unsecured creditors 26
	Equity -21
TOTAL 25	TOTAL 25

Figure 1: This balance sheet illustrates the capital structure of the firm, rather than the possible value entitlement of stakeholders. Therefore, in this figure the size of the balance sheet does not match the values.

The focus of this case is on bringing clarity to the value entitlement of the secured creditor at this stage. For this reason, I present the case as an allocation of value between creditors, and for these preliminary analyses, assume no value goes to the shareholders. In addition, the assumption in this case is that claim bifurcation takes place. On this basis, the secured creditor would only have a priority right over other creditors up to the value of its collateral. For the remaining of its claim, if there is any, the secured creditor would have an unsecured claim. Furthermore, illustrations as to the application of the no creditor worse off test and the distribution of value on the basis of a priority rule is out of the scope of the present case. Hence, this example assumes the value recovery of the unsecured creditors would be negligible in an alternative scenario (i.e. liquidation) and the secured creditor would be only entitled to the piecemeal liquidation value of its collateral on the basis of the no creditor worse off test. The additional assumption is that the remainder of the reorganization value is distributed among unsecured claimholders on a pro rata basis.

The question that arises in this context is to which part of the reorganization value the secured creditor can claim priority over the bondholders and the suppliers? As discussed in the previous section, there can be at least four different possible value entitlements, namely i) the piecemeal liquidation value, ii) going concern liquidation value, iii) the fair market value of encumbered assets and iv) the full reorganization value.

Assume that the piecemeal liquidation value, which is the total distress sale value of the assets, is 4. If one considers the value of the security rights to be equal to the piecemeal liquidation value of the assets (scenario i), the secured creditor would have a priority right over piecemeal liquidation value (4).

⁴³ In the figures, the U.S. accounting practice of listing Equity at the bottom is used, rather than the European approach of listing Equity on the top. The former is more in line with the waterfall distribution on value.

i) Interim balance sheet in reorganization based on piecemeal liquidation value entitlement of the secured creditor

ASSETS	EQUITY & LIABILITIES
4	Secured creditor 20
21	Unsecured creditors 26
	Equity -21
TOTAL 25	TOTAL 25

Figure 2

On the basis of this approach, the remainder of the reorganization value ($\Delta_1 21$) would be available for distribution among unsecured claimholders, namely the bondholders, the suppliers and the secured creditor to the extent that its claim is not secured. In this case, the payout to the unsecured claimholders would be 50%.

If the underlying assets are sold together through a going concern sale in a liquidation proceeding, the total value of the assets could be 12. The reason that the value of the assets is higher from the perspective of a prospective buyer could be due to the existence of highly specialized assets that are customized in accordance with the needs of that specific firm and the synergies available to the purchaser. If one equates the value of the security rights with the going concern liquidation value of the assets (scenario ii), the secured creditor would have a priority right over the going concern liquidation value (12).

ii) Interim balance sheet in reorganization based on going concern liquidation value entitlement of the secured creditor

ASSETS	EQUITY & LIABILITIES
12	Secured creditor 20
13	Unsecured creditors 26
	Equity -21
TOTAL 25	TOTAL 25

Figure 3

Based on the second approach, the remainder of the reorganization value ($\Delta_2 13$) would be available for distribution among the unsecured claimholders, which would lead to the payout of approximately 38.2%.

Alternatively, when assets are sold in an ordinary course of business, where they are individually exposed to the relevant market through extensive advertising and there is enough

time to identify prospective buyers and engage in negotiations to obtain the best price, the fair market value of the assets would be 16. In this light, if one considers the value of the security rights be equal to the total fair market value of the assets (scenario iii), the secured creditor would have a priority right over the market value of the assets (16).

iii) Interim balance sheet in reorganization based on market value entitlement of the secured creditor

ASSETS		EQUITY & LIABILITIES	
16		Secured creditor	20
9		Unsecured creditors	26
		Equity	-21
TOTAL	25	TOTAL	25

Figure 4

On the basis of this approach, the remainder of the reorganization value ($\Delta_3 9$) would be available for distribution among the unsecured claimholders, which yields to the pay out of 30%.

If in this hypothetical example, one would equate the value of the creditor's security rights with the reorganization value of the firm (scenario iv), the secured creditor would be entitled to recover the entire claim (20) ahead of other creditors. This would be the highest possible value that the secured creditor could capture in reorganization.

iv) Interim balance sheet in reorganization based on full reorganization value entitlement of the secured creditor

ASSETS		EQUITY & LIABILITIES	
20		Secured creditor	20
5		Unsecured creditors	26
		Equity	-21
TOTAL	25	TOTAL	25

Figure 5

In this case, the remainder of the reorganization value ($\Delta_4 5$) would be available for distribution among the bondholders and the suppliers, which would result in the payout of 19.2%.

This simplified example illustrates the wide range of possible outcomes that can be achieved as to the distribution of the reorganization value, depending on the choice between the possible approaches as to the determination of the value entitlement of secured creditors.

3.2 Adequate protection of secured creditors

The second core issue surrounding security interests in reorganization proceedings is the protection of the value of encumbered assets against potential negative impacts of imposing restrictions on their individual enforcement rights. Under U.S. law this is usually referred to as “adequate protection”.

In order to maximize value in reorganization, legal systems may impose restrictions to the security rights of creditors. Reorganization regimes may prevent individual enforcements that possibly diminish the going concern value of the debtor.⁴⁴ In addition, reorganization regimes may enable the debtor to use, sell, or lease the collateral in the continuing operation of the business during reorganization. Imposing constraints may not be limited to the period during reorganization, but also after the proceeding. The importance of recognizing such restrictions to the right of collateral enforcement by secured creditors has gained prominence in the current economic lending community where a secured creditor may have a security interest on all assets of a debtor.⁴⁵ In the absence of such a possibility, a reorganization regime is at the risk to convert into an asset foreclosure mechanism.

The risk of allowing a debtor to use, sell or lease encumbered assets during a reorganization proceeding is that the amount and the value of collateral may decline. This issue is more prominent with respect to certain sorts of assets which might be of a finite quantity or consumed at a faster rate than can be replaced. In addition, even if the debtor does not use or consume encumbered assets during a reorganization proceeding, the value of assets may not stay stable due to market fluctuations in the period between filing for reorganization and finalizing the proceeding. A possible decline in the value of encumbered assets may have an impact on the value entitlement of secured creditors. In this respect, several contentious issues may arise.⁴⁶

The first concern is how to determine a proper benchmark value in order to set the value that should be protected. The follow-up question is whether the value entitlement of secured creditors can be considered as a proper benchmark to protect secured creditors against a potential decline in the value of underlying assets.

The second issue is whether the debtor should be under a duty to protect the value of collateral or whether secured creditors have to actively request for a protection. If the latter is the case, would the value to be protected be the value of the interest as of the petition date or the date of the request for protection?

An equally fundamental point revolves around the rights of secured creditors whose collateral declines in value during reorganization. Can secured creditors foreclose on the respective

⁴⁴ ELI Report (n 33) para 376: In formal (restructuring and insolvency) proceedings, a stay must to the full extent also allow for organising negotiations and deciding on rescue options (plan or going concern sale). Here a stay should: completely stop enforcement actions of creditors (including the tax authority); ban the realisation of assets by secured creditors (...).”

⁴⁵ Harner (2015) (n 6) 515. See also Ayotte and Morrison (n 12) 513; Baird (2015) (n 2) 850.

⁴⁶ See generally, Nick Segal, ‘The Effect of Reorganization Proceeding on Security Interests: The Position Under English and U.S. Law’ (2007) 32 (3) Brooklyn Journal of International law 927, 950-954; Baird (2015) (n 2).

collateral to avoid further deterioration in value or would they instead have to be provided with alternative safeguards to be compensated for the loss in the economic value of the underlying assets?

3.3 Priming under interim financing

The third issue related to security interests in reorganization proceedings is that whether the law allows and should allow for a priming lien. In a reorganization proceeding, the DIP may have access to funds in order to continue the day-to-day operations of the business. Generally, the available funds are exhausted and the expected stream of cash flows may be insufficient for this purpose. Therefore, in such a case, the DIP may seek interim financing from third parties. It might be extremely difficult and time consuming for a debtor to persuade a third party to invest unless the lender is ensured that she is sufficiently protected against the possible unsuccessful reorganization attempt of the debtor. When there are unencumbered assets or postpetition assets, the debtor would, only if it is possible as a matter of law, grant security interests in such assets to the interim financier. However, in reorganization, the debtor is unlikely to hold any or sufficient unencumbered assets to grant an interim financing lender a security right.⁴⁷ In this light, some reorganization regimes allow debtors to create a security right that ranks ahead of a pre-existing security right in the same asset in order to facilitate access to interim financing.⁴⁸ In fact, reorganization regimes face a trade-off between two competing interests. On the one hand, the aim is to facilitate access to interim financing, for instance, by allowing debtors to create priming liens. On the other hand, one of the core features of security interests, which is the priority over proceeds of encumbered assets, is at stake. The question that arises is what legal protections do legal systems provide secured creditors whose prepetition security interests are affected in case of priming?

4 The position of secured creditors in reorganization

This section compares how the U.S., EU, Dutch and German law systems have responded to the questions on the value entitlement of secured creditors (§4.1), adequate protection of security rights (§4.2) and the position of secured creditors in case of interim financing (§4.3), respectively.

4.1 The value entitlement of secured creditors in reorganization: full value or not?

4.1.1 U.S. law

Under U.S. law, secured creditors that hold security interests on the entire prepetition assets of a debtor cannot claim the full reorganization value. One of the distinguished elements of the U.S. Bankruptcy Code is that it encompasses provisions concerning the extent to which prepetition security interests can be extended to assets that are acquired postpetition. According to the U.S. Bankruptcy Code, prepetition security interests can only be extended to the "proceeds, product, offspring, or profits" of the property that is secured prepetition.⁴⁹ Two

⁴⁷ Charles J Tabb, 'What's Wrong with Chapter 11' (2019) (University of Illinois College of Law Legal Studies Research paper 19-15) 1, 14.

⁴⁸ For more elaborated discussions see, Sandeep Dahiya and Korok Ray, 'Evaluating Debtor in Possession Financing' (2017) 34 Emory Bankruptcy Development Journal 57.

⁴⁹ Section 552 (a) U.S. Bankruptcy Code cuts off blanket liens in bankruptcy, based on which property that is acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any prepetition security agreement. This provision is subject to the exception stipulated in the first limb of Section 552 (b) U.S. Bankruptcy Code.

limitations to this general rule are stipulated in the second limb of Section 552 (b) and Section 506 (c). According to Section 552 (b), the court may treat the secured creditor's prepetition lien differently "based on the equities of the case."⁵⁰ The aim of this provision is to prevent windfalls for secured creditors and to give the courts broad discretion "to find an appropriate balance between the rights of secured creditors and the rehabilitative purposes of the Bankruptcy Code."⁵¹ There is generally limited case law in relation to Section 552 (b)⁵² as in practice the DIP often waives its right or stipulates that such equities do not exist in connection with postpetition financing or the use of cash collateral.⁵³ Based on the second exception—Section 506 (c) U.S. Bankruptcy Code—the DIP may recover from collateral the reasonable, necessary costs and expenses that are incurred to protect collateral.⁵⁴ Similar to the case of Section 552 (b), the DIP generally waives the right to surcharge collateral under Section 506 (c) and in exchange they enter into a court-approved carve-out agreement to recover certain costs and claims from the proceeds of collateral.⁵⁵

The U.S. Bankruptcy Code also encompasses rules concerning the determination of collateral value. As will be discussed below, overall, due to the high degree of flexibility as to the application and interpretation of the rules, there is no uniform approach in the U.S. concerning the determination of the precise value entitlement of secured creditors. While some courts only consider the piecemeal and going concern liquidation value of collateral as possible baselines (scenarios i and ii), some other courts do not exclude the possibility of determining the secured claims of creditors on the basis of the fair market value of collateral (scenario iii). Nevertheless, the recent trend of cases is moving towards the direction that, in certain instances, judges have the tendency to equate the secured claim of creditors with the fair market value of collateral.

In the U.S., there is also a mismatch between the view of the legislator on the distribution of value in reorganization and practice. Secured creditors, holding security interests on all prepetition assets of a debtor, generally sale the entire business as a going concern in the context of reorganization proceedings. In this case, the proceeds from the going concern sale of the business, which can be categorized as the higher end of the fair market value of collateral, are captured by the secured creditors and other creditors are remained empty-handed in reorganization.

Elaborated discussions with respect to these provisions can be found in Jacoby and Janger (n 6); Brubaker (2014) (n 7); Frost (n 4).

⁵⁰ ABI (n 9) 232-233 notes in assessing the equities of the case, courts generally consider three elements, which are "(i) the amount of time and estate funds that is spent on the collateral; (ii) the relative position of the secured party following the expenditure of estate time and money (i.e., whether the collateral has been enhanced); and (iii) the rehabilitative nature of the bankruptcy case. See *In re Laurel Hill Paper Co.*, 393 B.R. 89, 93 (Bankr. M.D.N.C. 2008).

⁵¹ The Fourth Circuit in *United Va. Bank v. Slab Fork Coal Co.* (*In re Slab Fork Coal Co.*), 784 F.2d 1188, 1191 (4th Cir. 1986), *cert. denied*, 477 U.S. 905 (1986); Jacoby and Janger (n 6) 727.

⁵² The existing case laws have taken contradictory approaches in this regard. See for instance, *Official Comm. of Unsecured Creditors v. UMB Bank, N.A.* (*In re Residential Capital, LLC*), 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013); *re Buffets Holdings Inc.*, 387 B.R. 115 (Bankr. D. Del. 2008); ABI (n 9) 232.

⁵³ ABI (n 9) 232.

⁵⁴ Section 506 (c) U.S. Bankruptcy Code; Senate report no. 95–989.

⁵⁵ Baird (2015) (n 2) 862 notes: "[q]uestions about whether other assets were used to enhance the value of the collateral do not arise because of the section 506(c) waiver given when the carve-out is negotiated." The use of carve-outs as Section 506 (c) U.S. Bankruptcy Code waiver has been highly criticized in *re Tenney Village Co., Inc.*, 104 B.R. 562, 567 (Bankr. D.N.H. 1989); ABI (n 9) 228.

4.1.1.1 The value entitlement of secured creditors: Sections 506 (a) and 1111 (b) (2) U.S.C. Under U.S. law, the “best interest of creditors” test sets the minimum value entitlement of creditors. The best interest of creditors test is meant to ensure that each individual creditor is compensated for the time value of the money that they would receive in a hypothetical liquidation scenario—a piecemeal or going concern sale. Pursuant to Section 1129 (a) (7) U.S. Bankruptcy Code and case law, a reorganization plan satisfies the test if the creditor receives “property that has a present value equal to that participant’s hypothetical Chapter 7 distribution if the debtor were liquidated instead of reorganized on the plan’s effective date.”⁵⁶ On the basis of this approach, secured creditors would be compensated for the time value of the money that they could have received in a liquidation proceeding.

As to the determination of the value entitlement of secured creditors on account of holding security interests, the Bankruptcy Code provides for two alternative options. The first possibility is claim bifurcation (Section 506 (a)). The second possibility is to invoke the right of election (Section 1111 (b) (2)).

Pursuant to Section 506 (a) U.S. Bankruptcy Code, the value of the secured claim of secured creditors has to be determined in light of the purpose of the valuation and of the proposed disposition or use of such property. According to the legislative history of Section 506 (a), “value does not necessarily contemplate forced sale or liquidation value of the collateral; nor does it imply a full going concern value. Courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case.”⁵⁷ In this respect, generally courts make a choice between the i) piecemeal liquidation value ii) going concern liquidation value and iii) the fair market value of encumbered assets. For the remainder of their claim, if there is any,⁵⁸ the creditors would have unsecured claims.

The judicial view on interpretation of Section 506 (a) is split. Some courts argue that in reorganization cases secured creditors are still entitled to the liquidation value of their collateral as the debtor is operating in bankruptcy.⁵⁹ Justice Stevens, notes “section 506 (a) provides the secured creditor only what it would get if the collateral were repossessed.” Justice Stevens asserted that the fair market value would give a windfall to undersecured creditors. According to this interpretation, the value of secured creditor’s collateral would be determined on the basis of either approach i) piecemeal liquidation value or approach ii) going concern liquidation value.

⁵⁶ In re SAI Holdings Ltd., No. 06-33227, 2007 WL 927936, 7 (Bankr. N.D. Ohio Mar. 26, 2007) (quoting 7 ALAN N. RESNICK ET AL., COLLIER ON BANKRUPTCY 1129.03[7][b] (15th ed. 2004)). In re River Glen Land P’ship, Case No. 14-32732, 2015 WL 588696, 8 (Bankr. E.D. Tenn. Feb. 11, 2015) (quoting In re Hockenberry, 457 B.R. 646, 653-54 (Bankr. S.D. Ohio 2011)).

⁵⁷ H.R.Rep. No. 95-595, (1977) 356; See also Adam J Levitin, *Business Bankruptcy: Financial Restructuring and Modern Commercial Markets* (Wolters Kluwer Law & Business 2018) 312.

⁵⁸ If the value of collateral, after deducting the expenses pursuant to Section 506 (c) U.S. Bankruptcy Code, is greater than the amount of the secured creditor’s claim, the creditor is oversecured. An oversecured creditor is entitled to postpetition interests on such claim and any reasonable fees, costs or charges provided for under the agreement or State statute under which such claim arose. See Section 506 (b) U.S. Bankruptcy Code; Elizabeth Warren, *Chapter 11: Reorganizing American Businesses* (Aspen publishing 2008).

⁵⁹ ABI (n 9) 212 notes “[t]he other issue that some other courts confront with is “whether a liquidation standard, if appropriate, should be analyzed on a forced-sale or orderly-sale basis.”

A contrary interpretation of ‘collateral value’ is provided by the Supreme Court in *Rash*⁶⁰—in the context of Chapter 13 U.S. Bankruptcy Code— which was subsequently reaffirmed by the bankruptcy court in *ResCap*, a Chapter 11 case.⁶¹ In *Rash* case, the Supreme Court held where under a proposed plan the debtor is going to retain collateral, relying on the fair market value of collateral accurately gauges the debtor’s use of the property.⁶² Therefore, on the basis of the Supreme Court’s interpretation, determination of the value of security rights on the basis of the fair market value of collateral (scenario iii) can be a possibility as well.

The alternative way of determining the value entitlement of secured creditors is the right of election under Section 1111 (b) (2) U.S. Bankruptcy Code. If collateral is not being sold, an undersecured creditor may elect to recognize the entire claim as a secured claim.⁶³ The right of election is meant to protect secured creditors from the undervaluation of collateral and enable them to enjoy future appreciation in the collateral or compensate for an initially low appraisal.⁶⁴

4.1.1.2 The distribution of the surplus value: Section 1129 (b) (2) (A)

As discussed earlier (§4.1.1.1), under the U.S. Bankruptcy Code, postpetition assets remain unencumbered unless they are the proceeds, product, offspring, or profits of the property that is secured prepetition. In addition, for the purpose of claim bifurcation, the highest possible value with which the secured claim of secured creditors may be equated is the fair market value of collateral. Therefore, under U.S. law, secured creditors do not have a priority claim over the full reorganization value.

Section 1129 (b) (2) (B), which formally articulates the Absolute Priority Rule (APR), regulates the distribution of the reorganization surplus value among classes of unsecured claimholders and shareholders. Based on the APR, a dissenting class of unsecured claimholders must “be paid in full before any lower ranking creditor or shareholder may receive anything under a reorganization plan.”⁶⁵ Subsequent to the U.S. Bankruptcy Code reform in 1979, the APR functions as a default distributional rule rather than the main rule. The APR only applies in relation to dissenting classes when there are disagreements among classes on the distribution of the reorganization surplus value. Hence, in the context of the U.S. Chapter 11, if creditors as groups consent, the prepetition shareholders can retain part or even all of the shares in the reorganized company.

In case of applying the APR, the ranking of classes is the key factor that determines the order of the surplus value distribution. The deficiency claims of undersecured creditors, which can

⁶⁰ *In Associates Commercial Corp. v. Rash* 520 U.S. 953 (1997).

⁶¹ *In re Residential Capital, LLC*, 497 B.R. 403, 412-13 (Bankr. S.D.N.Y. 2013).

⁶² *In Associates Commercial Corp. v. Rash* 520 U.S. 953 (1997). The Supreme Court used the term “replacement value’, which can be equated with the fair market value as in the Court’s view, both terms reflect “the price a willing buyer in the debtor’s trade, business, or situation would pay a willing seller to obtain property of like age and condition.”

⁶³ An undersecured creditor may opt for the right of election in order to be protected from the undervaluation of collateral and enjoy future appreciation in the collateral or compensate for an initially low appraisal. Section 1111(b)(1)(A)(ii), “expressly provides that recourse treatment is denied to a nonrecourse claim holder where the property securing the claim is sold under section 363 prior to confirmation or is to be sold under the plan of reorganization.” See also Brad B Erens and David A Hall, ‘Secured Lender Rights in 363 Sales and Related Issues of Lender Consent’ (2010) 18 ABI Law Review 535; ABI (n 9) ftm 152.

⁶⁴ Theodore Eisenberg, ‘The Undersecured Creditor in Reorganizations and the Nature of Security’ (1985) 38 Vanderbilt Law Review 931; Erens and Hall (n 63) 561-562 note “[a]n 1111(b) election protects a creditor against a quick sale of the property after a cramdown when the amount of the secured claim is determined at a time when the value of the property is temporarily depressed.”

⁶⁵ Baird and Jackson (1988) (n 42) 738.

be classified either separately from the class of general unsecured creditors or in the same class,⁶⁶ has a similar ranking to ordinary unsecured creditors' ranking.⁶⁷ As far as the relationship between dissenting creditors and shareholders is concerned, the notable consequence of the APR is that "when a firm owes more than its assets are worth, the shareholders receive nothing unless the creditors consent."⁶⁸ The Small Business Reorganization Act (SBRA) of 2019,⁶⁹ allows for deviation from the APR only under very limited circumstances. Based on the recent Act, the court may approve a plan that provides for retaining equity ownership over the objection of unsecured creditors as long as all projected disposable income of the debtor are proposed to be received under the plan within a three-year period or such longer period as the court may approve, which does not exceed five years.⁷⁰

In Chapter 11 reorganization procedures the practice has developed in a way through which secured creditors may have the possibility to circumvent the conventional reorganization plan procedure and the rules discussed regarding value distribution. Although Chapter 11 is geared towards reorganization of the debtor, the Chapter 11 proceeding has shifted from a traditional reorganization proceeding to a procedure that is mainly used as a process to sell all or substantially the entire assets of the enterprise pursuant to Section 363 U.S. Bankruptcy.⁷¹ The sale basically determines the maximum recovery that the parties involved in reorganization can attain.⁷² Subsequent to the sale of substantially all assets during a reorganization proceeding, the debtor would later submit a plan of liquidation providing for the distribution of the proceeds of the sale. Thanks to a section 363x sale, the legal entity would cease to exist. Therefore, in case of a section 363x sale, the surplus value that could be only captured as a result of the continuation of the legal entity through a conventional reorganization proceeding would not be captured any more. As a result, in cases, where a secured creditor holds security interests on the entire prepetition assets of a debtor, the creditor would be able to capture the proceeds from the sale, which can be equated with the higher end of the fair market value of collateral, without leaving any value on the table for distribution among other creditors.

The other mechanism through which secured creditors may inhibit the retention of the reorganization surplus value and capture the higher end of the fair market value of collateral is to adopt a loan-to-own strategy. Section 363 (k) Bankruptcy Code provides the secured creditor, whose collateral is offered for sale under Section 363 (b), with the right to 'credit bid' up to the amount of its debt claim to be protected against undervaluation of collateral. If the secured creditor is the highest bidder, the creditor would be permitted to off-set the value of

⁶⁶ The classification of the unsecured claims of undersecured creditors in a similar class as general unsecured creditors would increase the power of the former.

⁶⁷ There is a strong support of arranging the vertical order of the classes consistent with pre-insolvency priorities of the parties. See Bruce A Markell, 'A new Perspective on Unfair Discrimination in Chapter 11' (1998) 72 (2) American Bankruptcy Law Journal 227; Amy Timm, 'The Gift That Gives Too Much: Invalidating A Gifting Exception to The Absolute Priority Rule' (2013) University of Illinois Law Review 1649, 1650 states that "bankruptcy priority structure tracks the state law priority rights, or "place in line," that creditors bargained and paid for."

⁶⁸ Baird and Jackson (1988) (n 42) 738.

⁶⁹ Small Business Reorganization Act (SBRA) of 2019, Pub. L. No. 116-54, 133 Stat. 1079 (codified in 11 U.S.C. §§ 1181-1195 and scattered sections of 11 U.S.C. and 28 U.S.C.) The SBRA enacted a new Subchapter V of Chapter 11 of the U.S. Bankruptcy Code.

⁷⁰ Section 1191 (b) U.S. Bankruptcy Code.

⁷¹ See, for instance, Frost (n 4); Westbrook (n 4); Douglas G Baird and Robert K Rasmussen, 'Chapter 11 at Twilight' (2003) 56 Stanford Law Review 673; Harvey R Miller and Shai Y Waisman, 'Is Chapter 11 Bankrupt?' (2005) 47 Boston College Law Review 129; David A Skeel, Jr., 'Creditors' Ball: The "New" New Corporate Governance in Chapter 11' (2003) 152 University of Pennsylvania Law Review 917.

⁷² ABI (n 9) 202.

his interest against the purchase price of the property. On the basis of this rule, in cases where secured creditors have security interests on all prepetition assets of a debtor and they are undersecured, credit bidding is a strategy by which secured creditors have the chance to acquire all of the enterprise value of the debtor in satisfaction of their claim.⁷³ In such a case, instead of trying to maximize the sale price of its collateral, the creditor would be incentivized to prevent competitive bidding to acquire the debtor's assets solely through a credit bid of its prepetition secured loan, without additional investment.⁷⁴

4.1.2 EU Directive

EU law does not provide a decisive answer as to the question whether secured creditors can capture the full reorganization value or not. It also does not encompass rules concerning the extent to which prepetition security interests can be extended to postpetition assets. The reason for this is because in EU there is no unified system of security rights. Hence, the types of assets that can be encumbered and the extent to which security interests may extend to postpetition assets are regulated at national levels. Also, EU law does not encompass harmonized rules concerning value entitlement of secured creditors in reorganization. Under the Directive, member states are provided with a wide range of possible options to regulate the value entitlement of secured creditors, the application of each of which would lead to a diverse range of outcomes as to the value entitlements of secured creditors.

4.1.2.1 The value entitlement of secured creditors: Recital 44 and Section 10 (2) (d) Directive

As to the value entitlement of secured creditors, the Directive does not provide any specific rules. EU law does not mandate member states to implement the requirement of claim bifurcation into their national reorganization schemes. Also, member states that opt for a mandatory claim bifurcation requirement are not provided with further guidance concerning bifurcation of claims of secured creditors into secured and unsecured parts based on the value of underlying assets.⁷⁵ Therefore, member states, in addition to the decision of whether they want to impose a mandatory claim bifurcation requirement, in case of mandating claim bifurcation, have to decide if they want to provide rules concerning the determination of the value of encumbered assets or leave this matter to be decided on a case-by-case basis.⁷⁶

The Directive provides member states with the discretion to choose between one of the following thresholds to regulate the minimum value entitlement of creditors, including secured creditors.⁷⁷ Based on the Directive, unless a creditor agrees otherwise, no creditor may receive a value under the plan that is less than the value that such creditor could receive in the event of liquidation, which depending on the particular circumstances of each debtor, can be a piecemeal or going concern sale. The alternative option to implement the no creditor worse off test is to require that no dissenting creditor receives a value under the plan that is less than the

⁷³ Relevant Supreme court case in this regard, where the use of credit bidding as a mechanism to acquire the entire going concern value was not questioned by the Court is *RadLAX Gateway Hotel, LLC v. Amalgamated Bank (RadLAX)*, 132 S. Ct. 2065, 2073 (2012).

⁷⁴ Brubaker (2012) (n 7) 10; ABI (n 9) 202. See also, Ralph E Brubaker, 'The Post-RadLAX Ghosts of Pacific Lumber and Philly News (Part II): Limiting Credit Bidding' (2014) 34 (7) Bankruptcy Law Letter 1.

⁷⁵ Recital 44 Directive.

⁷⁶ Recital 45 Directive. According to Recital 42 Directive, national legislators should be able to require additional explanations in the restructuring plan concerning, for instance, the criteria of class formation, which may be relevant where there are undersecured claims.

⁷⁷ Section 10 (2) (d) in conjunction with recital 52 Directive.

value that the creditor would in the next best alternative restructuring plan scenario.⁷⁸ If a member state opts for the latter option, the respective national legislator may elaborate on the application of the rule, in particular, specify the criteria that have to be taken into consideration to determine the best alternative restructuring plan scenario.

4.1.2.2 The distribution of the surplus value: Section 11 (1) (c) and (2) Directive

EU law does not provide for a harmonized default distributional rule in a case where parties fail to reach a consensual agreement concerning the distribution of the going concern surplus value. One of the noticeable characteristics of the Directive is the introduction of the EU RPR as a preferred default distributional rule.⁷⁹ Pursuant to the EU RPR, “(...) dissenting voting class of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class.”⁸⁰ In other words, distribution of any value to junior stakeholders, such as shareholders is allowed as long as the dissenting senior classes are treated more favorably. The Directive does not provide further explanation on how the EU RPR distributes value among stakeholders.⁸¹ As the EU RPR stands now, the precise application of the rule is unclear under the Directive. In this light, further explanation and rules concerning the application of the EU RPR has to be elaborated by national legislators who choose to implement this default distributional rule.⁸²

The Directive allows for implementation of the APR by ‘way of derogation from the RPR’. Based on the APR, the dissenting class of creditors has to be paid in *full* before distributing any value to a lower ranking class.⁸³ Generally, the application of the APR leads to a different result compared to the EU RPR, which allows distribution of value to more junior classes as long as the dissenting classes above the junior class is treated more favorably.

In adopting the APR, member states “have discretion in implementing the concept of ‘payment in full’, including in relation to the timing of the payment, as long as the principal of the claim and, in the case of secured creditors, the value of the collateral are protected” as well as “the choice of the equivalent means by which the original claim could be satisfied in full.”⁸⁴ According to the Directive, certain creditors or shareholders should be able to retain value despite paying more senior dissenting classes in full. For instance, derogation from the APR is

⁷⁸ For the definition of the ‘best-interest-of-creditors test’ see Article 2 (6) Directive. See also recitals 49, 50 and 52 Directive. Pursuant to recital 63 Directive, “judicial or administrative authorities should only decide on the valuation of a business — either in liquidation or in the next-best-alternative scenario, if the restructuring plan was not confirmed — if a dissenting affected party challenges the restructuring plan. This should not prevent Member States from carrying out valuations in another context under national law.” For a general analysis as to this approach see Riz Mokal and Ignacio Tirado, ‘Has Newton Has His Day? Relativity and Realism in European Restructuring’ (2018/19) 20 Eurofenix. See also, Marcus Backes and Daniel Blankenburg, ‘Präventive Restrukturierung’ in Christoph Morgen (ed); Dominik Skauradszun, ‘Restructuring Companies During and After the Covid-19 Pandemic’ (2021) Nottingham Insolvency and Business Law e-Journal (NIBLeJ).

⁷⁹ According to the October 2018 version of the draft Directive (articles 5-6), the introduction of the EU RPR emanates from the Council’s concern to avoid imposing the burdensome and costly requirements of compliance with the APR. However, opponents of the EU RPR argue that this flexibility is at cost of certainty and fairness. See for instance, de Weijs, Jonkers and Malakotipour (n 29); Jonathan Seymour and Steven L Schwarcz, ‘Corporate Restructuring under Relative and Absolute Priority Default Rules: A Comparative Assessment’ 2021 (1) University of Illinois Law Review 1.

⁸⁰ Article 11 (1) (c) Directive.

⁸¹ For possible approaches as to the allocation of value based on the EU RPR see Madaus (2020) (n 6).

⁸² Madaus (2020) (n 6) provides guidance concerning the application and interpretation of the EU RPR.

⁸³ Article 11 (1) (c) and 11 (2) Directive. The APR is considered a rule of creditor protection. See for instance, In *Czyzewski v. Jevic Holding Corp*, US Supreme Court (137 S. Ct. 973) 22 March 2017 (*Czyzewski v. Jevic*) the US Supreme court considered the APR “as the cornerstone of reorganization practice and theory”. See also Jonathan C Lipson, ‘The Secret Life of Priority: Corporate Reorganization After Jevic’ (2018) 93 Washington Law Review 631.

⁸⁴ Recital 55 Directive.

possible where it is considered fair that equity holders keep certain interests under the plan or that that essential suppliers covered by the provision on the stay of individual enforcement actions are paid before more senior classes of creditors.⁸⁵

4.1.3 Dutch law

An overview of the history of the Dutch scheme shows that the legislator has actively taken steps toward clarification and limitation of the value entitlements of secured creditors in reorganization. While the WHOA does not encompass rules concerning the possibility to extend prepetition security interests to postpetition assets, it encompasses rules concerning the determination of the value that secured creditors can claim on account of holding security interests. The WHOA also regulates the allowed forms of distribution of such value to secured creditors. The matter that is unclear under the Dutch scheme is the determination of the circumstances under which deviation from the WHOA priority rule is allowed, which has to be decided by courts.

4.1.3.1 The value entitlement of secured creditors: Sections 374 (3) and 384 (3) Fw

Under Dutch law, the value that secured creditors can claim to receive on account of holding security interests in reorganization is the value that is expected to have been obtained by secured creditors in a bankruptcy (“faillissement”) case according to the legal ranking on the basis of their rights of pledge or mortgage. Based on the WHOA, the expected value entitlement in a bankruptcy scenario is a basis for determination of both the priority entitlement (Section 374 (3)) and the minimum value recovery of secured creditors (Section 383 (3)).

In accordance to Section 374 Dutch Bankruptcy Act, claim bifurcation is mandatory. On the basis of the third paragraph of this provision, the secured portion of the claim of secured creditors is determined by the value that secured creditors would expectedly receive in the event of bankruptcy on the basis of their security interests. For the remainder of their claim, if there is any, secured creditors would have an unsecured claim, which has to be classified in a separate class.

The no creditor worse off requirement under Section 383 (3) Dutch Bankruptcy Act sets the minimum entitlement of each creditor in case of restructuring. Based on the WHOA, if it appears that a dissenting creditor is *significantly* worse off than in the event of bankruptcy, the court can refuse confirmation of a proposed restructuring plan.⁸⁶ According to the legislative history of the WHOA, a mere comparison between the absolute value that a secured creditor is proposed to obtain and the value that the creditor obtains in cash in a hypothetical bankruptcy scenario, may not be sufficient for the purpose of the no creditor worse off test. Accordingly, if a plan proposes non-cash distribution such as a delayed or dispersed payment of the debt, the

⁸⁵ Recital 56 Directive. See also, Bob Wessels and Rolef J de Weijs, ‘Proposed Recommendations for the Reform of Chapter 11 U.S. Bankruptcy Code’ (2015) Amsterdam Law School Research Paper Number 2015-14, 16 note “[i]f the value of the company is closely related to the persons of the shareholders, who are possibly also the managers of the company, it becomes difficult to reorganize the company without their continued involvement.”

⁸⁶ Section 384 (3) Fw and Parliamentary Papers II 2018/19, 35 249, no. 3., 17 (EM). <https://www.bjutijdschriften.nl/tijdschrift/maandbladvermogensrecht/2020/6/MvV_1574-5767_2020_030_006_001/fullscreen> accessed 10 June 2022.

terms of the payment should be on “market terms”. This would mean that secured creditors have right to interest and the claim will continue to be covered by collateral.⁸⁷

Although the above described rules under the WHOA provide indications concerning the value entitlements of secured creditors, the determination of the value that secured creditors can expectedly receive in bankruptcy is by itself open to interpretation. Is the benchmark value based on a hypothetical piecemeal or going concern sale of the collateral in a bankruptcy scenario? In addition, given that in a Dutch bankruptcy proceeding there are several possible ways of foreclosing on collateral (i.e. public or private sale by the secured creditor or the trustee) the question that arises is which of the methods of collateral foreclosure should be used as a benchmark? An overview of the legislative history of the WHOA sheds further light as to how to understand the value entitlement of secured creditors, without answering all the questions.

The legislative history of the WHOA suggests that it has undergone noticeable developments in relation to the regulation of the value that secured creditors are entitled to claim in reorganization on account of holding security interests. In the first consultation version of the bill, “the private sale value of collateral” was suggested to be considered as a basis for valuation of security interests of secured creditors in reorganization. The private sale value of collateral would basically amount to the first category of collateral baseline value (scenario i).⁸⁸ In addition, secured creditors were suggested to have a cash-out option on the basis of the private sale value of collateral. Later, in the second consultation version of the WHOA, this proposal was removed.⁸⁹ The second consultation did not encompass specific rules concerning the value entitlements of secured creditors in reorganization and left the valuation basis open. Following interventions of members in parliament by means of proposed amendment in favor of strengthening the position of unsecured SME creditors,⁹⁰ the draft amendment of the WHOA was introduced. This early version of the draft amendment proposed to reel in the entitlements of secured creditors. The security right value was suggested to be the value that the secured creditors themselves could achieve in short term by exercising the right of private execution.⁹¹ The private execution of collateral within a short time would result in lower proceeds compared to alternative possibilities that secured creditors generally choose to foreclose on collateral in liquidation (i.e. foreclosure through the trustee).⁹² Against this background, in order to avoid the development of biasness in secured creditors against reorganization proceedings, this proposal was not pursued.⁹³ Instead, a watered down version of explicitly curbing the

⁸⁷ Eerste Kamer, Memorie van antwoord 2020/21, 35249, C, 4 (hereinafter Eerste Kamer).

⁸⁸ Wet continuïteit ondernemingen (WCO) II (14 August 2014) <<https://www.internetconsultatie.nl/wco2/details>> accessed 23 June 2022.

⁸⁹ Kamerstukken II 2019/2020, 35249, nr.3 <<https://zoek.officielebekendmakingen.nl/kst-35249-3.html>> accessed 23 June 2022.

⁹⁰ De ChristenUnie, de SP en de PvdA submitted the proposal for amendment. See also, Stieneke van der Graaf, ‘ChristenUnie strengthens the position of SMEs in reorganisations’ (ChristenUnie, 19 May 2020) <<https://www.christenunie.nl/blog/2020/05/19/ChristenUnie-maakt-positie-MKB-sterker-bij-reorganisaties>> 24 June 2022. This approach has been inspired from Jonkers and van Moorsel (n 42).

⁹¹ Kamerstukken II 2019/2020, 35249, nr.9.

⁹² The third consultation version of the WHOA provoked debates in literature. See, for instance, Jonkers and van Moorsel (n 42); Nicolaes Tollenaar ‘Amendementen op de WHOA – tikkeltje onbesuisd’ (2020) 23 Tijdschrift voor Insolventierecht 1; van den Berg (n 36); Frank M J Verstijlen, ‘Whoa: Omkering Van Waarden’ (2020) 27 Nederlands Juristenblad 1943, 1948-1950; Arpi Karapetian, Leos Lennarts and Frank M J Verstijlen, ‘De positie van concurrente schuldeisers in faillissement’ (Rapport aan het WODC uitgebracht door Rijksuniversiteit Groningen, 2020) (hereinafter WODC report)

⁹³ Reinout Vriesendorp and Omar Salah, ‘De WHOA: een nieuw herstructureringsinstrument’ (2020) 6 Maandblad voor Vermogensrecht 205.

entitlements of the secured creditors was proposed. Section 374 (3) ultimately opted for the value that is expected to have been obtained by secured creditors in a bankruptcy case as a basis. According to the Senate's memorandum, the yield expectation in case of bankruptcy, depending on the case at hand, can be either based on the continuity of business or complete discontinuity.⁹⁴

As it can be inferred from the legislative history of the WHOA, the legislator did not have the intention to entitle secured creditors to any value higher than the piecemeal or going concern liquidation value of collateral (scenarios i and ii) on account of holding security interests in reorganization. In the Netherlands, literature tries to tip the scales in favor of secured creditors. The argument is that in bankruptcy the execution is ideally conducted in a way that the highest possible proceeds are realized (i.e. private sale of assets as a going concern by the trustee). It is argued that in such a case, the secured creditors holding security interests on all assets of a debtor would recoup most of the value.⁹⁵ According to this viewpoint, the basis for valuation of secured creditors' security interests should be a value higher than the piecemeal or the going concern liquidation value of collateral (i.e. the fair market value of collateral (scenario iii)).⁹⁶ This standpoint can be criticized on two fronts. First, any viewpoint arguing a larger value entitlement for secured creditors is at odds with the law and the legislative history described earlier. Second, under Dutch law, secured creditors can always foreclose on the collateral individually (scenario i).⁹⁷ However, if secured creditors want to pursue a going concern scenario, there has to be a joint effort by both the trustee and the secured creditors. The very reason that the trustee may engage in private/public asset foreclosure is that the involvement would result in availability of sufficient fund to make a distribution to the liquidation state for the benefit of the *entire* body of creditors.⁹⁸ The additional argument in favor of secured creditors is that where the debtors' (encumbered) assets are not liquidated in reorganization, the secured claim of secured creditors should be based on the fair market value of collateral (scenario iii) because unlike a bankruptcy proceeding, they may not receive cash payments.⁹⁹ The shortcoming of this viewpoint is that it fails to make a distinction between the concept of no creditor worse off test (Section 384 (3)), and the value entitlement of secured creditors on account of holding security interest on the basis of Section 374 (3). The no creditor worse off principle has a broader scope. It aims to ensure that (secured) creditors are not in a worse *position* compared to their position in a liquidation proceeding. Therefore, the concern regarding the form of value distribution in reorganization would fall within the scope of the no creditor worse off principle, rather than Section 374 (3).

4.1.3.2 The distribution of the surplus value: Section 384 (4) Fw

As discussed above, in reorganization, the secured claim of secured creditors is determined based on the value that secured creditors were expected to receive in bankruptcy on account of holding security interests. Hence, under Dutch law, the reorganization surplus value remains unencumbered. The WHOA provides for default rules concerning the distribution of the reorganization surplus value. In the absence of a consensual plan, the court may confirm the

⁹⁴ Eerste Kamer (n 87) 6

⁹⁵ Verstijlen (n 92) 1948-1950; van den Berg (n 36); WODC report (n 92).

⁹⁶ See in particular, van den Berg (n 36).

⁹⁷ Section 57 Fw.

⁹⁸ Sections 179 and 180 Fw.

⁹⁹ Van den Berg (n 36); Tollenaar 2020 (n 92).

non-consensual plan provided that it complies with the four grounds stipulated in Section 384 (4) Dutch Bankruptcy Act, two of which— the 20% rule (Section 384 (4) (a)) and the WHOA priority rule (Section 384 (4) (b))— relate to the distribution of the reorganization surplus value. The third and the fourth requirements, Sections 384 (4) (c) and (d), relate to the allowed forms of value distribution.

4.1.3.2.1 The 20% rule

Under the WHOA, classes of SME trade creditors and tort claimholders are entitled to obtain 20% of the value of their claim from the reorganization surplus value.¹⁰⁰ The 20% rule was introduced in later consultation versions of the bill to provide for transparency and protect unsecured SME creditors from strategic and unnecessary write-offs, which may result from artificial undervaluation.¹⁰¹ According to the explanatory memorandum of the WHOA, on the one hand, the rule is in line with the objective of the WHOA to ensure smaller SME creditors who are suppliers of the debtor benefit from a restructuring agreement. On the other hand, the 20% rule is deemed to be fair since ordinary unsecured SME take a part in achieving the reorganization surplus value, their commitment to the company is essential for the survival of the company and this category of creditors have less scope for the damage that occurs as a result of the haircut to their initial claim.

4.1.3.2.2 The WHOA priority rule

Subsequent to the application of the 20% rule, the distribution of the remainder of the reorganization surplus value takes place in accordance with the WHOA priority rule. The priority rule under the WHOA concerns the distribution of the reorganization surplus value among unsecured classes of claimholders and shareholders. While the consultation version of the WHOA proposed inclusion of a priority rule similar to the APR in the U.S. Chapter 11, the priority rule changed at the last minute, without the reason being explained in the bill or the accompanying explanatory memorandum.

The WHOA priority rule contains the main rule and an exception to the rule. The WHOA priority rule provides for waterfall distribution of the surplus value, on the basis of which shareholders cannot claim any value before the creditors' claim are fully paid. A deviation from the legal or contractual order of priority is possible, where there are reasonable grounds for such deviation and the interests of the dissenting class are not harmed. While the initial draft amendment to the WHOA proposed to limit the options to deviate from the WHOA priority rule only in favor of shareholders that provide (non) financial market-based consideration,¹⁰² the House of Representatives in the Dutch parliament rejected the proposed amendment to provide flexibility in application of the rule. For this reason, as the law stands now, neither the WHOA itself nor the accompanying memorandum specifies the circumstances that deviation

¹⁰⁰ The 20% rule is only applicable to classes who are classified together in a separate class in accordance to Section 374 (2) Fw. The rule does not apply to (1) parties such as distressed debt buyers that have bought up receivables for less than 20% of the value, (2) financiers with a subordinated loan without security, (3) legal entities within the group that provide mutual financing, (4) shareholders who also have an unsecured claim on the debtor, and (5) bondholders. As to application of the 20% rule see also Kamerstukken II 2019/20, 35249, nr. 25 (amendment). See also Eerste Kamer (n 87); Section 375 §2 (f), (e), (g) Fw.

¹⁰¹ Neither Section 374 (2) nor Section 384 (4) (a) were included in the initial draft bill; Wet continuïteit ondernemingen (WCO) II (14 August 2014) < <https://www.internetconsultatie.nl/wco2/details> > accessed 23 June 2022.

¹⁰² Kamerstukken II, 35 249, nr. 11.

from the statutory order is allowed.¹⁰³ Hence, courts have the discretion to determine whether deviation from the waterfall distribution of the surplus value is allowed on a case-by-case basis.

4.1.3.2.3 *Forms of value distribution: (non) cash-out option*

In addition to the existence of a rule on value entitlement of secured creditors in reorganization, the WHOA regulates the types of payments that creditors can claim to receive. According to Section 384 (4) (c), unsecured classes of creditors are entitled to claim cash payment equal to the amount that they would have expected to receive in cash in a liquidation of the debtor's assets in bankruptcy. The right to claim cash payment does not exist with respect to dissenting classes of secured claimholders.¹⁰⁴ Based on 384 (4) (d) Dutch Bankruptcy Act, a dissenting class of secured claimholders should rather have the possibility to choose other non-cash forms of distribution. The WHOA has left the determination of acceptable non-cash forms of distribution open to be decided by the court. The exclusion of secured creditors from having the right to demand a cash-out payment is a noticeable amendment to the WHOA with respect to the entitlements of secured creditors in reorganization proceedings.¹⁰⁵ The underlying rationale for excluding secured creditors from the right to receive cash distribution is to prevent secured creditors from gaining a dominant position in reorganization proceedings as in Dutch bankruptcies they have an estimated recovery rate of 90%¹⁰⁶ while payments are almost never made to ordinary creditors.¹⁰⁷

4.1.4 German law

German law does not provide an explicit answer as to the question whether secured creditors can claim the full reorganization value or not. Nevertheless, the analogy between the StaRUG and the insolvency plan procedure under the InsO suggests that secured creditors are not entitled to claim the full reorganization value as the prescribed ranking order in the context of the InsO for the purpose of the distribution of the surplus value does not contain the class of secured creditors. In addition, based on the StaRUG, the value that secured creditors would receive without the plan indicates their entitlement in a reorganization proceeding. The legislator, however, has not provided explicit guidance as to the application of this rule. Therefore, the precise value entitlement of secured creditors under the StaRUG is yet unclear.

4.1.4.1 The value entitlement of secured creditors: Sections 26 (1) No 1, 64 (1) StaRUG

The StaRUG does not encompass specific rules concerning the value entitlement of secured creditors.¹⁰⁸ The relevant rule concerning the value entitlement of secured creditors is the prohibition of worse off treatment, which serves dual purposes. It is deemed as one of the conditions for application of the cross-class cramdown mechanism (Section 26 (1) No 1) and as a protection for individual dissenting voting parties (Section 64 (1)).

¹⁰³ For elaborated discussion see the WHOA priority rule and its implications on creditor protection see Wiepke Bartstra, Rolef J de Weijts and Aart Jonkers, 'WHAO-Priority Rule en WHOA-initiatiefrechten: Gat en schuldeiserbescherming bij reorganisaties' (2020) 26 (2) Tijdschrift voor Insolventierecht 96.

¹⁰⁴ Section 384 (4) (d) Fw.

¹⁰⁵ Section 384 (4) (c) and (d) Fw.

¹⁰⁶ Eerste Kamer (n 87).

¹⁰⁷ Ibid.

¹⁰⁸ The value of underlying collateral only indicates the voting right of the class of secured creditors that are holders of separate entitlements to determine whether the 75% majority requirement is achieved in such classes, Section 24 (1) No 2 StaRUG.

In the context of the rights of secured creditors, no individual dissenting secured creditor should be worse off as a result of the restructuring plan than the creditor would be without the plan. For the purpose of the no creditor worse off test, a comparative calculation in accordance with Section 6 (2) StaRUG is required to demonstrate how the creditor would stand with and without the restructuring plan. The text of the StaRUG itself is unclear whether the scenario without the plan only refers to the relative situation of the secured creditor in a hypothetical liquidation proceeding or it also encompasses alternative non-liquidation scenarios. The explanatory memorandum of the legislation provides clarifications in this respect. On the basis of the explanatory memorandum, the application of the no creditor worse off principle in the context of the StaRUG requires consideration of other continuation (going concern) scenarios that are sufficiently probable and present themselves as the next best alternative.¹⁰⁹ The recent judgment of the District Court of Dresden¹¹⁰ sheds further light as to the application of the no creditor worse-off test in the context of the StaRUG. In that case, the court considered a piecemeal liquidation scenario a benchmark for the purpose of the no creditor worse off test as the debtor could demonstrate that there was no investor in the market to purchase the business as a going concern and it was unlikely to be able to continue the business in an insolvency proceeding as in that case some public clients could no longer continue their relationship with the debtor.¹¹¹

4.1.4.2 The distribution of the surplus value: Sections 26 (1) No 2, 27 and 28 StaRUG

The StaRUG does not encompass a specific rule to determine whether secured creditors can claim priority rights over the surplus value or not. In light of the German insolvency law rules concerning the restructuring plan procedure, the general opinion of commentators is that under the StaRUG there is no priority relationship between secured and unsecured creditors as to the distribution of the surplus value.¹¹² The additional argument in support of not recognizing a statutory hierarchy between secured and unsecured creditors in the context of the distribution of the surplus value is that secured creditors already enjoy a separate entitlement based on the no creditor worse off principle; hence, they are not entitled to claim priority over the remaining value (surplus value).¹¹³

Under the StaRUG,¹¹⁴ the members of a dissenting class should receive a fair share in the economic value under the plan. Further elaboration on this requirement is provided in Sections 27 (the German priority rule) and 28 (deviation grounds from the German priority rule) StaRUG. The German priority rule requires compliance with the following three conditions. First, no individual creditor should receive economic values in excess of the full amount of their respective claim.¹¹⁵ Second, it is required to equally treat creditors that have the same insolvency law statutory ranking. According to Section 28 (1) StaRUG, it is possible to deviate from the equal treatment of classes of same rank according to the type of economic difficulties

¹⁰⁹ Gesetzentwurf der Bundesregierung (19/24181) 163 <<https://dserver.bundestag.de/btd/19/241/1924181.pdf>> accessed 2 April 2022.

¹¹⁰ District Court of Dresden (07 June 2021) – 574 RES 2/21 = NZI 2021, 893.

¹¹¹ Madaus and Ehmke (n 1); Präventive Restrukturierung: Kommentar zur europäischen Richtlinie über präventive Restrukturierungsrahmen (RWS 2019) Art 10 para 37.

¹¹² Katharina Hansen 'StaRUG, §27' in Matthias Wolgast and Philipp Grauer (eds) *StaRUG online*, para 10; Morgen/Kowalewski/Praß, StaRUG, § 27, para 34. Braun-StaRUG/Herzig, § 27. See also Skauradszun/Fridgen/Spahlinger, StaRUG, § 27, para 19; K Schmidt/*Spliedt*, § 245, Rn. 23, Uhlenbruck/Lüer/Streit, InsO§ 245, para 24.

¹¹³ *Ibid.*

¹¹⁴ Section 26 (1) No 2 StaRUG.

¹¹⁵ Section 27 (1) No 1 StaRUG.

to be overcome and the circumstances.¹¹⁶ However, such deviation is not possible if the dissenting class holds more than half of the voting rights of the creditors of the relevant ranking class.¹¹⁷

The third condition to comply with the German priority rule is that neither classes of lower ranking claimholders nor classes of shareholders should receive an economic value unless the deviation can be justified based on the needs of the case in accordance with Section 28 (2) StaRUG.¹¹⁸ Where the involvement of the debtor or the shareholder is essential for the restructuring, such parties can retain ownership in the business of the debtor without any further contribution if the infringement of creditor's rights is considered to be minor (i.e. an extension of financings by up to 18 months).¹¹⁹ Based on the explanatory memorandum, if a plan can only be implemented with the personal commitment of the debtor or a shareholder and only through the debtor or the shareholder's commitment surplus value can be realized, it may be appropriate to leave or provide the person concerned with a value for this commitment to continue the company. In other words, the contributions of the debtor or the shareholder should not be substitutable and that the participation seems essential.¹²⁰ In such cases, the realization is believed to be in the interest of the creditors and the surplus value would not be created without the debtor or the shareholder.¹²¹

4.1.5 Summary and comparative assessment as to value entitlement of secured creditors

The priority right of secured creditors as to the reorganization value is associated with the extent to which a legal system allows creating security interests on the debtor's assets. Under U.S., Dutch and German legal systems, there is a possibility to create security interests on a broad range of existing and future assets. In order to avoid windfall gains for secured creditors, U.S. law has imposed limits on the extent to which prepetition security interests can be extended to postpetition assets. Such explicit rules and limitations, however, do not exist under EU, Dutch and German legal systems. The absence of regulations in this respect may, therefore, open the door for uncertainties concerning the scope of assets over which secured creditors can claim a priority entitlement in reorganization.

The analyses of this section illustrate that under U.S., Dutch and German legal systems secured creditors are not entitled to the full reorganization value (scenario iv). The noticeable element that results in a considerable distinction between the four legal systems is the distinctive approaches of legislators concerning the regulation of the value of secured creditors' security interests. Among the legal systems, Dutch law has taken the most robust approach, based on which the priority value entitlement of secured creditors is no value higher than the going concern liquidation value of collateral. In addition, Dutch law recognizes non-cash forms of

¹¹⁶ See also District Court of Hamburg (12 April 2021) – 61a RES 1/21 = NZI 2021, 544; Madaus and Ehmke (n 1).

¹¹⁷ According to Section 27 (2) StaRUG, the fictitious consent of dissenting class of shareholders is achieved where, according to Section 27 (2) StaRUG, no individual creditor receives economic values that exceeds the full amount of their claim. In addition, subject to Section 28 (2) No 1 StaRUG, no shareholder, who could be on an equal insolvency statutory ranking with the members of the dissenting class, retains economic value C.f. Section 245 (3) No. 2 InsO.

¹¹⁸ Section 27 (2) No 2 StaRUG.

¹¹⁹ Section 28 (2) No 1 and No 2 StaRUG. See also Madaus and Ehmke (n 1).

¹²⁰ Gesetzentwurf der Bundesregierung – SanInsFoG (BT-Drs. 19/24181) 201. See also Section 245 (2) 2 InsO.

¹²¹ Ibid 130.

distribution to fulfill secured claims of secured creditors unless the majority in each voting class agrees otherwise.

EU and German legal systems provide limited guidance concerning the value entitlement of secured creditors. While U.S. law encompasses rules concerning the value entitlements of secured creditors, the flexibility as to the application of the rule has resulted in different judicial interpretations. Nevertheless, the recent Supreme Court's approach illustrates in cases where the collateral is proposed to be used by the debtor under the reorganization plan, the fair market value of the encumbered asset (scenario iii) is used as a benchmark value. However, the trend towards a section 363x sale in the context of reorganization proceedings and the possibility to adopt a loan-to-own strategy, suggest that secured creditors actually capture the higher end of fair market value of collateral. Thanks to the mentioned strategies, the Chapter 11 proceeding has converted into an asset foreclosure mechanism for the interest of secured creditors, instead of a mechanism that facilitates the retention of the reorganization surplus value for the benefit of the entire body of creditors.

As the Dutch and German reorganization regimes have recently entered into force, it is too early to conclude whether the reorganization proceedings in these legal systems operate *de facto* to maximize the collective return to all creditors, or they are systems of the winner—the secured creditor—takes the entire value.

4.2 The adequate protection of secured creditors

4.2.1 U.S. law

The U.S. Bankruptcy Code requires adequate protection of secured creditors in a case where the automatic stay is in effect, a debtor uses, sells or leases a secured creditor's collateral or engages in priming a postpetition secured creditor's lien.¹²² U.S. law does not provide precise definition of the "adequate protection", but courts have interpreted it to mean "compensation to secured creditors for any depreciation or diminution in the value of the secured creditor's interest caused by the debtor in possession's use of collateral during the chapter 11 case."¹²³ The legislators did not intend the concept of adequate protection be strictly confined to minimum protections under the Bankruptcy Code.¹²⁴ As a result of this, Section 361 offers three non-exclusive means to provide secured creditors with adequate protection.

The first possibility to afford adequate protection is periodic cash payments. This method is deemed to be appropriate in a case where a consumed or depreciated collateral is of a finite quantity or consumed in the ordinary course of the business at a faster rate than it will be replaced.¹²⁵ The second example of adequate protection is to replace liens or provide additional liens to the extent that the stay, use, sale, lease or grant of a postpetition lien on the collateral results in decrease in value of the collateral. The third possible method is to implement more case-specific forms of relief that will result in the realization of the "inequitable equivalent" of

¹²² Section 361 U.S. Bankruptcy Code; *United Savs. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365 (1988). See also H.R. REP. No. 595, 95th Cong., 1st Sess. 43-44 (1977), 339.

¹²³ ABI (n 9) 69. See also ABI (n 9) fn.274, citing several cases as examples: *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd*, 484 U.S. 365 (1988); *In re Delta Res., Inc.*, 54 F.3d 722, 730 (11th Cir. 1995), cert. denied, 516 U.S. 980 (1995); *In re Cason*, 190 B.R. 917, 928 (Bankr. N.D. Ala. 1995).

¹²⁴ Andrew N Karlen, 'Adequate Protection under the Bankruptcy Code, Its Role in Business Reorganization' (1982) (2) Pace Law Review 1, 10.

¹²⁵ See also, house report no. 95-595.

the secured creditor's interest in the collateral.¹²⁶ The "indubitable equivalence" requirement under Section 361 (3) is meant to make adequate protection "a flexible concept adaptable to the various circumstances in which it is applied."¹²⁷ The legislative history of the U.S. Bankruptcy Code only provides limited guidance as to the "indubitable equivalence" requirement. According to the legislative history, "the abandonment of the collateral to the creditor would clearly satisfy indubitable equivalence while unsecured notes as to the secured claim or equity securities of the debtor would not be the indubitable equivalent."¹²⁸

As discussed in §3.2, the value of collateral is a key component of the concept of adequate protection.¹²⁹ The Bankruptcy Code, however, does not specify how value is to be determined nor does it specify when it is to be determined.¹³⁰ The legislator has deliberately left these matters to be decided on a case-by-case basis by courts. According to the Senate's explanation, "[i]n light of the restrictive approach of the section to the availability of means of providing adequate protection, flexibility is important to permit the courts to adapt to varying circumstances and changing modes of financing."¹³¹ In this light, in the context of adequate protection of secured creditors courts have used different approaches in valuing collateral, such as the liquidation value, the going concern value, and the various market valuations.¹³²

In addition to the preventive measure, the U.S. Bankruptcy Code provides for a compensatory measure. The U.S. Chapter 11 entitles secured creditors to have a "superpriority" claim over other unsecured priority claims as a remedy once the secured creditor proves the protection is inadequate. The U.S. Chapter 11, however, does not provide sufficient guidance on the *assessment* and *proof* of insufficient protection. Furthermore, the secured creditor claiming lack of adequate protection has the burden of proof, but the Bankruptcy Code does not specify how and when the value of collateral has to be determined.

4.2.2 EU Directive

EU legal system does not provide for specific rules concerning the adequate protection of secured creditors during a stay.¹³³ The Directive, rather encompasses general rules on exclusion of claims from a stay in certain circumstances and lifting a stay, the application of which would have implications on adequate protection of secured creditors during a stay. Among the set of

¹²⁶ The recognition of this method as an example of providing adequate protection emanates from Judge Learned Hand's opinion in *re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935).

¹²⁷ Karlen (n 125) 12.

¹²⁸ H.R. Rep. No. 95-595 (1977).

¹²⁹ *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273 (1940). See also ABI, 69. Karlen (n 125) ftn. 94 discusses the possible implications of the value assigned to the collateral on technical decisions. The author states "[t]he value assigned to the collateral by a secured creditor often may be an important tactical decision. For example, a creditor asserting a high collateral valuation in the early stages of a case risks a determination that he is not in need of adequate protection. Conversely, a low valuation might be unbelievable or can make it easier for the debtor to satisfy a creditor's claim in a reorganization plan. Moreover, the lower the value to be protected, the easier it will be to provide adequate protection; if the valuation is too low, it might be determined that the interest is a valueless junior lien unworthy of adequate protection. Valuation should not pass the risk of the debtor's continued operations to the creditor. On the other hand, premature anticipation of liquidation should not cause the termination of a case which, if continued, could result in the debtor's rehabilitation, or at least in a more substantial distribution to creditor."

¹³⁰ House report no. 95-595. It should be noted that valuation for the purpose of adequate protection of a secured creditor is not binding upon the trustee/debtor or creditor at the distribution stage when determining the secured status of a creditor.

¹³¹ House report no. 95-595.

¹³² ABI (n 9) 69-70. See for instance, *In re American Kitchen Foods, Inc.*, 9 COLLIER BANKR. CAS. (MB) 537 (Bankr. D. Me. 1976) 553; *In re 620 Church Street Building Corp.*, 299 U.S. 24 (1936), 27.

¹³³ See also Francisco Garcimartín and Nuria Bermejo, 'Involving secured creditors in restructuring proceedings' in Paul J Omar and Jennifer LL Gant (eds), *Research Handbook on Corporate Restructuring* (Edward Elgar 2021) 120, 137.

general protections that the Directive provides creditors against the potential negative impacts of a stay, the protection that may be more relevant for adequate protection of secured creditors is that a creditor should not be unfairly prejudiced by the stay. The Directive elaborates on this point with respect to secured creditors. According to recitals 34 and 37, secured creditors would be unfairly prejudiced by way of an uncompensated loss, depreciation of collateral, or having their claim substantially worse-off as a result of the stay.

The Directive does not encompass provisions on compensation or guarantees for secured creditors whose collateral is likely to decline in value during the stay.¹³⁴ Therefore, the decision on how to compensate secured creditors for a possible decrease in value of their collateral is left to the discretion of national legislators. Furthermore, the Directive does not indicate how the baseline collateral value for the purpose of adequate protection of secured creditors has to be determined.

4.2.3 Dutch law

Under the WHOA, the rights to impose a stay, use, consume or dispose of assets can be only exercised upon the fulfillment of certain general conditions and sufficient protection of the interests of secured creditors, which are discussed below.

Pursuant to Section 376 (1) the Dutch Bankruptcy Act, the court grants the request for a stay if three conditions are fulfilled. Firstly, the stay has to be necessary for the continuation of the debtor's business during the reorganization proceeding. Secondly, it is in the interest of the general body of creditors. Finally, the stay does not substantially harm the interests of the third parties and creditors.¹³⁵ The court has some leeway in the assessment of these conditions.¹³⁶ If the conditions are no longer complied with, the judge could terminate the stay ex officio or upon the request of the debtor, the plan expert, if appointed, or the third parties, attaching party and creditor who filed the bankruptcy petition.¹³⁷ The court, prior to deciding on termination of the stay, has to give all these parties and an observer, if appointed, the opportunity to express their views.¹³⁸

In addition to the general protections discussed above, the Dutch Bankruptcy Act encompasses a specific provision regarding the protection of the interests of secured creditors against a possible decline in the value of collateral due to the use, consumption or the disposition of assets. Based on Section 377 (3) Dutch Bankruptcy Act, the court will revoke or limit the power to use, consume or dispose of assets at the request of the third parties concerned such as secured creditors if they are not sufficiently protected. The legislation, however, does not illustrate in which circumstances secured creditors are adequately protected. According to the explanatory memorandum of the WHOA, in order to ensure the interests of secured creditors are not harmed by a stay, the debtor is required to provide the affected secured creditor with a replacement security interest.¹³⁹ This implies that courts may assess adequate protection of secured creditors

¹³⁴ Recital 37 Directive.

¹³⁵ Section 376 (4) Fw.

¹³⁶ Reinout Vriesendorp and Wies van Kesteren 'de WHOA en de rechter: de leidlaar' 2019 (36) Tijdschrift voor Insolventierecht 277.

¹³⁷ Section 376 (10) Fw.

¹³⁸ Section 376 (11) Fw.

¹³⁹ Kamerstukken II 2019/2020, 35249, nr.3, 20

on a case-by-case basis. Therefore, the court has a high degree of discretion in assessing whether the conditions, which aim at protection of creditors, are fulfilled in order to allow the debtor to exercise the aforementioned powers. In addition, neither the Dutch legislation nor the explanatory memorandum provide guidance on the determination of the benchmark collateral value for the purpose of the adequate protection of secured creditors. Furthermore, the WHOA does not provide for any compensatory measure in a case where the value of collateral has actually declined.

4.2.4 German law

Under German law, when it is necessary to safeguard the prospect of achieving the restructuring goal, the court, upon the request of the debtor, may order to block enforcement and recovery attempts of all or certain creditors, including secured creditors that hold security interests on moveable property.¹⁴⁰ During a stay, assets can be used by the debtor for the continuation of the business insofar as they are of considerable importance for this purpose.¹⁴¹ In order to protect the interest of the general body of creditors and facilitate reorganization, the order of a stay is issued if certain conditions are met.¹⁴² Firstly, the restructuring plan should be in principle complete and conclusive.¹⁴³ Secondly, the plan contains accurate facts, there is no prospect that the plan is not being confirmed, the debtor is not yet threatened with insolvency in the sense of Section 17 InsO and the request to order a stay is necessary for achieving the restructuring objective. In addition, it is expected that the debtor is willing and able to align the management with the interests of the creditors as a whole and the stay is meant to be served on all creditors affected by it.¹⁴⁴

The StaRUG does not provide any particular provision as to the adequate protection of secured creditors. Nevertheless, there are three gateways for secured creditors to protect their interests during a stay. First, there is a possibility to cancel the stabilization order at the request of a creditor that is affected by the order provided that the creditor demonstrates the reasons for the termination.¹⁴⁵ Second, according to Section 54 (1) StaRUG, the secured creditor has to be paid the interest owed and compensated by ongoing payments for any loss in value of collateral, in so far as satisfaction could be expected.¹⁴⁶ The StaRUG, however, does not indicate the baseline value for the purpose of determining the loss in value of collateral. Third, pursuant to Section 57 StaRUG, the affected creditor may claim damages if the order of a stay was issued on the basis of intentionally or negligently incorrect information.

4.2.5 Summary and comparative assessment as to adequate protection

The protection of creditors' security interests against a possible decline in the value of collateral during reorganization is intended to balance prepetition rights of secured creditors with

¹⁴⁰ Sections 29 (2) No 3; 49; 50 and 51 StaRUG.

¹⁴¹ Section 49 (1) No (1) and No 2 StaRUG.

¹⁴² Section 51 StaRUG.

¹⁴³ Section 51 (1) StaRUG. According to Section 51 (3) StaRUG, as an exception, the court may still impose a stay even in the absence of a restructuring plan provided that the debtor submits the plan within the time period that the court sets.

¹⁴⁴ See also Section 59 (1) No 4 StaRUG.

¹⁴⁵ Section 59 (2) StaRUG.

¹⁴⁶ This StaRUG provision is comparable with Section 21 (2) No 5 InsO based on which the preliminary insolvency administrator must ensure that the collateral basis is not reduced by further access to the collateral. Kirsten Sschümann-Kleber, Gerrit Hölzle and Manuel Holzmann, 'Act on the Further Development of Restructuring and Insolvency Law' (29-12-2020, Görg) <<https://www.goerg.de/en/about-gorg>> accessed 20 May 2022.

reorganizational objectives of the estate.¹⁴⁷ The failure to provide secured creditors with safeguards in this respect would undermine the core features of security rights in reorganization, which can result in the creditors' bias against such proceedings.

EU law has left a considerable degree of discretion to national legislators concerning the regulation of the adequate protection of secured creditors. German law provides for compensatory measures concerning the protection of secured creditors against the decline in value of collateral. Dutch law stands at the opposite end and has only adopted a preventive approach. Given that under Dutch law, in a liquidation proceeding secured creditors are not subject to a stay and are entitled to individually foreclose on collateral, the WHOA fails to provide sufficient protections to secured creditors against the potential negative consequences resulting from the application of rules that are meant to facilitate reorganization proceedings.

Among the four legal systems, U.S. law provides for a more elaborated regulation concerning the protection of secured creditors against a possible decline in the value of collateral. The requirement of adequate protection of secured creditors under the U.S. Chapter 11 contains the preventive and compensatory elements addressed above. Nevertheless, the U.S. Chapter 11 does not offer full-fledged protection. Firstly, the U.S. Chapter 11 does not provide sufficient guidance on the assessment and proof of insufficient protection. Secondly, the secured creditor claiming lack of adequate protection has the burden of proof, but the Bankruptcy Code does not specify how and when the value of collateral has to be determined.

Having a benchmark value is critical for the purpose of safeguarding the interests of a secured creditor during the reorganization procedure. The failure of the legislators in the four legal systems to indicate the baseline value for the purpose of the adequate protection of secured creditors provides flexibility to courts to adapt to varying circumstances. However, this would complicate the application of the rule on protection of security interests against a decline in value of collateral to the detriment of secured creditors for whose protection the rule is meant to function.

4.3 Priming under interim financing

4.3.1 U.S. law

The U.S. Bankruptcy Code recognizes the concept of priming as a means of protection of interim financiers provided that two conditions are fulfilled. Firstly, the court must conclude that the debtor is unable to obtain such credit otherwise. Secondly, the debtor has to demonstrate to the court that the interests of the prepetition secured creditor, who are affected as a result of the priming, is "adequately protected."¹⁴⁸

According to case law, an affected prepetition secured creditor is adequately protected in one of the following circumstances. The first way to adequately protect an affected prepetition secured creditor is that the debtor demonstrates sufficient equity will remain in the asset after the senior lien is granted to cover the indebtedness of the creditor.¹⁴⁹ Alternatively, the debtor has to demonstrate the proceeds from the priming loan would result in enhancing the value of

¹⁴⁷ ABI (n 9) 72.

¹⁴⁸ Section 361 U.S. Bankruptcy Code.

¹⁴⁹ Segal (n 46) 969.

the collateral. The other example of adequate protection in the context of interim financing is that the prepetition lender is granted replacement liens on the debtor's other assets.¹⁵⁰

In practice, prepetition secured creditors remain the main sources of interim financing as the Bankruptcy Code imposes strict conditions with respect to priming.¹⁵¹ As a result, in a reorganization proceeding there is a possibility for prepetition secured creditors to further enhance their position through obtaining postpetition financing facilities, namely cross-collateralization and roll-up provisions.¹⁵² The effect of such provisions is that they “provide additional protection to the prepetition lenders on their prepetition claims against the estate.”¹⁵³ There is no explicit provision under the Bankruptcy Code prohibiting postpetition facilities. Courts may examine the permissibility of such practices under Section 364 (e) and subject them to reversal if lack of good faith is established.¹⁵⁴ Case law as to whether courts should approve a cross-collateralization or roll-ups is split. While these practices are disfavored by some courts,¹⁵⁵ in a number of other cases, courts permitted cross-collateralization or roll-ups.¹⁵⁶ The collected data on U.S. bankruptcy cases that were filed during the latter half of 2001 demonstrate that 80 percent of priming liens involve cross-collateralization.¹⁵⁷ The possible effect in practice is that even if postpetition assets are not considered encumbered by prepetition security interests, could still be encumbered to secure postpetition lending.¹⁵⁸ Therefore, the lender, who is also a prepetition security right holder, has the chance capture the entire going concern value in reorganization.

In addition to the opportunistic uses of postpetition financing facilities by prepetition secured creditors, studies suggest that in the U.S. secured creditors enhance their control over the outcome of reorganization proceedings through providing interim financing. The empirical study by Prof. Ayotte and Prof. Morrison suggests that the secured creditors' exercise of control raises issues of potential creditor conflict between the senior and junior claimholders.¹⁵⁹ The

¹⁵⁰ *Ibid* 969 cites *In re Chicago, Missouri and Western Ry. Co.*, 90 B.R. 344 (Bankr. N.D. Ill. 1988); E.g., *In re Sky Valley*, 100 B.R. 107 (Bankr. N.D. Ga. 1988).

¹⁵¹ The conditions to create a priming lien are as follows: firstly, priming is considered the last resort, meaning that other court should be convinced that other options to obtain credit are unavailable. Secondly, the Bankruptcy Code requires adequate protection of existing secured creditors. The strict conditions make obtaining a priming lien ‘extraordinary hard’. See also, Tabb (n 47) 14.

¹⁵² *Ibid* 15, ABI (n 9) 74-75.

¹⁵³ ABI (n 9) 74; Tabb (n 47) 15.

¹⁵⁴ ABI (n 9) ftn 293.

¹⁵⁵ *In re Cooper Commons, LLC*, 430 F.3d 1215 (9th Cir. 2005); *In re Ellingsen MacLean Oil Co.*, 834 F.2d 599 (6th Cir. 1987); *In re Texlon Corp.*, 596 F.2d 1092 (2d Cir. 1979). On numerous occasions, courts have found that circumstances justified granting such relief. *In re Vanguard Diversified, Inc.*, 31 B.R. 364 (Bankr. E.D.N.Y. 1983); *In re Beker Industries Corp.*, 58 B.R. 725 (Bankr. S.D.N.Y. 1986); *In re Flagstaff Foodservice Corp.*, 739 F.2d 73 (2d Cir. 1984).

¹⁵⁶ ABI (n 9) ftn 293 cites the following as example of cases allowing cross-collateralization; *In re Ames Dep't Stores, Inc.*, 115 B.R. 34, 39-40 (Bankr. S.D.N.Y. 1990); *In re FCX, Inc.*, 54 B.R. 833, 840 (Bankr. E.D.N.C. 1985); *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983); *In re Gen. Oil Distrib., Inc.*, 20 B.R. 873, 875-76 (Bankr. E.D.N.Y. 1982). For cases disallowing cross-collateralization, see *Shapiro v. Saybrook Mfg. Co., Inc. (In re Saybrook Mfg. Co., Inc.)*, 963 F.2d 1490, 1494-96 (11th Cir. 1992) (cross-collateralization is *per se* impermissible); *In re Texlon Corp.*, 596 F.2d 1092 (2d Cir. 1979); *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716 (S.D. Fla. 2010). For cases allowing roll-ups in certain circumstances, see *In re Uno Rest. Holdings Corp.*, Ch. 11 Case No. 10-10209 (MG) (Bankr. S.D.N.Y. Jan. 20, 2010); *In re Foamex Int'l Inc.*, Ch. 11 Case No. 09-10560 (KJC) (Bankr. D. Del. Feb. 18, 2009); *In re Aleris Int'l, Inc.*, Ch. 11 Case No. 09-10478 (BLS) (Bankr. D. Del. Feb. 12, 2009); *In re Tronox Inc.*, Ch. 11 Case No. 09-10156 (ALG) (Bankr. S.D.N.Y. Jan. 12, 2009); *In re Lyondell Chem. Co.*, Ch. 11 Case No. 09-10023 (REG) (Bankr. S.D.N.Y. Jan. 6, 2009).

¹⁵⁷ Ayotte and Morrison (n 12) 525.

¹⁵⁸ Brubaker (2014) (n 7) 13.

¹⁵⁹ The existence of creditor conflict has been discussed in a number of scholarly papers. See, for instance, Chaim J Fortgang and Thomas M Mayer, ‘Trading Claims and Taking Control of Corporations in Chapter 11’ (1990) 12 *Cardozo Law Review* 115;

“creditor conflict distorts economic outcomes in bankruptcy”,¹⁶⁰ which may yield inefficiently quick sales, when they are oversecured, in some cases or inefficiently slow sales or reorganizations in others, when the secured creditors are under-secured.¹⁶¹

4.3.2 EU Directive

EU law recognizes the concept of priming and allows, but does not mandate, national legislators to provide for such a possibility.¹⁶² The Directive, however, does not provide for any rules nor guidance to safeguard interests of prepetition secured creditors whose security interests are affected as a result of priming. As a minimum, the Directive requires member states to give financing priority over unsecured claims in subsequent insolvency procedures.¹⁶³ In this respect, the background policy consideration is noted in recital 68 Directive, which states “(...) encouraging new lenders to take the enhanced risk of investing in a viable debtor in financial difficulties could require further incentives such as, for example, giving such financing priority at least over unsecured claims in subsequent insolvency procedures.” In this light, member states that introduce the concept of priming would have to provide measures to protect secured creditors whose prepetition security rights are affected as a result of the priming.

4.3.3 Dutch law

Under Dutch law, the possibility to create security interests on an encumbered asset only exists where the prepetition secured creditor consents.¹⁶⁴ Therefore, the concept of priming does not exist under Dutch law unless the secured creditors whose interests are at stake agree.¹⁶⁵

Dutch law does not encompass a specific provision against opportunistic uses of interim financing by pre-existing secured creditors. Nevertheless, the general conditions of raising interim financing under the WHOA may mitigate such risks to some extent.¹⁶⁶ Under Dutch law, courts may authorize an interim financing request only if the legal act is, *inter alia*, reasonably assumed to serve the interests of the debtor’s joint creditors and does not materially harm the interests of individual creditors. Therefore, if the court concludes that the disadvantages of postpetition facilities are more than the advantages of the interim financing that the prepetition secured creditor provides, the request is likely to be rejected.

4.3.4 German law

German law does not recognize the concept of priming. Hence, prepetition senior secured creditors may remain the most accessible sources of financing. The StaRUG does not provide

Frank Partnoy and David Skeel, ‘The Promise and Perils of Credit Derivatives’ (2007) 75 University of Cincinnati Law Review 1019; Ayotte and Morrison (n 12) 525.

¹⁶⁰ Ayotte and Morrison (n 12) 520-515.

¹⁶¹ Ibid.

¹⁶² Article 17 (4) Directive.

¹⁶³ Articles 17 (4), 18 (1) and 18 (5) Directive. According to Article 17 (3) Directive, member states may exclude from the scope of the protection interim financing transactions that are granted after the debtor becomes unable to pay its debts as they fall due.

¹⁶⁴ Peter JM Declercq, ‘Restructuring European Distressed Debt: Netherlands Suspension of Payment Proceeding... The Netherlands Chapter 11?’ (2003) 77 American Bankruptcy Law Journal 392-93; Jalling Bosker, ‘Financing Corporate Rescue – The Dutch Approach. A Cross-Border Comparison’ (2017) 5 Nottingham Insolvency and Business Law eJournal (IBLeJ) 4.

¹⁶⁵ Flip van der Drift and Koen Durlinger, ‘De positie van de noodfinancier onder de WHOA – voldoende comfortabel?’ (2020) Tijdschrift voor Insolventierecht 314.

¹⁶⁶ Section 42 (a) Fw.

detailed rules concerning interim financing. A brief and non-elaborated reference to interim financing can be found in Section 50 (2) No 2 StaRUG, which requires the debtor to provide a well-founded presentation of the sources of financing.¹⁶⁷ Courts may only reject authorizing financing plans that are incompatible with the restructuring goal. In this light, different judicial approaches towards postpetition facilities such as cross-collateralization or roll-ups provisions is expected. Depending on whether a court considers maximization of the total to creditors or rescuing viable enterprises as the *primary* goal of reorganization, there might be variations in the treatment of interim financing plans that provide for postpetition facilities.¹⁶⁸

4.3.5 Summary and comparative assessment as to priming under interim financing

Considering that the creation of a priming lien potentially curtails the very key feature of security rights, the legal systems have adopted strict approaches with respect to priming. The Directive has provided member states with the discretion to decide on the possibility of recognizing priming in the context of interim financing. Neither the WHOA nor the StaRUG recognizes the concept of priming.¹⁶⁹ The U.S. Bankruptcy Code allows creation of priming liens subject to strict conditions. The requirement of adequate protection of prepetition secured creditors, holding lien on the same asset, makes obtaining a priming lien ‘extraordinary hard’.¹⁷⁰

Because of the prohibition of priming based on Dutch law and German law and the high standards of the adequate protection requirement under U.S. law, where the entire assets of a debtor are encumbered, prepetition secured creditors are likely to remain the main sources of interim financing. However, the legal systems, especially U.S. law, do not fare well in curbing risks of opportunism related to interim financing.

A fully-fledged rule on interim financing should not only provide for ex ante checks against opportunistic uses of interim financing, but also impose ex post safeguards. Under U.S. law, the reversal or modification on appeal of an interim financing authorization act is only possible where it is established that the DIP financier did not provide the financing in good faith.¹⁷¹ Due to the absence of sufficient legislative guidance, case law as to the permissibility of postpetition facility provisions is split. In addition, based on empirical evidences, secured creditors successfully gain control over the proceedings through issuing interim financing.

The ex post assessment of transaction is by and large the European approach.¹⁷² From a European perspective, it is common to evaluate interim financing transactions against opportunistic uses in the context of transaction avoidance. Although “rules on transaction avoidance have great difficulties in providing an apt framework for the assessment of interim financing”¹⁷³, postpetition financing facilities, namely cross-collateralization and roll-up provisions can fit well within transaction avoidance. As the effect of cross-collateralization and

¹⁶⁷ Gesetzentwurf der Bundesregierung – SanInsFoG (BT-Drs. 19/24181) 155.

¹⁶⁸ In line with the objectives of the EU Directive, the aim of the StaRUG is to rescue viable enterprises, maximize the total value to creditors, owners and the economy as a whole and prevent unnecessary job losses. See Recitals 3 and 35 EU Directive.

¹⁶⁹ Under Dutch and German law, the creation of a priming lien is only possible through a contractual agreement with the secured creditor that has first ranking security over the asset. See also INSOL International, ‘Reforms in Selected EU Member States in Light of the Directive on Preventive Restructuring Frameworks’ (INSOL Special Report, April 2020) 54.

¹⁷⁰ Tabb (n 47) 14.

¹⁷¹ Section 364 (e) U.S. Bankruptcy Code.

¹⁷² Rolef J de Weijs and Meren Baltjes, ‘Opening the Door for the Opportunistic Use of Interim Financing: A Critical Assessment of the EU Draft Directive on Preventive Restructuring Frameworks’ (2018) 27 International Insolvency Review 223, 232.

¹⁷³ Ibid 231.

roll-up provisions is that they provide additional protection to the DIP lender as far as the old credit is concerned,¹⁷⁴ such provisions can be categorized as preferences,¹⁷⁵ which is a ground for transaction avoidance. As to the possibility to enhance control over reorganization proceedings through issuing interim financing, the existing data is inadequate to analyze whether such strategy is a common practice and whether it is permissible under the WHOA and the StaRUG.

4.4 Interim conclusion

The comparative assessment of the reorganization regimes showed the variety of approaches that legal systems have taken with respect to the regulation of the value entitlement of secured creditors. The assessment also illustrated how practice may diverge from the rules.

The U.S. Bankruptcy Code encompasses rules concerning the value entitlement of secured creditors and the adequate protection of secured creditors against a possible decline in value of collateral during the procedure and in case of priming. However, the considerable degree of leeway in interpretation of rules as to the value entitlement of secured creditors, the opportunistic uses of interim financing by pre-existing secured creditors, the increased use of a section 363x sale as a replacement of a conventional reorganization plan proceeding, and the possibility to adopt a loan-own strategy, have turned the Chapter 11 proceeding into a system in which the secured creditor takes almost all the value. The conversion of the U.S Chapter 11 proceeding into a (secured) creditor-controlled proceeding¹⁷⁶ is against the legislator's objective which is facilitating a collective insolvency proceeding that operates for the benefit of the entire body of creditors and gives debtors the opportunity to reorganize.¹⁷⁷ The distortive economic outcomes resulting from the increase in secured creditors' control power in a Chapter 11 proceeding would exacerbate in cases where the creditors are oversecured.¹⁷⁸ Oversecured creditors have the tendency to force an immediate resolution through a section 363x sale in the context of reorganizing to avoid potential delays in the procedure even if selling the firm does not maximize the value. The additional negative implication would be that managers may invest in inefficient strategies to delay filing for a reorganization proceeding.¹⁷⁹

The EU Directive only provides minimum harmonization and barely touches upon the position of secured creditors in reorganization. Although the Directive is not expected to provide an outright harmonization, national legislators' wide degree of discretion as to the treatment of secured creditors and the possibility to opt between the APR and EU RPR may open a new window for abusive forum shopping.¹⁸⁰ The comparison between Dutch and German reorganization schemes illustrate how diverse the position of secured creditors in reorganization can be among member states.

¹⁷⁴ ABI (n 9) 74; Tabb (n 47) 15.

¹⁷⁵ Transaction avoidance can be divided into two broad basic categories: preferences and transactions at an undervalue. For comprehensive analyses in this respect see De Weijs and Baltjes (n 173) 231.

¹⁷⁶ Skeel (n 71) 1029; Kenneth M Ayotte, Edith S Hotchkiss and Karin S Thorburn, 'Governance in financial distress and bankruptcy' in Mike Wright et al (eds) *The Oxford Handbook of Corporate Governance* (Oxford University Press 2013).

¹⁷⁷ On the objectives of the legislator see *Canadian Pacific Forest Products Ltd v JD Irving Ltd* (1995) 66 F 3d 1436, 1442.

¹⁷⁸ Ayotte and Morrison (n 12); Lynn M LoPucki and Joseph W Doherty, 'Bankruptcy Fire Sales' (2007) 106 *Michigan Law Review* 1. See also in general, Garcimartín and Bermejo (n 135).

¹⁷⁹ Barry E Adler, Vedran Capkun, and Lawrence A Weiss, 'Destruction of Value in the New Era of Chapter 11' (2008) 29 (2) *The Journal of Law, Economics and Organization* 461.

¹⁸⁰ De Weijs, Jonkers and Malakotipour (n 29).

Dutch law has taken a progressive approach as to the treatment of secured creditors in collective insolvency proceedings. In a liquidation proceeding, secured creditors have strong rights and are entitled to foreclose on their collateral irrespective of the existence of a stay. In reorganization, however, the WHOA imposes limitations on strong powers of secured creditors to facilitate reorganization. The distinguished feature of the WHOA is that it encompasses rules concerning the three main questions of I) value entitlement of secured creditors; II) adequate protection; and III) priming. While the legislator has taken a robust approach concerning the determination of the value entitlement of secured creditors, the concept of adequate protection is left without sufficient legislative elaboration. The failure to provide full-fledged protections to secure creditors in reorganization may result in secured creditors' bias against such proceedings as they are entitled to strong rights in alternative enforcement procedures.

Under German law, the position of secured creditors and their precise value entitlement is very much left to be decided on a case-by-case basis as it does not encompass particular rules in these respects. The lack of sufficient legislative regulations as to the position of secured creditors in reorganization may cause two negative consequences. First, the resulting uncertainty is likely to reflect, *ex ante*, in the cost of capital. Second, considering that secured creditors, which are mainly banks, play pivotal roles in German economy as the main sources of corporate financing,¹⁸¹ the absence of sufficient regulations concerning the position of secured creditors may pave the way for secured creditors to strengthen their control power over reorganization proceedings and, eventually, result in the diversion of reorganization from its main objectives.

5 Conclusion

Different approaches have been taken by U.S., EU, Dutch and German legal systems as to the regulation of the value entitlements of secured creditors and their rights in reorganization. As it can be inferred from the legislations and the accompanied explanatory memorandums of the legal systems, the legislators are against the distribution of the full reorganization value to secured creditors. In practice also there does not seem to be a possibility for secured creditors to claim the full reorganization value. Nevertheless, the lack of sufficient legislative responses and high degree of flexibility as to application of some reorganization rules may result in a disparity between the value entitlements of secured creditors based on law and the actual value that they capture in practice. The failure to mitigate the inconsistency between the objectives of the legislator and practice would undermine the economics considerations that the legislator takes into account in regulating the position of secured creditors in reorganization.

The comparative analysis in this paper showed that in response to the trade-off between facilitating reorganization proceedings and upholding the key features of security interests, reorganization rules may function as double-edged swords. The experience of the U.S. Chapter 11 in the context of priming under interim financing is illustrative in this respect. The high standards of the adequate protection requirement in case of priming are meant to safeguard the very core feature of security interests, which is the priority over proceeds of encumbered assets. The other side of the coin is that thanks to these high standards, prepetition secured creditors

¹⁸¹ Natasha Kalara and Lu Zhang, 'The changing landscape of firm financing in Europe, the United States and Japan' (Netherlands CPB Netherlands Bureau for Economic Policy Analysis, discussion paper 383) 6-9.

are normally the main sources of interim financing. The effect, in practice, is that secured creditors frequently try to opportunistically make use of this possibility and steer the proceeding in their own interest. As a consequence, the Chapter 11 proceeding has been mainly converted into an asset foreclosure mechanism that is diverted from its very objective, which is capturing the reorganization surplus value for the benefit of all creditors involved in such proceeding.

In liquidation, the commencement of the proceeding is only permissible in cases where the sale of assets would result in meaningful distributions to (unsecured) creditors.¹⁸² Reorganization is not different from liquidation proceedings in a sense that it is meant to solve, *inter alia*, the collective action problem to maximize the value for the entire body of creditors. In this light, the introduction of fully-fledged rules to curb the potential undeliberate consequences resulting from the application of reorganization rules that have, direct or indirect, impacts on the value entitlement of secured creditors is essential. The failure to make assessments and take effective actions in this respect would result in suboptimal consequences. On the one hand, the distribution of secured creditors' value for the benefit of other stakeholders may incite secured creditors to invoke alternative debt enforcement mechanisms and obstruct the possibility to maximize the going concern value through reorganization. On the other hand, there is a possibility that reorganization proceedings turn into mechanisms where all— parties involved in reorganization and the reorganization regime itself— would be in service of one, namely the secured creditor(s) holding security interests on the entire prepetition assets of a debtor.

¹⁸² See, for instance, 'Chapter 7 Bankruptcy Basics' (U.S. Courts) <<https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-7-bankruptcy-basics>> accessed 10 May 2022; Sections 179 and 180 Fw.