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**Prioritizing SME Debtor's Equity Retention: Espousing Relativity  
over Fairness and Equitability?**

Comparing Relative Priority Rule with Fair and Equitable Test

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Advanced Masters Thesis

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Location: Leiden, Netherlands

**PERSONAL DECLARATION STATEMENT**

I hereby certify that this is an original work, that this thesis does not contain any materials from other sources unless these sources have been clearly identified in the footnotes or the Bibliography, and any and all quotations have been properly marked as such and full attribution made to the respective authors thereof.

I further authorise Leiden University, the Faculty of Law, Advanced Masters Programme in International Civil and Commercial Law, its programme Board and Director, and/or any authorised agents of the institution, and persons named herein and above, to place my thesis in library or other repository, including but not limited to, associates websites, for the use of visitors to or personnel of said library or other repository. Access shall include but not be limited to hard copy or electronic media.

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Signature:

A handwritten signature in blue ink that reads "Raghav" followed by a period.

**LIST OF ABBREVIATIONS**

<b>ABBREVIATIONS</b>	<b>FULL FORMS</b>
11 USC	Chapter 11 of the United States of America, Bankruptcy Code
ABI	American Bankruptcy Institute
APR	Absolute Priority Rule
BIT	Best Interest of Creditors Test
EU	European Union
EU- PRD	Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring framework, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt
FET	Fair and Equitable Test
PDI	Projected Disposable Income
RPR	Relative Priority Rule
SBRA	Small Business Reorganisation Act, 2019
SME Debtors	Small and Medium Scale Debtors
US	United States of America

## **EXECUTIVE SUMMARY**

In this thesis, I assess the extent to which the RPR enables equity retention for SME Debtors during their preventive restructuring, in comparison to the FET. I do this by comparing (i) the RPR under Article 11(1)(c) of the EU-PRD and (ii) the FET under Section 1191(c) of the SBRA. The research framework consists of one primary question and three sub-questions that have defined the descriptive and comparative character of this thesis:

- (I)** To what extent does RPR enable equity interests' retention for SME Debtors in comparison to FET?
  - (1)** What characteristics of SME Debtors enable equity interests' retention in them during restructuring?
  - (2)** To what extent does RPR under EU-PRD enable equity interests' retention for SME Debtors?
  - (3)** To what extent does FET under SBRA enable equity interests' retention for SME Debtors?

### **Thesis Outline and Research Methodology**

This thesis consists of an introduction, four chapters, and a conclusion. The first chapter is focussed on answering the first sub-research question delineated above. I start by outlining some basic concepts which enable us to understand the significance of restructuring for the SME Debtors, and the manner in which Fairness Tests are applied under a restructuring. Secondly, based on the understanding of these concepts, I outline the challenges associated with equity retention and the reasons for enabling such equity retention for the SME Debtors during their restructuring. Thirdly, based on this understanding, I conduct a literature review to (i) delineate the issues in defining SME Debtors and (ii) review peculiar characteristics of SME Debtors due to which equity retention in them is crucial for their successful restructuring. The purpose of conducting this review is to provide answers to the first sub-research question and also arrive at a working definition for SME Debtors which is used as a practical point of reference for conducting comparative analysis in the subsequent chapters.

The second chapter addresses the second sub-research question. Firstly, I conduct a historical legal search and literature review to trace the theoretical development of the RPR in European context. Secondly, I review the concept of the RPR and the requirements for its application under the EU-PRD. Thirdly, building on this understanding of the RPR, I analyse how RPR enables equity interests' retention for SME Debtors during restructuring. I do this by (i) highlighting the academic debates on equity retention enabling ability of the RPR and (ii) conducting a quantitative analysis of hypothetical data in tabular form (Table 1) to assess the extent to which the RPR enables equity retention for SME Debtors when compared to the BIT and APR.

The third sub-research question drives the research design and structure of the third chapter. Firstly, I conduct historical legal research and literature review to discuss the theoretical development of Fairness Tests in US. The aim of this historical research is to trace the development trajectory of the Fairness Test of the RPR in US and look at the form in which the Fairness Test has presently been incorporated under the SBRA, in the form of FET. Secondly, I review the requirements for the application of the FET under the SBRA. Thirdly, based on this examination, I analyze how the FET under the SBRA enables equity interests' retention for SME Debtors. I do this by (i) conducting doctrinal research by relying on literature and legal precedents and (ii) conducting quantitative analysis of hypothetical data in tabular form (Table 2).

In the fourth and final chapter, I compare the RPR under EU-PRD with the FET under the SBRA, to answer the primary research question. Firstly, I shed light on the differences in the RPR's conception under EU-PRD from the theorisations in US to understand if these differences shake the credibility of RPR as a Fairness Test, in so far as its equity retention enabling ability is concerned. Secondly, I

summarise the key differences in application of RPR under Article 11(1)(c) of PRD and the FET under the SBRA. Thirdly, to understand the differences from a practical perspective, I conduct a quantitative analysis under Table 3, to compare the distribution possibilities under the FET and the RPR. Lastly, using the results arrived at, based on this quantitative analysis, I compare both the RPR and the FET based on 4 indicative factors, (i) early access incentivisation, (ii) balancing of the creditor and equity holders' interests, (iii) possibility of consensual plan confirmation (iv) impetus for equity retention on a macro-economic scale.

Lastly, I conclude my thesis by (i) summarising the findings arrived at, based on the comparative analysis under chapters 1 to 4 and by (ii) providing suggestions to EU Member States which are yet to implement the EU-PRD, to implement the RPR in such a manner that it facilitates equity interests' retention for SME Debtors, by finding orientation in the FET under the SBRA.

### **Assumptions and Limitations**

I have limited the discussion on application of the cram down rules and the APR to the extent it is necessary for answering the research and sub-research questions outlined above. I make 3 assumptions to streamline the comparative analysis for practical purposes:

- (i) The EU-PRD does not provide specific standards for what amounts to a relatively better treatment under the RPR.<sup>1</sup> I assume that classes senior in priority ranking would be provided a relatively better treatment under the RPR if they receive a higher percentage distribution on their claims than any junior class of creditors or equity holders.<sup>2</sup>
- (ii) An SME Debtor has been defined differently in the domestic laws of different EU member states and US.<sup>3</sup> I arrive at a working definition for an SME Debtor which is used as an axiomatic point of reference for conducting the analysis. Based on its working definition, an SME Debtor has been characterised as having:
  - 1. Limited resources and lacks of access to finance
  - 2. Heavily Interdependent with entrepreneurship, having closely intermingled business and personal debts
  - 3. Suffers from creditor passivity
  - 4. Lacks incentives to access restructuring at an early stage the formal insolvency process
  - 5. Failure of its business might also lead to failures in the supply chain since its customers are also SMEs and depend heavily on timely payment.
- (iii) The EU-PRD provides Member states the option to exempt SME Debtors from the obligation to (1) treat affected parties in separate classes<sup>4</sup> and (2) satisfy the requirements of a cross-class cram down mechanism and resultantly, the Fairness Tests of RPR and APR.<sup>5</sup> In the event these exemptions are provided, then the Fairness Test of the RPR would not be applicable in the first place. It is assumed that SME Debtors have not been exempted under these provisions of EU-PRD.

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<sup>1</sup> Article 11(1)(c), Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring framework, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt ('EU-PRD')

<sup>2</sup> The assumption has been discussed under Section 2.3. of this thesis

<sup>3</sup> Discussed under section 1.4.3 of this thesis

<sup>4</sup> Recital 58 and Article 12(1), EU-PRD

<sup>5</sup> Recital 45, EU-PRD

## **OVERVIEW OF MAIN FINDINGS**

This thesis is focussed on understanding the extent to which RPR enables equity retention for SME Debtors during their restructuring, in comparison to the FET under the SBRA. I do this by comparing RPR under Article 11(1)(c) of the EU-PRD with the FET under 11 USC Section 1191(c).

Firstly, I arrive at a Working Definition for SME Debtors, which is used as a point of reference for conducting this comparative research. Based on this Working Definition, SME Debtors, may be characterised as having (i) limited resources and lack access to finance, (ii) heavy interdependency with entrepreneurship, (iii) creditor passivity, (iv) lack of incentives to access the restructure at an early stage and (v) from a macro-economic perspective, have as their customers other SMEs which also depend heavily on timely payments.

Secondly, I conduct a historical legal search and literature review which reveals that concept of RPR as developed under the EU-PRD is indeed starkly different from the concept theorised in US. However, the mere fact that the RPR under the EU-PRD is different from the RPR theorised in US, does not shake its credibility as a Fairness Test in so far as its equity interest's retention enabling ability for SME Debtors is concerned.

Thirdly, I conduct a quantitative analysis using hypothetical data to compare the distributional possibilities under the FET and the RPR which reveals 3 notable differences between the RPR and the FET:

- (i) There is a higher possibility of equity interests' retention (in percentage) under the FET, in comparison to the RPR. This is due to the fact that under the RPR, equity interest holders cannot be provided a relatively higher distribution (in percentage) than the distribution (in percentage) provided to the junior most ranking creditor class, while no such requirement exists under the FET. It may be possible under the FET for equity holders to even retain 100% of their equity interests in certain situations.
- (ii) There is a higher possibility for junior ranking unsecured creditors to be provided more distribution (in percentage) under the FET than the under the RPR. Again, this stems from the RPR as a result of which a relatively higher distribution would necessarily have to be provided to more senior ranking creditors.
- (iii) The FET provides more flexibility by permitting an SME Debtor to plan out the distribution possibilities under the repayment plan, based on pressing needs and concerns of their business. This may increase the possibility of a successful restructuring of the SME Debtor, while it makes payment based on the repayment plan, in comparison to the RPR under the EU-PRD.

A comparative analysis of the RPR with the FET shows that FET increases the possibility of enabling equity retention for SME Debtors during their restructuring, in comparison to the RPR. This analysis is based on the conclusions arrived at, based on an analysis of 4 equity retention indicators:

- (i) SME Debtors seem to be relatively more incentivised to access the restructuring process at an early stage, under the FET in comparison to the RPR.
- (ii) While both the RPR and FET prevent creditor exploitation and avert risk-taking behaviour which SME Debtors may indulge in, the FET seems to relatively achieve a better balance between creditors rights protection and equity interests.
- (iii) The FET increases the possibility of consensual confirmation in comparison to the RPR
- (iv) From a macro-economic perspective, it seems too early to assess based on available statistical information, the success of these Fairness Tests in enabling equity interests' retention. However, the SME Debtors have so far shown confidence in both the RPR and the FET.

Based on this analysis, I assert that Member States, who have not yet implemented EU-PRD, may incorporate the RPR as a Fairness Test in a manner that it enables retention of equity retention for SME Debtors, by finding orientation under the FET in the SBRA. To allow the SME Debtors to gain from the equity interests' retention enabling ability of the FET, while implementing the RPR, a Relaxed RPR approach may be permitted. This Relaxed RPR approach can be applied using the existing provisions under the EU-PRD. Member States may permit SME Debtors under this Relaxed RPR approach to:

- (i)** Either have a straight discharge procedure or alternatively make payments based on repayment plans, or a combination of both, by relying on Recital 45 of the EU-PRD. If an SME Debtor chooses to make payments based on the repayment plan, Member States may provide for the following stipulations, by relying on Article 8(1)(h) and Article 10(3) of the EU-PRD:
  - (1)** a test similar to the Reasonable Likelihood Test to ensure that the SME Debtors will be able to make all the payments in a timely manner under the repayment plan, and
  - (2)** Stipulation that SME Debtor is required to include protections within the plans, including liquidation of non-exempt assets and the satisfaction of a test similar to the Default Remedies Test to ensure that the rights of creditors are protected if payments under the repayment plan are not made
- (ii)** Derogate from the strict application of the RPR, by relying on Article 11(2) of the EU-PRD, in the following situations:
  - (1)** when equity retention is necessary for enabling a successful restructuring of the SME Debtor, and
  - (2)** when for the successful restructuring of the SME Debtor and for the SME Debtor to be reasonably able to make all the payments based on the repayment plan, the unsecured junior creditor classes would necessarily have to be provided a better treatment (higher distribution in percentage) than the senior ranking unsecured creditor classes.

It is hoped that Member States will find some guidance, based on the suggestions stipulated above, to implement the RPR in a manner that it strengthens the equity interests' retention ability of the RPR.

## INTRODUCTION

*'What may look like one person and some inconsequential assets to an outside may be something very different to that person, her family and the individuals she employs.<sup>6</sup> Small businesses make up approximately 99.7% of all US employer firms and frequently cited as engines of economic growth. Yet, the odds of building a successful small business are stacked against entrepreneurs.'*<sup>7</sup>

SME Debtors are the backbone of economy in both EU and US and yet, they are the ones which are most prone to failures.<sup>8</sup> COVID-19 pandemic has only exacerbated this problem.<sup>9</sup> One of the objectives of the EU-PRD is to enable the SME Debtors in financial difficulties to revive their business by accessing the restructuring process at an early stage.<sup>10</sup> For a successful restructuring of SME Debtors, equity retention is crucial, since the SME Debtors are often, heavily dependent on its entrepreneur's managerial skills, connections and expertise for their business.<sup>11</sup> At the same time, the goal of a successful restructuring is to not only retain equity but also balance the rights of creditors and other stakeholders.<sup>12</sup> There is a conflict related to the nature of entitlement of debt claims distribution amongst the creditors and equity holders during restructuring, referred to as the debt/equity bargain (Hereinafter referred to as the '**Debt/Equity Bargain**').<sup>13</sup>

The EU-PRD strives to balance the 'Debt/Equity Bargain' by including two alternative fairness tests of priority in cases where a restructuring plan is not approved by parties who are affected by it, the APR<sup>14</sup> and RPR.<sup>15</sup> The last-minute inclusion<sup>16</sup> of the RPR under the EU-PRD triggered a heated scholarly

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<sup>6</sup> Michelle M. Harner, Associate Judge, United States District Court for the District of Maryland, Legislative Update, 'Are small and Medium-Sized companies worth saving?', 34 AM Bankr. Inst. J. 8 (8-9 July 2015) ABI Journal

<sup>7</sup> Michelle M Harner, Associate Judge, United States District Court for the District of Maryland, 'Mitigating Financial risk for Small Business Enterprises', University of Maryland, No. 2011-53, Vol 6:2, 470

<sup>8</sup> Office of Advocacy SBA, 'Small Businesses Generate 44 Percent of the U.S. Economic Activity' (Release No. 19-1 ADV, January 30, 2019) <<https://advocacy.sba.gov/2019/01/30/small-businesses-generate-44-percent-of-u-s-economic-activity/>> Accessed July 12, 2022; Recital 17, EU-PRD

<sup>9</sup> Gerhard Huemer, 'The economic impact of COVID-19 on SMEs in Europe' (SME United, Crafts & SMEs in Europe, 30 June 2020) <<https://www.smeunited.eu/admin/storage/smeunited/200630-covidsurvey-results.pdf>> Accessed July 12, 2022; Daniel Wilmoth, 'The Effects of the COVID-19 Pandemic on Small Businesses', (Office of Advocacy, U.S. Small Business Administration, Issue Brief Number 16, March 2021) <<https://cdn.advocacy.sba.gov/wp-content/uploads/2021/03/02112318/COVID-19-Impact-On-Small-Business.pdf>> Accessed July 12, 2022

<sup>10</sup> Recital 2 and 17, EU-PRD

<sup>11</sup> Lorenzo Stanghellini et. Al, *Best Practices in European Restructuring, Contractualised Distress Resolution in the Shadow of the Law*, (2018, Wolters Kluwer), ('**CODIRE**') 34 [2.2.2], UNCITRAL Draft Text MSME Insolvency (n 35), [19]; European Law Institute (ELI), 'Rescue of Business in Insolvency Law', 2017 <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3032309](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3032309)> Accessed July 12, 2022 ('**ELI Business Rescue Report**'), 367-374

<sup>12</sup> Recital 3, EU-PRD; *In re Wildwood Villages, LLC*, Case No. 3:20-bk-02569-RCT (Bankr. M.D. Fla. May. 4, 2021), 6

<sup>13</sup> CODIRE (n 42), 32 [2.1]

<sup>14</sup> Article 11(2), EU-PRD

<sup>15</sup> Article 11(1)(c), EU-PRD

<sup>16</sup> Inclusion was made by the Proposal for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30, Brussels 17 December 2018, 15556/18, 2016/0359(COD),

debate<sup>17</sup> on whether the APR should be preferred instead of the RPR. Since EU-PRD is yet to be implemented by many EU member states (Hereinafter referred to as the '**Member States**'), it remains to be seen whether Member States will adopt the RPR or APR.<sup>18</sup> Interestingly, it has been asserted by legal scholars that although EU-PRD incorporates RPR based on its theorisation by legal scholars in US, RPR has not been incorporated in the same form as theorised in US.<sup>19</sup> Intriguingly, under 11 USC, SBRA was enacted recently on February 19, 2020, to streamline the restructuring process specifically for SME Debtors.<sup>20</sup> Instead of incorporating the RPR, SBRA introduced a new fairness test in the form of FET. FET mandates that SME Debtors to repay creditors while retaining equity in the form of PDI.<sup>21</sup>

Given this backdrop, it is quite intriguing to analyse the extent to which the RPR enables equity retention for SME Debtors, by comparing it with the FET under the SBRA. The scope of this thesis is restricted to a comparison of the RPR under Article 11(1)(c) of the EU-PRD with the FET under Section 1191(c) of the SBRA. The research design for this thesis has been driven by the research hypothesis which in essence boils down to answering the follow question and sub-questions:

- (i) To what extent does the RPR enable equity interests' retention for SME Debtors in comparison to FET?

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Article 11(1)(c) at 73 <<https://data.consilium.europa.eu/doc/document/ST-15556-2018-INIT/en/pdf>> Accessed July 12, 2022

<sup>17</sup> Bob Wessels, '2019-03-doc10 The full version of my reply to professor De Weijs et al' (22 March 2019) <<https://bobwessels.nl/blog/2019-03-doc10-the-full-version-of-my-reply-to-professor-de-weijs-et-al/>> Accessed July 12, 2022 ('**Bob Wessels Reply**'); Stephan Madaus, 'Leaving the Shadows of US Bankruptcy Law: A proposal to divide the realms of Insolvency and Restructuring Laws' (4 June 2018), *Eur Bus Org Law Rev* (2018) 19:615–647 < <https://doi.org/10.1007/s40804-018-0113-7>> Accessed July 12, 2022 ('**Madaus Leaving shadows of US Bankruptcy Law**'); Riz Mokal and Ignacio Tirado, 'Has Newton had his day? Relativity and realism in European Restructuring', *Butterworths Journal of International Banking and Financial Law*, April 2019, ('**Mokal and Tirado**'); R.J. de Wijs et al, 'The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by allowing 'Relative Priority (RPR)' (2019) University of Amsterdam, UvA-Dare (Digital Academy Repository), 125(4), 477-493 Accessed July 12, 2022 ('**De Weijs et. Al. Imminent Distortion of Insolvency Law**'); Giulia Ballerini, 'The Priorities dilemma in the EU preventive restructuring directive: Absolute or relative Priority Rule?' (2020) Wiley, *INSOL International* < 10.1002/iir.1399> Accessed July 12, 2022 ('**Ballerini**'); Jonathan M. Seymour and Steven L. Schwarz, 'Corporate Restructuring under Relative and Absolute Priority Default Rules: A comparative assessment', *University of Illinois Law Review* 2021 U. Ill. L. Rev. ('**Seymour and Schwarz**')

<sup>18</sup> The deadline for implementation as per Article 34(1) of EU-PRD was 17.07.2021 but some Member States have opted for an extension of one year under Article 34(2) of EU-PRD for whom the deadline for implementation is 17.07.2022; For details of the National Transposition measures by European Union member states refer to European Union, National transposition Measures communicated by Member States concerning Directive EU/2019/1023, Document No. 32019L1023 <<https://eur-lex.europa.eu/legal-content/EN/NIM/?uri=celex:32019L1023>> Accessed July 12, 2022

<sup>19</sup>R.J. De Weijs, 'Preventive restructuring framework and the last-minute introduction of Relative Priority, (20 March 2019, Letter to the European Parliament Committee Juri (Legal Affairs) Rapporteurs) <<https://drive.google.com/file/d/114Xeljvi2Ljarl5aR6c7DBUv3YX2OINa/view>> Accessed July 12, 2022, 5 ('**De Weijs Letter**'); Douglas G. Baird, (March 7, 2019, Letter addressed to Prof. De Weijs) <<https://drive.google.com/file/d/114Xeljvi2Ljarl5aR6c7DBUv3YX2OINa/view>> Accessed July 12, 2022 ('**Douglas Baird's Letter**')

<sup>20</sup> Congress House of Representatives, 'Small Business Reorganisation Act, 2019', Judiciary Committee Report 116-171, 116<sup>th</sup> Congress 1<sup>st</sup> Session, <<https://www.govinfo.gov/content/pkg/CRPT-116hrpt171/pdf/CRPT-116hrpt171.pdf>> Accessed July 12, 2022, ('**Judiciary Committee Report**'), 1 and 3

<sup>21</sup> 11 USC Section 1191(c)

- (1) What characteristics of SME Debtors enable equity interests' retention in them during restructuring?
- (2) To what extent does the RPR under EU-PRD enable equity interests' retention for SME Debtors?
- (3) To what extent does the FET under SBRA enable equity interests' retention for SME Debtors?

The fairness tests of the APR, RPR and FET have collectively been referred to as '**Fairness Tests**' and each individually as a '**Fairness Test**' hereinafter.

The thesis consists of 4 chapters and a conclusion. The first chapter is focussed on answering the first sub-research question. In this chapter, I set the stage by outlining some basic concepts which enable us to understand the significance of restructuring for the SME Debtors and delineate the challenges associated with equity retention during restructuring. I also arrive at a working definition for SME Debtors which is used as a practical point of reference for conducting comparative analysis in the subsequent chapters.

The second chapter addresses the second sub-research question. I conduct historical legal research and literature review to trace the genesis of RPR as a concept in European context. I also (i) highlight academic and (ii) conduct a quantitative analysis, to assess the extent to which RPR enables equity retention for SME Debtors.

The third sub-research question drives the research design and structure of the third chapter. I conduct historical legal search and literature review to trace the development of the concept of RPR in US. I then look at how FET as a Fairness test evolved in US and discuss the requirements for its application under the SBRA. I analyze how the FET under the SBRA enables equity interests' retention for SME Debtors by (i) conducting doctrinal research by relying on literature and legal precedents and a (ii) quantitative analysis.

In the final chapter, I compare the RPR under EU-PRD with the FET under the SBRA. Firstly, I summarise the differences in application of RPR under Article 11(1)(c) of PRD and the FET under the 11 USC Section 1191(c). Then, I conduct a quantitative analysis to compare the distribution possibilities under the FET and the RPR. Finally, using the results arrived at, based on this quantitative analysis, I compare both the RPR and the FET based on a number of equity retention indicators, to arrive at my findings.

Lastly, I conclude my thesis by (i) summarising the findings arrived at, and (ii) providing suggestions to EU Member States which are yet to implement the EU-PRD, to implement the RPR in such a manner that it facilitates equity interests' retention for SME Debtors, by finding orientation in the FET under the SBRA.

I have limited the discussion on application of the cram down rules and the APR to the extent it is necessary for answering these questions. Further, I make 3 assumptions to streamline the comparative analysis for practical purposes:

- (i) The EU-PRD does not provide specific standards for what amounts to a relatively better treatment under the RPR.<sup>22</sup> I assume that classes senior in priority ranking would be provided a relatively better treatment under the RPR if they receive a higher percentage distribution on their claims than any junior class of creditors or equity holders.<sup>23</sup>

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<sup>22</sup> Article 11(1)(c), EU-PRD

<sup>23</sup> The assumption has been discussed under section 2.3 of this thesis

- (ii) The EU-PRD provides Member states the option to exempt SME Debtor from the obligation to (1) treat affected parties in separate classes<sup>24</sup> and (2) satisfying the requirement of a cross-class cram down mechanism and resultantly, the Fairness Tests of RPR and APR.<sup>25</sup> In the event these exemptions are provided, then the Fairness Test of the RPR would not be applicable in the first place. It is assumed that SME Debtors have not been exempted from treating the creditors in separate classes or from the application of cross-class cram rules.
- (iii) An SME Debtor has been defined differently in the domestic law of different EU member states and US.<sup>26</sup> I arrive at a working definition for an SME Debtor based on its peculiar characteristics, because of which equity retention in them is critical for their successful restructuring. This working definition is used as an axiomatic point of reference for conducting the analysis.

## **1 CHAPTER 1: EQUITY INTERESTS' RETENTION FOR SME DEBTORS AND FAIRNESS TESTS**

### **1.1 Introduction**

This chapter is focussed on answering the first sub-research question 'What characteristics of SME Debtors enable equity interests' retention in them during restructuring?'. Firstly, I set the stage by outlining some basic concepts which enable us to understand the significance of restructuring for the SME Debtors and the manner in which Fairness Tests are applied during their restructuring. Secondly, based on the understanding of these concepts, I delineate the challenges associated with equity retention and the reasons for enabling equity retention for the SME Debtors during their restructuring. Thirdly, premised on understanding of challenges associated with equity retention for SME Debtors, I conduct a literature review to (i) delineate the issues in defining SME Debtors and (ii) review peculiar characteristics of SME Debtors due to which equity retention in them during restructuring is crucial for their successful restructuring. The purpose of conducting this review is to provide answers to the first sub-research question and arrive at a working definition for SME Debtors which is used as a practical point of reference for conducting comparative analysis in the subsequent chapters.

### **1.2 Setting the Stage: Outlining some basic concepts**

I briefly outline some basic concepts such as the purport of restructuring process for SME Debtors, BIT, APR, RPR and FET. Building on these concepts, I explain why equity retention is required for SME Debtors in the next sub-section

#### **1.2.1 Purport of Restructuring for SME Debtors**

The EU-PRD states that a restructuring plan is aimed at reorganising the debtor's business that includes changing the composition, conditions of structure of the debtor's assets and liabilities or any other part of the debtor's capital structure, including by sales of assets or parts of the business or the business as a whole, as well as carrying out any operational changes or a combination of these elements.<sup>27</sup> Similarly, under SBRA, a plan of reorganisation may be proposed through which the SME Debtor proposes to repay its creditors by restructuring its debts, liabilities and capital structure.<sup>28</sup> The goal of this

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<sup>24</sup> Recital 58 and Article 12(1), EU-PRD

<sup>25</sup> Recital 45, EU-PRD

<sup>26</sup> Discussed under section 1.4 of this thesis

<sup>27</sup> Article 2(1)(1), EU-PRD

<sup>28</sup> 11 USC Sections 1189 to 1191

restructuring process, both under EU-PRD and SBRA, is to enable the SME Debtor in financial difficulties to continue business while balancing the rights of all parties involved, including the creditors.<sup>29</sup> A plan for restructuring a debtor may be adopted by the affected parties<sup>30</sup> by voting or confirming a plan by the court.<sup>31</sup> While confirming such restructuring plans, amongst other factors, the court shall be required to ensure that the plan satisfies the BIT as a baseline requirement.<sup>32</sup> However, certain restructuring plans which affect the claims or interests of dissenting affected parties, shall only be binding, if they are confirmed by the court by way of a cram down.<sup>33</sup> The EU-PRD additionally requires the Fairness Tests of APR or RPR should be satisfied if the restructuring plans affect the claims or interests of dissenting affected parties.<sup>34</sup> SBRA, on the other hand requires that the plan does not discriminate unfairly and satisfies the Fairness Test of the FET for operation of a cram down.<sup>35</sup> These tests are outlined in the subsequent sub-sections.

### 1.2.2 Best-interest-of-creditors test

Satisfying the BIT requires that no dissenting creditor is worse off under a restructuring plan than it would be in the case of liquidation.<sup>36</sup> EU-PRD additionally provides the next-best-alternative scenario instead of liquidation as a baseline requirement for testing whether the creditors are in a worse off position.<sup>37</sup> The next-best-alternative scenario has been interpreted by academicians to be a scenario which is realistically likely to materialise if the plan were not approved.<sup>38</sup> BIT should be applied in cases where a plan needs to be confirmed in order to be binding for dissenting creditors/classes of creditors.<sup>39</sup> It protects the value of existing entitlements, setting the baseline for distribution.<sup>40</sup> It aims to guarantee the realisable value of existing claims and equity rights of dissenting stakeholders (Hereinafter referred to as the '**Realisable Value**'). The surplus generated under a restructuring plan, based on cooperation of stakeholders as a going concern by providing future finance, workforce, supplies etc. may be referred to as the '**Reorganisation Surplus**'.<sup>41</sup> While the BIT sets a baseline for a minimum distribution of the realisable value, the Fairness Tests of APR, RPR and FET set the baseline for determining the fairness

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<sup>29</sup> Recital 2 and 3, EU-PRD; *In re Wildwood Villages, LLC*, Case No. 3:20-bk-02569-RCT (Bankr. M.D. Fla. May. 4, 2021), 6

<sup>30</sup>As per Article 1(2), EU-PRD, affected parties means creditors, including, where applicable under national law, workers, or classes of creditors and, where applicable, under national law, equity holders, whose claims or interests, respectively, are directly affected by a restructuring plan

<sup>31</sup> Article 9, EU-PRD provides the conditions for adoption of a restructuring plan; SBRA provides rules for confirmation of a plan under 11 USC, Sections 1129 and 1191(c)

<sup>32</sup> Article 10(2)(d), EU-PRD

<sup>33</sup> Article 11, EU-PRD; 11 USC Section 1129(b)(1)

<sup>34</sup> Art. 11, EU-PRD

<sup>35</sup> 11 USC Sections 1191(b) and (c)

<sup>36</sup> Recital 50, 52 and Article 1(6), EU-PRD; 11 USC Section 1129(a)(7)

<sup>37</sup> Art. 1(6), EU-PRD

<sup>38</sup> Riz Mokal and Ignacio Tirado, 'Has Newton had his day? Relativity and realism in European Restructuring', *Butterworths Journal of International Banking and Financial Law*, April 2019, ('**Mokal and Tirado**') 233

<sup>39</sup> Recital 52, EU-PRD

<sup>40</sup> Prof. Dr. Stephan Madaus, 'Is the Relative Priority Rule right for your jurisdiction? A simple guide to RPR' (18 January 2020) WP 2020-1, 1 ('**Simple Guide to RPR**')

<sup>41</sup> *Ibid*, 2 and 3

of the distribution of the expected Reorganisation Surplus to be achieved under the restructuring plan which is required to be confirmed.<sup>42</sup>

### 1.2.3 APR and RPR under the EU-PRD

The APR was first developed in US as a Fairness Test based on which the court could deny the approval of going-concern asset sale where its distribution violated the priority that would apply in liquidation.<sup>43</sup> Under the APR in the EU-PRD, Member States may protect a dissenting class of affected creditors by ensuring that such dissenting class is paid in full if a more junior class receives any distribution or keeps any interest under the restructuring plan.<sup>44</sup> The APR was however criticised on account of its rigidity. This rigidity, it was argued, encouraged hold-out behaviour of certain privileged classes of creditors who by objecting to the plan in case they were not paid in full, would frustrate an otherwise value creating restructuring plan.<sup>45</sup> The RPR was proposed as an alternative, to allow derogations from the rigidities of the APR. RPR under the EU-PRD requires that 'dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class, and that no class of affected parties can, under the restructuring plan receive or keep more than the full amount of its claims of interests'.<sup>46</sup> EU-PRD states that the RPR is an anti-discrimination-based fairness test that leaves to the discretion of stakeholders to decide a distance or multiplier for the plan distributions to classes with different ranks.<sup>47</sup> The concept of the RPR has been theorised differently by scholars in US and European context. These concepts are discussed further under Chapters 2 and 3 of this thesis.

### 1.2.4 FET under the SBRA

Under the SBRA, in cases of confirmation of a non-consensual plan, the FET requirement is to be satisfied with respect to each class of claims or interests that is impaired under, and has not accepted, the plan. This entails fulfilment of three conditions:

- (i) The plan should allow the secured claim holders to retain liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity and that each holder of claim receives on account of such claim, deferred cash payment the value of such holder's interest in such property.<sup>48</sup>
- (ii) The plan should provide that all the PDI of the SME Debtor to be received in the 3-year period (or the extended period up to 5 years), shall be applied to make payments under the plan or alternatively, the value of the property to be distributed under the plan within the 3-year period (or extended 5 period up to 5 years) should not be less than the PDI of the SME Debtor.<sup>49</sup>

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<sup>42</sup> Simple Guide to RPR (n 40), 2

<sup>43</sup> ELI Business Rescue Report, (n 11) 38 and 39; Stephen J. Lubben, 'The Overstated Absolute Priority Rule' 21 Fordham Journal of Corporate & Financial Law 2016, 58 ('Lubben')

<sup>44</sup> Recital 55 and Article 11(2), EU-PRD

<sup>45</sup> ELI Business Rescue Report (n 11), 324;

<sup>46</sup> Article 11(1)(c) and (d), EU-PRD

<sup>47</sup> Simple Guide to RPR (n 11), 5

<sup>48</sup> 11 USC Section 1129(b)(2)(A) and Section 1191(c)(1)

<sup>49</sup> 11 USC Section 1191(c)(2)

- (iii) The SME Debtor should be able to, or there is a reasonable likelihood that the debtor shall be able to, make all the payments under the plan,<sup>50</sup> and the plan provides appropriate remedies to protect the holders of claims or interests in the events that payments are not made.<sup>51</sup>

These requirements are discussed in detail in Chapter 3 of this thesis. For now, only the basic concepts have been outlined.

### 1.3 Necessity of equity retention in SME Debtors

Based on the understanding of basic concepts outlined in the preceding sub-section, I briefly shed light on the overarching challenge with equity retention during restructuring: the Debt/Equity Bargain. Thereafter, I underline why equity retention is required for SME Debtors during their restructuring.

#### 1.3.1 Fundamental Challenge with Equity Retention: the Debt/Equity Bargain

There is a fundamental conflict related to nature of entitlement of debt claims distribution amongst the creditors and equity holders during restructuring, termed as the '*Debt/Equity bargain*'.<sup>52</sup> This Debt-Equity Bargain is fundamental to the deliberation of whether equity interests should be retained during restructuring. Creditors in principle are entitled to be paid before equity receives anything. However, they cannot gain any additional benefits. They may claim only against the debtor's assets and have no recourse to its equity holders. Equity holders are residual claimants and not entitled to any particular return at all, any such return being contingent on the prior satisfaction of the debt claims.<sup>53</sup> The concept of Debt/Equity Bargain is based on the idea that creditor's legal rights are forcibly rewritten in a way that is detrimental to them, at least, prima facie. Therefore, equity interests' retention at the cost of creditor's interests might be unjustified.<sup>54</sup>

#### 1.3.2 Requirement of equity retention for successful restructuring of the SME Debtors

Ordinarily, equity holders as residual owners of the debtor are entitled to the profits generated based on the performance of the debtor, and therefore, it is justified for such equity holders to also suffer losses during restructuring.<sup>55</sup> It is pertinent to however, differentiate the preventive restructuring process from other modes of insolvency where revival of the business may not be the priority. Wessels justifies this argument by stating, in his prominently cited remark '*It is not about insolvency law as we know it.*'<sup>56</sup> The calculus outlined above for providing preference to creditor differs, when SME Debtors are involved, considering their peculiar characteristics.<sup>57</sup> The SME Debtor is often owned by the equity holders and not creditors.<sup>58</sup> Equity retention for SME Debtors is crucial for their revival since the same persons may be performing the combined role of manager and residual risk-bearer, who is the also equity holder in an SME. Equity retention may also be important to retain the goodwill of certain suppliers, customers

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<sup>50</sup> 11 USC Section 1191(c)(3)(A)

<sup>51</sup> 11 USC Section 1191(c)(3)(B)

<sup>52</sup> CODIRE (n 11), 32 [2.1]

<sup>53</sup> Ibid

<sup>54</sup> CODIRE (n 11), 33 [2.1]

<sup>55</sup> Recital 67 and Article 34(1)(a), Bank Resolution and Recovery Directive (BRRD) Directive on establishing a framework for the recovery and resolution of credit institutions and investment firms, 2014/59/EU, L 173/190

<sup>56</sup> Ibid

<sup>57</sup> Michelle Craig, 'The New Value Exception: A Plea for Modification or Elimination', 11 EMORY BANKR. DEV. J. 781, 816-17 (1995), 812

<sup>58</sup> Gerard McCormack, 'The European Restructuring Directive' (2021, Elgar Corporate and Insolvency Law and Practice) ('**McCormack**') 8.83

and employees of the SME Debtor.<sup>59</sup> Further, It incentivises equity holding management to access the process early. This is particularly important because a delay in accessing restructuring could result in a worse outcome for the creditors.<sup>60</sup> Shareholders should be interested in early restructuring because their equity shares are affected and devalued before the creditors' claims.<sup>61</sup>

#### 1.4 Arriving at a Working Definition for SME Debtors to conduct research

Having highlighted the necessity of equity retention for SME Debtors during their restructuring, I will now outline the issues with defining SME Debtors, review their peculiar characteristics that enable such equity retention and finally, arrive at a working definition based on such characteristics.

##### 1.4.1 Challenges in providing a standardized definition for SME Debtors

Under the EU-PRD, the concept of an SME is to be understood as defined by the national law of Member States.<sup>62</sup> EU-PRD states<sup>63</sup> that Member States, in defining micro, small and medium sized enterprises, could give due consideration to directive 2013/34/EU of the European Parliament (EP) and of the Council<sup>64</sup> or the Commission Recommendation of 6 May 2003.<sup>65</sup> The 6 May 2003 recommendation of the Commission defines micro, small and medium sized enterprises to be comprising of any entity engaged in an economic activity, irrespective of its legal form, that is not part of an enterprise group and falls within a set of three criteria; staff headcount, annual turnover and annual balance sheet.<sup>66</sup> The binding definition under the EU-PRD is therefore, rather broad and includes a wide range of enterprises from the sole entrepreneur or artisan to a company of 250 employees with a turnover of EUR 50 million annual turnover. As a corollary, the impact of equity interests' retention in such SMEs may also be quite divergent.<sup>67</sup>

SBRA instead of providing a definition for SMEs based on the number of their employees or turnover, stipulates that a debtor is eligible to apply for restructuring proceedings under SBRA based on the nature of its activities and contingent debts.<sup>68</sup> A debtor is eligible to elect restructuring proceedings under SBRA if the debtor:

- (i) Is a 'person'. A person includes an individual, corporation or partnership but does not include a governmental unit.<sup>69</sup>

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<sup>59</sup> Ibid

<sup>60</sup> CODIRE (n 42), 34

<sup>61</sup> CODIRE (n 42), 17

<sup>62</sup> Article 2(c), EU-PRD

<sup>63</sup> Recital 18, EU-PRD

<sup>64</sup> Directive 2013/14 of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings amending directive 2006/43/EC of the European Parliament and repealing council directives 78/660/EEC and 83/349/EEC

<sup>65</sup> Commission recommendation of 6 May 2003 concerning the definition of Micro, Small and Medium Sized Enterprises (OJ L 124, 20.5.2003, p. 36) ('**SME Recommendation**')

<sup>66</sup> Recitals 4 to 16, SME Recommendation (n 65)

<sup>67</sup> Madaus Stephan, European Parliament, Legal and Parliamentary Affairs, 'The Impact of SMEs of the Proposal of Preventive Restructuring, Second Chance and Improvement Measures, In-depth Analysis of the JURI Committee' (May 2017, Directorate General for Internal Policies of the Union, Policy Department for Citizens' Right and Constitutional Affairs), 7

<sup>68</sup> 11 USC Section 1182 (1)

<sup>69</sup> 11 USC Section 101(41)

- (ii) Is engaged in commercial or business activity. A debtor conducting active operations at the time of the filing of the petition under SBRA, meets the eligibility requirement that it is 'engaged in commercial or business activities'.<sup>70</sup>
- (iii) Does not have aggregate non-contingent liquidated secured and unsecured debts on the date of filing of the petition of more than \$7.5 million.<sup>71</sup> It does not include any member of a group of affiliated debtors that has aggregated debts in excess of this limit of \$7.5 million.<sup>72</sup>
- (iv) At least 50% of the debts arise from the debtor's commercial or business activities.<sup>73</sup>

It is evident that there is a lack of consistency in defining SMEs. In the US, definitions have been provided based on the nature of activities and debt threshold. EU jurisdictions also have different definitions based on characteristics such as the number of employees, turnover and sales. Within each criterion, the exact standard that is used to define what constitutes an SME also varies greatly in each Member State.<sup>74</sup> Given this lack of consistency, the Report of European Law Institute on Rescue of Business in Insolvency Law (Hereinafter referred to as the '**ELI Business Rescue Report**') concludes that it is close to impossible to provide a definition of classes of businesses that can be labelled micro or small-sized that would fit all Member States.<sup>75</sup> Given this inconsistency, I follow an approach similar to the one adopted in the Business Rescue Report.<sup>76</sup> Instead of focussing on qualification thresholds, I review SME Debtor characteristics which necessitate equity interests' retention in them during their restructuring, in the next sub-section.

#### 1.4.2 Peculiar SME Debtor Characteristics

I conduct a literature review to scrutinise the peculiar characteristics of SME Debtors and arrive at a working definition for SME Debtors based on such characteristics.

##### 1.4.2.1 Lack of resources and limited access to finance

The first peculiar characteristic of SME Debtor is the limited availability of resources and resultantly, limited outsider expectations. They often have less capital, a lower market share, smaller workforce, fewer resources and often very few or no assets.<sup>77</sup> These physical assets may already be encumbered

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<sup>70</sup> *In re Ellingsworth Residential Community Association, Inc.*, 619 B.R. 519 (Bankr. M.D. Fla. 2019); *NetJets Aviation, Inc. v. RS Air, LLC* WL 1288608 (B.A.P. 9th Cir. 2022), 6-8

<sup>71</sup> Earlier the threshold limit was \$2,725,625. This limit was later amended by the Coronavirus Aid, Relief and Economic Security Act, 2020 (CARES Act) and increased to \$7,500,000. This increased threshold expired in March 28, 2022. On June 7, 2022, the Congress passed the Bankruptcy Threshold Adjustment and Technical Corrections Act, Pub. L. No. 117-151, restored the debt threshold to \$7,500,000.

<sup>72</sup> 11 USC Section 1182(1)(B)(i)

<sup>73</sup> 11 USC Section 1182(1)(A)

<sup>74</sup> World Bank Group Insolvency and Creditor/Debtor Regimes Task Force, Working Group on the Treatment of MSME Insolvency, 'Report on the Treatment of MSME Insolvency' (2017, International Bank for Reconstruction and Development/ the World Bank) ('**World Bank Report**'), 3

<sup>75</sup> ELI Business Rescue Report, (n 11), 365 at [746] and [747]; Pertinently, the ELI Business Rescue Report also points out that the overall picture reveals that a special treatment is available for small, but not for medium sized businesses. The ELI Business Rescue Report therefore segregates these two classes of businesses (i) MSEs (Micro and small sized enterprises) which refers to the classes of businesses at the lower end and (ii) SMEs (small and medium sized enterprises).

<sup>76</sup> ELI Business Rescue report (n 11), 334 to 338

<sup>77</sup> Peer Stein, Oya P. Pinar Ardic, and Martin Hommes, 'Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises', (2013, Washington),

to one or a very limited number of secured creditors.<sup>78</sup> Unencumbered assets are usually of little or no value for distribution.<sup>79</sup> SME Debtors are burdened with larger collateral requirements, which makes raising finance in situations of financial distress difficult for them, if not impossible. Such excessive collateral requirements are often imposed because of the asymmetry of bargaining power and the lack of financial information.<sup>80</sup> Entrepreneurs often take a high level of personal financial risk to start an SME; the most common of which is personally guaranteeing business loans<sup>81</sup>. Access to credit is often made subject to the granting of personal guarantees by the owners or their relatives and friends.<sup>82</sup>

#### 1.4.2.2 *Centralised governance and entrepreneurship interdependency*

The second characteristic is the interdependency of SME Debtors with entrepreneurship since a small business usually thrives of the entrepreneur and often, the entrepreneur's family.<sup>83</sup> The report on best practices in European restructuring (Hereinafter referred to as '**CODIRE**') states SMEs often operate without a separate legal personality and have closely intermingled business and personal debts and a centralised governance model in which ownership, control and management overlap. Given the nature, size and/or location of the business and its turnover, the business may not be viable unless the same persons were both managers and equity owners, thereby effectively cross-subsidising the two roles.<sup>84</sup> Their retention in the SME Debtor may be crucial for successful reorganisation of the SME Debtor since they bring to the SME Debtor their soft variables such as their experience, contacts, know-how and other skills which are crucial for an SME Debtor's survival.<sup>85</sup>

#### 1.4.2.3 *Lack of Incentives to access the restructuring process*

The third peculiar characteristic is that they lack incentives to access the restructuring procedure at an early stage. SME Debtors rarely use formal insolvency proceedings voluntarily and when they do it, it is almost inevitably too late to preserve value.<sup>86</sup> The reasons for lack of incentives to access the procedure are multi-fold:

- i) Many SMEs are disadvantaged because they lack the sophistication to identify and react to financial distress.<sup>87</sup> SME Debtors often seek advice too late, and such advice, not infrequently, is poor since the debtors can only afford to pay very small fees. This may result in SMEs waiting too long before initiating the insolvency process.<sup>88</sup>

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<<https://openknowledge.worldbank.org/handle/10986/21728>> Accessed July 12, 2022, 11; ELI Report (n 11), [754]-[755]

<sup>78</sup> United Nations Commission on International Trade Law, 'Insolvency of micro, small and medium-sized enterprises, Draft Text on Simplified Insolvency regime', (22nd March 2019, Working Group V, 55th Session), A/CN.9/WG.V/WP.166, ('**UNCITRAL Draft Text MSME Insolvency**') [16]

<sup>79</sup>Ibid [18]

<sup>80</sup> UNCITRAL Draft Text MSME Insolvency (n 78) [14]

<sup>81</sup> World Bank Report (n 74), 6

<sup>82</sup> UNCITRAL Draft Text MSME Insolvency (n 78) [15]-[16]

<sup>83</sup> ELI Report (n 11), [749]

<sup>84</sup> CODIRE (n 11), 34 [2.2.2]

<sup>85</sup> Ballerini (n 17), 9

<sup>86</sup> CODIRE (n 11), 234 at [1.2]

<sup>87</sup> Davis et. Al., 'The Modular Approach to Micro, Small and Medium Enterprise Insolvency', (2016, Allard Faculty Publications, Working Paper), 20–21

<sup>88</sup> World Bank Report (n 74), 10

- ii) Lack of adequate financial information also has an effect on the ability of creditor to monitor the debtor.<sup>89</sup>
- iii) The manager, who is also frequently the owner of an SME Debtor, may not be incentivised to access the insolvency procedure, out of fear of damaging to its commercial reputation or its relationship with its employees, suppliers and the market. It may also disrupt the existing lines of credit.<sup>90</sup>

It seems that incentivising SMEs to file for insolvency procedures is challenging and incentivising them to do so in a timely fashion is even more challenging.<sup>91</sup>

#### **1.4.2.4** *Creditor Passivity*

The fourth peculiar characteristic of SME Debtors is their creditor passivity. Creditor passivity arises when creditors refrain from participating in the insolvency process upon weighing the amount they estimate they will receive from such participation vis-à-vis the time and money this effort requires. Since for SMEs the costs often outweigh the returns, it would be reasonable for the creditors to refrain from getting involved in the proceedings.<sup>92</sup> The debtor and the secured creditors are usually the main beneficiaries of orderly restructuring. Resultantly, the situation is dominated by insider incentives to have orderly proceedings while stakeholders other than secured creditors and the debtor, have good reasons to stay passive.<sup>93</sup>

#### **1.4.2.5** *Macro-economic challenges*

Lastly, from a macro-economic perspective, a well-functioning restructuring and insolvency framework for SMEs must be well equipped to handle a large number of cases with little to no assets or creditor activity.<sup>94</sup> SME Debtors could be the clients of other micro or small businesses that would share the same characteristics and may heavily depend on payments from their clients, with the consequence that the failure of one business may cause additional failures in the supply chain.<sup>95</sup>

### **1.4.3 Working Definition of SME Debtors**

Summarily, based on the review of peculiar characteristics, an SME Debtor can therefore be characterised as having:

- (i) Limited resources and lack of access to finance,
- (ii) Interdependency with entrepreneurship, having closely intermingled business and personal debts,
- (iii) Suffering from creditor passivity,
- (iv) Lack of incentives to access restructuring at an early stage of the formal insolvency process and
- (v) From a macro-economic perspective, the failure of business might also lead to failures in the supply chain since its customers are also SMEs and depend heavily on timely payment.

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<sup>89</sup> CODIRE (n 11), 234-235

<sup>90</sup> UNCITRAL Draft Text MSME Insolvency (n 78), [19]

<sup>91</sup> World Bank Report (n 74), 12

<sup>92</sup> World Bank Report (n 74), 12

<sup>93</sup> ELI Business Rescue Report (n 11), [756]

<sup>94</sup> ELI Business Rescue Report (n 11), [371]

<sup>95</sup> UNCITRAL Draft Text MSME Insolvency (n 78), [13]

This working definition of SME Debtors (Hereinafter referred to as the '**Working Definition**') has been used to conduct the comparative analysis for testing RPR and FET, in the subsequent chapters.

The following observations may be concluded from the analysis in this chapter. While considering the purport of restructuring and the manner in which the BIT and Fairness Tests are applied during restructuring, I reviewed some peculiar characteristics of SME Debtors. It can be summarised that SME Debtors have certain peculiar characteristics, such as limited resources, entrepreneurship interdependency, creditor passivity, interdependency on other SMEs and lack of incentives to access the restructuring process at an early stage, because of which equity interests' retention is required for their successful restructuring. Based on these peculiar characteristics, I have arrived at a working definition for SME Debtors which has used as practical point of reference to conduct further analysis in this thesis.

## **2 CHAPTER 2: EQUITY INTERESTS' RETENTION UNDER THE RPR OF EU-PRD**

### **2.1 Introduction**

I attempt to answer the second sub-research question in this chapter, 'To what extent does the RPR under the EU-PRD enable equity interests' retention for SME Debtors during restructuring?'. I use the concepts and Working Definition of SME Debtors delineated in Chapter 1 to conduct this analysis. Firstly, I perform a historical legal search and literature review to trace the theoretical development of the RPR in European context. Secondly, I review the concept of RPR and the requirements for its application under the EU-PRD. Thirdly, building on this understanding of the RPR, I analyse how RPR enables equity interests' retention for SME Debtors during restructuring. I do this by (i) highlighting the academic debates on equity retention enabling ability of RPR and (ii) conducting a quantitative analysis of hypothetical data (Table 1) to assess the extent to which RPR enables equity retention for SME Debtors when compared to the BIT and APR tests under the EU-PRD.

### **2.2 Tracing the development of RPR in European Context**

I primarily look at two prominent sources of literature to trace the development of the RPR in European context, (i) ELI Business Rescue Report which provided reports and recommendations on a wide variety of themes affected by rescue of financially distressed businesses,<sup>96</sup> and (ii) CODIRE which crystallised guidelines and policy recommendations for best practices in restructuring based on empirical evidence from Germany, Italy, Spain and the UK. These two reports seem to have fostered the inclusion of RPR in its present form under Article 11(1)(c) of the EU-PRD. ELI Business Rescue Report was one of the first to provide recommendations for use of RPR in the European context. It was pointed out that a number of scholars have been sceptical of APR and have tried to develop a more flexible rule in the form of the RPR, by placing reliance on the concept of RPR as promulgated by *inter alia*, by Baird.<sup>97</sup> The Report stated that a Fairness Test should not dictate that junior creditors or shareholder may not receive any value before all senior creditors have been paid in full. Instead, it should be possible to keep

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<sup>96</sup> ELLI Business Rescue Report (n 11), 5

<sup>97</sup> ELI Business Rescue Report (n 8), 324; Reliance under footnote 1084 of the ELI Business Rescue Report has been placed on Douglas G Baird, 'Priority Matters: Absolute Priority, Relative Priority and the Costs of Bankruptcy', U. Penn L. Rev. 785 (2016), 582; Lubben (n 43) 581. Reliance under Footnote 1085 of the ELI Business Rescue Report has been placed on the ABI Commission to Study the Reform of Chapter 11, (2014), 213 <<https://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1096&context=books>> Accessed 12 July 2022 ('**ABI Commission Report**')

such stakeholders in the capital structure as long as the restructuring plan provides for the senior classes to be treated more favourably.<sup>98</sup> The Report asserted that:

*'A more flexible (relative) priority rule would better reflect pre-insolvency entitlements as it allows to create a new capital structure that also keeps everyone in the picture.'*<sup>99</sup>

The concept of RPR as delineated in the ELI Business Rescue Report was supported by CODIRE.<sup>100</sup> The RPR as explained by CODIRE would require that:

- (i) each dissenting class is to receive treatment at least as favourable as other classes within the same rank
- (ii) no class of a lower rank is to be given equivalent or better treatment than it;
- (iii) higher ranking classes must receive no more than the full economic value of their claim.<sup>101</sup>

Intriguingly, Baird strongly disagreed how the concept of RPR, as theorised by him, had been interpreted by scholars in Europe. He wrote a letter to De Weijs, anguished that his work had been misunderstood in the European context.<sup>102</sup> Weijs then addressed a letter to the European Parliament Committee (whereby Baird's letter was also annexed), arguing that the last-minute inclusion of the RPR was completely unjustified and should not be included in the finalised draft of EU-PRD.<sup>103</sup> De Weijs et. al, in their publication also argued that adopting of the RPR rule would be a grave mistake since it was confusingly labelled as the RPR but was in fact, starkly different from the US proposals for the RPR.<sup>104</sup> This view was also supported by Ballerini, Seymour and Schwarz.<sup>105</sup> On the other hand, many legal scholars such as Wessels, Mokal, Tirado and Madaus, supported the inclusion of RPR in the form in which it was proposed under the EU-PRD.<sup>106</sup> In Chapter 3, I discuss in further detail the form of RPR as theorised in US to understand the differences in the form of RPR proposed in European context from the form of RPR proposed in US.

Despite the heated academic debates centred around the form of the RPR in which it was proposed under the EU-PRD, the same language was retained and included in the finalised draft of the EU-PRD.<sup>107</sup> The RPR was included under Article 11(1)(c) of the EU-PRD. I discuss the requirements of application of the RPR under the EU-PRD in the next sub-section.

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<sup>98</sup> ELI Business Rescue Report, (n 11), 335 and 336

<sup>99</sup> ELI Business Rescue Report (n 11), 334

<sup>100</sup> Reliance by CODIRE has also been placed under footnote 10 on page 46 on Madaus Leaving the shadows of US Bankruptcy Law (n 17)

<sup>101</sup> CODIRE (n 42), Policy Recommendation 2.16

<sup>102</sup> Douglas Baird's Letter (n 19)

<sup>103</sup> De Weijs Letter (n 19)

<sup>104</sup> De Weijs et. al. Imminent Distortion of European Insolvency Law (n 17), 11

<sup>105</sup> Ballerini (n 17), 17; Seymour and Schwarz (n 17), 49 and 50

<sup>106</sup> Bob Wessels Reply (n 17); Madaus Leaving shadows of US Bankruptcy Law (n 17);

<sup>107</sup> For details of the procedure of adoption, refer to the procedure at EUR-Lex, 'Document 32019L1023', 2016/03569/COD <<https://eur-lex.europa.eu/legal-content/EN/HIS/?uri=celex:32019L1023>> Accessed on 12 July 2022

## 2.3 Application of the RPR under the EU-PRD

The Fairness Test of the APR or RPR shall have to be applied, taking into account the stipulations outlined under Articles 9, 10 and 11. I briefly outline these requirements before discussing the Fairness test of RPR under Article 11(1)(c) of the EU-PRD.

### 2.3.1 Preconditions under Articles 9, 10 and 11 for application of the RPR

Article 9 of the EU-PRD stipulates the conditions for adoption of a restructuring plan. It states that all affected parties shall have a right to vote on the restructuring plan.<sup>108</sup> The affected parties are required to be treated in separate classes which reflect sufficient commonality of interest. However, Member States may provide the option to SME Debtors to opt out of such requirement to treat affected parties in separate classes.<sup>109</sup> Article 9(6) of the EU-PRD states that restructuring plan can be adopted by affected parties, if a majority of their claims or interests is obtained in each class. The majority percentage is to be decided by a Member State and should not be higher than 75% of the amount of claims or interests in each class.

Article 10 of the EU-PRD provides the details for confirmation of a restructuring plan. Any restructuring plan that (i) affects the claims or interests of dissenting affected parties or (ii) provides for new financing, shall be binding only if the plan is confirmed by a court.<sup>110</sup> Article 10(2) and 10(3) state the conditions under which such plans may be confirmed by a court:

- (i) The plan should satisfy the BIT. A judicial or administrative authority is only required to examine the BIT, if a restructuring plan is challenged on the ground that it does not satisfy the BIT.
- (ii) Creditors with sufficient commonality of interest in the same class are treated equally, and in a manner proportionate to their claim.
- (iii) Judicial or administrative authorities are able to refuse to confirm a restructuring plan that does not have a reasonable prospect of preventing insolvency of the debtor or ensuring the viability of the business.<sup>111</sup>

Article 11 of the EU-PRD delineates the conditions for operation of a cross-class cram down. A cross-class cram down is operational if the majority percentage for affected parties in every voting class under Article 9(6) (as discussed earlier in this sub-section) has not been achieved. The restructuring plan will become binding on these dissenting voting classes if it is approved by the court way of a cross-class cram down.<sup>112</sup> For a cross-class cram down, in addition to the stipulations provided under Article 10(2) and 10(3) (as discussed earlier in this sub-section), the following conditions should be satisfied:

- (i) It has been approved by:
  - (1) A majority of the voting classes of affected parties, provided that at least one of those classes is a secured class of creditors or is senior to the ordinary unsecured creditors class; or
  - (2) At least one of the voting classes of affected parties, other than equity-holders class, or any other class, which upon a valuation would not receive any payment.

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<sup>108</sup> Article 9(2), EU-PRD

<sup>109</sup> Article 9(4), EU-PRD

<sup>110</sup> Article 10(1)(a), EU-PRD

<sup>111</sup> Article 10(3), EU-PRD

<sup>112</sup> Article 11(1), EU-PRD

(3) In a case with only two classes of creditors, the consent of one class is sufficient for cram down to be approved, assuming other requirements are met.<sup>113</sup>

(ii) No class of affected parties receive or keep more than the full amount of their claims.<sup>114</sup>

Having outlined the stipulations under Articles 9, 10 and 11 of the EU-PRD, I discuss the concept of RPR as provided under Article 11(1)(c) of the EU-PRD in the next sub-section

### 2.3.2 RPR under Article 11(1)(c) of the EU-PRD

Article 11(1)(c) and Article 11(2) paragraph 1, provide for the RPR and APR as Fairness Tests which are to be satisfied, for the operation of a cross-class cram down.<sup>115</sup> Article 11(1)(c) which incorporates the RPR under the EU-PRD, reads as:

*'it ensures that dissenting voting classes of affected creditors are treated as favourably as any other class of the same rank and more favourably than any junior class...'*

From a literal reading of Article 11(1)(c), it is discernible that the RPR requires that dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class.<sup>116</sup> It has been asserted that the EU-PRD fails to clarify the standard for treating a senior class '*more favourably*' than a junior class'.<sup>117</sup> Although these assertions might hold ground, it is assumed for the purposes of the thesis that senior creditor classes would be treated '*more favourably*' if they receive a greater percentage distribution on their claims than any other junior class.<sup>118</sup> It is clarified that this amount is different from the face amount paid to senior creditors which exceeds the amount paid to junior creditor class. This might produce arbitrary results. For instance, if a plan pays 1 million to a senior creditor class where 2 million are owed to it and 2 million to a junior class where 5 million are owed to that class, it would then satisfy the RPR, despite the fact that the face value of amount being paid to junior creditor class is more than what is paid to the senior creditor class.<sup>119</sup>

The EU-PRD states that Member States may exclude equity holders from the application of cross-class cram down and the Fairness Tests (factoring for the fact that the debtor is an SME).<sup>120</sup> In fact, on account of their relatively simple capital structure, SME Debtors may be exempted from the obligation to treat affected parties in separate classes.<sup>121</sup> This would in essence mean that only one voting class is present for approving the restructuring plan. In this situation, the provisions of Article 10(2)(b) of the EU-PRD would mandate that all creditors in this one class are treated equally and, in a manner, proportionate to their claim. It seems that the RPR under Article 11(1)(c) cannot be applicable in such a situation since a relatively better treatment cannot be provided to any creditor classes, there being only one class of creditors. Therefore, for practical purposes, it is assumed in this that SME Debtors have not been

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<sup>113</sup> Recital 54 and Article 11(1)(b), EU-PRD

<sup>114</sup> Article 11(1)(d), EU-PRD

<sup>115</sup> The EU-PRD gives the Member states a choice between enacting APR or RPR.

<sup>116</sup> Article 11(1)(c) and (d), EU-PRD

<sup>117</sup> De Weijts et. al. Imminent Distortion of European Insolvency Law (n 17) 17-19

<sup>118</sup> In De Weijts et. al. Imminent Distortion of European Insolvency Law (n 17), at 18, it has been suggested this as one of the possible standards amongst others,

<sup>119</sup> Based on the example provided in Seymour and Schwarz (n 17) at footnote 102 on page 25

<sup>120</sup> Recital 58 and Article 12, EU-PRD

<sup>121</sup> Recital 45, EU-PRD

exempted from either treating the creditors in separate classes or from the application of cross-class cram rules. It is assumed that the RPR is applicable

### 2.3.3 Relaxed RPR approach under EU-PRD

Based on the Working Definition of SME Debtors, there may be situations where the success of their future business depends on the continued contribution of the equity holders retaining their rights in the SME. In certain situations, equity holders would be required to be paid in full, while the creditors would not be paid in such a manner. However, such a distribution mechanism cannot be confirmed under the RPR, when applied in its strictest sense, since the creditors are required to be provided a relatively better treatment before providing value to the equity holders.<sup>122</sup> In such a situation, the EU-PRD provides for a general derogation from the priority rule under the second paragraph to Article 11(2) to allow for the so termed 'relaxed RPR' (Hereinafter referred to as "**Relaxed RPR**").<sup>123</sup> The derogations from Article 11(1)(c) are only permissible if:

- i) It is necessary in order to achieve the aims of the restructuring plan; and
- ii) the restructuring plan does not unfairly prejudice the rights or interests of any affected parties.<sup>124</sup>

This Relaxed RPR approach has been asserted to be justified in governing the fairness test in cramdown situations.<sup>125</sup> Having discussed the application of the RPR, it is useful at this stage to understand the manner in which the repayment based on the RPR is to be made under the restructuring plan and the stage at which the SME Debtor would be discharged.

### 2.3.4 Discharge of the SME Debtor based on repayment under the RPR

The EU-PRD allows Member States to either have straight debt discharge procedures or alternatively repayment plans.<sup>126</sup> Article 2(11) defines a '*repayment plan*' as a programme of payments of specified amounts on specified dates by an insolvent entrepreneur to creditors, or alternatively a periodic transfer to creditors of a certain part of the entrepreneur's disposable income during the discharge period. A full discharge of debtor under EU-PRD should not exceed 3 years.<sup>127</sup> However, derogation from this rule may be justified by reasons laid down in the national law of Member States.<sup>128</sup> Therefore, the SME Debtor may either have a straight debt discharge or choose to make payments based on a repayment plan for a period of up to 3 years and only upon payment of this amount, will the SME Debtor be discharged from its obligations. Having discussed the requirements for application of RPR and repayment mechanism based on the RPR leading to a discharge of the SME Debtor, I will now shed light on how this form of RPR enables equity retention for SME Debtors by conducting a literature review on the equity retention enabling ability of the RPR in the next sub-section.

## 2.4 Equity interests' retention for SME Debtors under the RPR in EU-PRD

The RPR, in comparison to the APR, increases the chances of awarding more value under the plan to equity holders.<sup>129</sup> In the event a Relaxed RPR approach is adopted, it is possible for the equity holders

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<sup>122</sup> Simple Guide to RPR, (n 40), Example 9 on page 6

<sup>123</sup> As phrased in the Simple Guide to RPR (n 40), 4

<sup>124</sup> Article 11(2), Second paragraph, EU-PRD

<sup>125</sup> Simple Guide to RPR (n 40), 6

<sup>126</sup> Article 21(1)(a), EU-PRD

<sup>127</sup> Article 21 and Recital 75, EU-PRD

<sup>128</sup> Recital 78, EU-PRD

<sup>129</sup> Mokal and Tirado (n 17), 235

to retain 100% of their pre-petition rights, while refraining from making full payments to the creditors.<sup>130</sup> It has been asserted that the RPR, by protecting the relative position of dissenting classes of creditors but without creating hold-out incentives.<sup>131</sup> The RPR makes it more feasible for plans to be confirmed that permit equity holders to retain a stake in the debtor or its business which in turn is likely to incentivise greater and more timely use of restructuring proceedings by SME Debtors.<sup>132</sup> It also provides protection to equity holders from secured creditors who might impose unreasonably onerous terms for providing credit by creating collateral on the SME Debtor's assets; with an aim to obtain equity interests in exchange in the event of restructuring of an SME Debtor.<sup>133</sup>

In order to further expound on this viewpoint, I conduct quantitative analysis using hypothetical figures in Table 1 below to understand the extent to which the RPR enables equity interests' retention for SME Debtors, in comparison to the BIT and the APR.

## 2.5 Hypothetical Illustration to understand application of BIT with RPR (Table 1)

As explained earlier, both APR and RPR as fairness tests require that BIT is satisfied in the first place for their application. I look at a hypothetical example to understand the manner in which BIT may be conjointly applied with the RPR to enable equity retention, largely based on Madaus' example.<sup>134</sup> I take hypothetical figures assuming that if the BIT is applied, a senior creditor class could expect 100, the unsecured creditors could expect 10 and the junior dissenting unsecured creditors and equity are not left with any value. The Reorganisation surplus is 70 and therefore, the total value based on the restructuring plan is 180. For the full satisfaction of their value, the classes of creditors and equity holders need to be paid the following amounts, (i) secured creditors-110, (ii) senior dissenting unsecured creditors – 50, (iii) Junior dissenting unsecured creditors – 60 and (iv) equity holders – 25. A 3-year time period for making payments under the restructuring plan is usually considered to be appropriate for SME Debtors under the EU-PRD.<sup>135</sup> For practical convenience, I accordingly assume that the payment is to be made according to a repayment plan within 3 years by the SME Debtor. Table 1 illustrates the distribution possibilities when BIT is applied in conjunction with the RPR and APR.

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<sup>130</sup> Simple Guide to RPR (n 40), 6

<sup>131</sup> CODIRE (n 11), 46

<sup>132</sup> CODIRE (n 11), 46

<sup>133</sup> CODIRE (n 11), 47. These strategies are commonly referred to as "loan-to-own" strategies

<sup>134</sup> Simple Guide to RPR (n 40), Example 7 on page 5

<sup>135</sup> Recital 78 and Article 21(1), EU-PRD

**TABLE 1: DISTRIBUTION POSSIBILITIES UNDER THE RPR IN EU-PRD**

	<b>BIT</b> (Minimum Realisable Value set by BIT is 110)	<b>APR</b> (When total value payable under the repayment plan is 180)	<b>RPR</b> (When total value payable under the repayment plan is 180)
<b>DISSENTING SECURED SENIOR CREDITORS</b>	100	110	<b>100 (90.9%)</b> (Any value between 100 to 110 may be provided as long as other applicable conditions <sup>136</sup> are satisfied)
<b>DISSENTING SENIOR UNSECURED CREDITORS</b>	10	50	<b>40 (80%)</b> (Any value lesser than 90.9% of the total value of 50 may be provided as long as other applicable conditions are satisfied)
<b>DISSENTING JUNIOR UNSECURED CREDITORS</b>	0	20 (Need to be paid 60 to be satisfied in full but only gets 20 due to limited reorganisation surplus)	<b>30 (50%)</b> (any value lesser than 80% may be provided as long as other applicable conditions are satisfied)
<b>EQUITY HOLDERS</b>	0	0	<b>10 (40%)</b> (Any value lesser than the 50% of total value of 25 may be provided to junior creditors)

Applying both the RPR and BIT, a restructuring plan may only be confirmed over the veto of a dissenting class if the following conditions are satisfied:

- (i) The plan distributes as Realisable Value to dissenting unsecured senior creditors class of at least 80% and not more than 90.9% of their total claim price.
- (ii) The plan distributes as Realisable Value to dissenting unsecured junior creditors class not more than 80% of their total claim price.
- (iii) The plan does not leave value with equity holders any value equal to or more than the percentage distributed to dissenting unsecured junior creditor class. In this case the value would be not more than 50% of its total valued price.
- (iv) The plan does not give more value to any other class of the same ranking. No junior class may receive value equal to or exceeding the value distributed to a more senior class unless such a class is voting to accept such a distribution.<sup>137</sup>

Under these conditions since a more favourable treatment has been accorded to a senior ranked creditor class in accordance with Article 11(1)(c), the RPR has been satisfied. Evidently, a restructuring plan that leaves shareholders for instance with value of 10 and junior creditors with 30, could not be confirmed

<sup>136</sup> The conditions are summarised subsequently in the paragraph following the table

<sup>137</sup> Simple Guide to RPR (n 40), 5

under APR since both the senior secured creditor class (with value of 110) and dissenting unsecured creditors (value of 50) would have to be paid in full. Resultantly, APR introduces a specific distance between classes of different ranks and to that extent may be considered to be more rigid in comparison to the RPR.<sup>138</sup> It is pertinent to clarify here that the equity holders cannot retain a higher percentage of their total amount than the percentage provided to other creditor classes.<sup>139</sup> Based on this analysis, it is apparent that while the RPR enables equity retention for SME Debtors, it may be difficult where such relatively better treatment to creditor classes exhausts the total value based on reorganisation before equity holders receive anything. Possibility of equity retention will decrease under the RPR if the Reorganisation Surplus decreases.

Summarily, it can be concluded based on the analysis in this chapter that that RPR's inclusion was not supported by many scholars in the European context. Despite debates centred around the form in which it was proposed under the EU-PRD, this form of the RPR was retained under Article 11(1)(c) of the EU-PRD. This form of RPR mandates provides for a relatively better treatment for a senior ranking class. Article 11(2) also provides derogation from the RPR in the form of a Relaxed RPR approach. Doctrinal research and quantitative analysis show that the RPR enables equity retention for SME Debtors. However, it also indicates that in certain situations of restructuring equity retention may be difficult for SME Debtors, when distribution of the limited amount of Reorganisation Surplus (even while providing only a relatively better treatment) leaves equity holders with no value.

### **3 CHAPTER 3: EQUITY INTERESTS' RETENTION UNDER THE FET OF SBRA**

#### **3.1 Introduction**

The theme driving the structure and research design in this chapter is to provide answers to the third research sub-research question 'To what extent does the FET under the SBRA enable equity interests' retention for SME Debtors during restructuring?'. The structure of this chapter is similar to the proceeding Chapter 2. Firstly, I conduct historical legal research and literature review to understand the theoretical development of Fairness Tests in US. The aim of this research is to trace the development trajectory of the Fairness Test of RPR in US and look at the form in which the Fairness Test has presently been incorporated under the SBRA (in the form of FET). Secondly, I review the requirements for the application of the FET under the SBRA. Thirdly, based on this examination, I analyze how the FET under the SBRA enables equity interests' retention for SME Debtors. I do this by (i) conducting doctrinal research by relying on literature and legal precedents and (ii) conducting quantitative analysis of hypothetical data in tabular form (Table 2).

#### **3.2 Tracing the development of Fairness Tests of RPR and the FET in US**

Having discussed the form of RPR theorised in the European context under Chapter 2, I now examine the form of PRR, as theorised in US. I also examine how the FET as a Fairness Test was included under the SBRA, in its present form. The RPR has been proposed by legal scholars in US as early as the late 19<sup>th</sup> century.<sup>140</sup> It is pertinent to clarify that scholars have used the phrase '*relative priority*' to describe

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<sup>138</sup> ABI Commission Report (n 97), 213

<sup>139</sup> Based on the illustration provided in Seymour and Schwarz (n 17), 33

<sup>140</sup> See Generally, Douglas G. Baird, 'Present at the Creation: The SEC and the Origins of the Absolute Priority Rule', (2010) 18 AM Bankr Ins L Rev 591, 595. (Douglas states that because of the RPR, 19<sup>th</sup> century reorganisation

a wide variety of Fairness Tests that may be used as alternatives to the APR.<sup>141</sup> Prominent amongst the legal scholars have been Bonbright and Bergerman who highlighted the concept of the RPR in 1928. They endorsed the RPR as an alternative to the APR arguing that the RPR was more congruent with investor they observed; asserting that senior investors in equity receiverships often allowed junior investors to be paid in full.<sup>142</sup> Another prominent scholar who theorised the RPR has been Baird.<sup>143</sup> He argued that under the RPR, the day of valuation should be postponed to a later date by designing a distribution mechanism that to some extent 'perpetuates the optionality in the junior investors' position'.<sup>144</sup> His conception of the RPR was that initially all the common stock of the enterprise might be allocated to a senior class based on conservative valuation. Thereafter, junior classes may purchase some or all of this common stock, either directly from the senior class or from reorganised debtor at a postponed date of valuation, at a price sufficient to provide the senior investors a full recovery.<sup>145</sup>

The ABI Commission, which was formed to study the reforms of 11 USC, recommended that the RPR should be applied for restructuring of SME Debtors in their final report in 2014 (Hereinafter referred to as the '**ABI Commission Report**').<sup>146</sup> The commissioners determined that the RPR as a Fairness Test should create an equity retention structure that would appropriately align the interests of prepetition management and equity with the SME Debtor's restructuring and protect the interests of unsecured creditors.<sup>147</sup> For distributions to secured creditors, the ABI Commission Report recommended that 11 USC Section 1129(b)(2)(A), should remain applicable as it is. This section provides that secured creditors should retain liens securing such claims and each holder should receive deferred cash payments totalling the value of such claim.<sup>148</sup> For distributions to unsecured creditors, the Report recommended two forms of equity retention models which have been labelled as the RPR, (i) new value exception (Hereinafter referred to as the '**New Value Exception**') and (ii) SME equity retention plan (Hereinafter referred to as the '**SME Equity Retention Plan**').<sup>149</sup>

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law was quite successful. He places reliance on the reorganisation in the case of *Atchison, Topeka & Santa Fe Railway Co. v. United States*, 284, 254 (1931) which commenced in 1893.

<sup>141</sup> Anthony Casey, 'The Creditors Bargain and Option-Preservation Priority in Chapter 11', 78 University of Chicago Law Review 759 (2011), Footnote 25

<sup>142</sup> Bonbright and Bergerman, 'Two Rival theorised of Priority Rights of Security Holders in a Corporate Reorganisation', Columbia Law Review Feb, 1928, Vol. 28, No. 2 (February 1928), 131 ('**Bonbright and Bergerman**')

<sup>143</sup> See generally, Douglas G. Baird and Donald S. Bernstein, 'Absolute Priority, Valuation Uncertainty and the Reorganisation Bargain' (2005) John M. Olin Program in Law and Economics Working Paper No. 259 ('**Douglas and Donald**')

<sup>144</sup> Ibid, 42

<sup>145</sup> Douglas and Donald (n 143), 42-43

<sup>146</sup> Reliance under footnote 1085 of ELI Business Rescue Report (n 8) has been placed on ABI Commission Report (n 124)

<sup>147</sup> ABI Commission Report (n 97), 300

<sup>148</sup> 11 USC Section 1129(b)(2)(A); ABI Commission Report (n 97), 296

<sup>149</sup> ABI Commission Report (n 97), 296. The ABI Commission Report also proposed the redemption option value plan as an alternative to the APR. However, the Report did not recommend the application redemption option value plan's application for restructuring of SME Debtors

### 3.2.1 SME Equity Retention Plan

Under the SME Equity Retention Plan, the pre-petition equity security holders continue to provide their skills to SME Debtors to support the reorganisation plan.<sup>150</sup> The court may confirm an SME Equity Retention Plan by way of a cram down if the plan satisfies the following requirements:

- (i) The pre-petition equity holders continue to support the SME Debtor's successful restructuring by remaining involved on a reasonable basis, in the ongoing operations of the reorganised SME Debtor.
- (ii) The reorganised SME Debtor pays to the unsecured creditors its excess cash flow (calculated based on SME Debtor's operating cash flow) for each of the 3 full fiscal years following the effective date of the restructuring plan.
- (iii) The pre-petition equity holders retain 100% of the voting rights but receive no more than 15% of the reorganised SME Debtor's economic interests.
- (iv) The pre-petition unsecured creditors receive 100% of a class of preferred stock, similar preferred interests or payment obligations issued by the reorganised SME Debtor no the effective date of the restructuring plan. They would also be entitled to 85% of any economic distributions from the reorganised debtor.
- (v) The creditors interests mature after 4 years from the effective date of the restructuring plan, at which time the interests should convert into 85% of the equity ownership in the reorganised SME Debtor. The pre-petition equity holders have the option to pay the creditors after a period of 4 years, to retain equity interests in the SME Debtor.<sup>151</sup>

### 3.2.2 New Value Exception

Under the New Value Exception (also known as new value corollary), a pre-petition equity holders should be permitted to retain or purchase an interest in the reorganised SME Debtor, provided that such interest-holder contributes new money or money's worth to the debtor's restructuring efforts.<sup>152</sup> This money should be an aggregate amount that is reasonably proportionate to the interest retained or purchased and that is subject to a reasonable market test.<sup>153</sup> Based on the Report's recommendations a New Value Exception required:

- (i) New money or money's worth;
- (ii) in an amount proportionate to the equity received or retained by prepetition equity security holders; and
- (iii) that would be subject to a reasonable market test.<sup>154</sup>

The ABI Commission Report did not define what would be a reasonable market test and stated that the courts should determine the same based on peculiar facts of each case.<sup>155</sup> The courts have adopted this test and concluded that this test stands satisfied where the new value contribution was greatly in

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<sup>150</sup> ABI Commission Report (n 97), 297

<sup>151</sup> ABI Commission Report (n 97), 297 and 301

<sup>152</sup> ABI Commission Report (n 97), 224

<sup>153</sup> *Bank of America National Trust and Savings Assn. v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999)

<sup>154</sup> ABI Commission Report (n 97) 225 and 226

<sup>155</sup> *Ibid*

excess of the value of equity interests based on either a pro-forma balance sheet of the restructured debtor or capitalization of the restructured debtor's projected income.<sup>156</sup>

Intriguingly, in July 2019, the Congress, published a report (Hereinafter referred to as '**Judiciary Committee Report**'), deriving substantially from the recommendations made in the ABI Commission Report.<sup>157</sup> This Judiciary Committee Report proposed a new legislation, SBRA, to streamline the restructuring process specifically for small scale businesses.<sup>158</sup> However, instead of adopting the forms of RPR proposed by the ABI Commission Report strictly, it adopted the FET as a Fairness Test in cases of cram down confirmation.<sup>159</sup> The application of the FET as a Fairness Test under the SBRA is discussed in the next sub-section.

### 3.3 Application of the FET under the SBRA

SBRA was enacted to '*streamline the bankruptcy process by which the small business debtors reorganise and rehabilitate their financial affairs*'<sup>160</sup>, considering that small business debtors did not have claims large enough to warrant the time and resources to claim relief under the extant 11 USC provisions.<sup>161</sup> Under SBRA, only the debtor has an exclusive right to file a restructuring plan, in exclusion to all other parties.<sup>162</sup> 11 USC Section 1191(a) stipulates the requirements which are to be fulfilled for confirmation of a plan. A consensual plan must be accepted by all affected classes to be confirmed.<sup>163</sup> In the event the plan is not confirmed consensually, it may be confirmed by way of a cram down.<sup>164</sup> For confirmation of a plan through cram down, it is not required that all affected creditor classes accept the plan or that even at least one affected class of creditor accepts it. The court may cram down a plan even if no affected class of claims accepts the plan, as long as the plan does not discriminate unfairly and the FET requirement has been satisfied, with respect to each affected class of claims or interests that has not accepted the plan.<sup>165</sup> Pertinently, the BIT is applicable during cram down and offers protection to the creditor who has not accepted the plan by mandating that the creditor must receive under the plan property with a value not less than what the creditor would receive if the debtor were liquidated.<sup>166</sup> If the plan is confirmed through cram down, the debtor is not discharged until the payment of all dues within the first 3 years of the plan (or the extendable period or up to 5 years as the case may be).<sup>167</sup> In the event of non-confirmation of the plan, the court may convert the case to either a bankruptcy case under Chapter 7 if there is sufficient cause established, that SBRA Proceedings were preferred by the SME Debtor in bad faith, there is no likelihood of rehabilitation or there has been gross mismanagement

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<sup>156</sup> *In re Red Mountain Machinery Company*, 451 B.R. 897 (Bankr. D. Ariz 2011), 906

<sup>157</sup> Judiciary Committee Report (n 20), 4

<sup>158</sup> *Ibid*

<sup>159</sup> Judiciary Committee Report, (n 20), 7-8

<sup>160</sup> Judiciary Committee Report (n 20), 1

<sup>161</sup> Judiciary Committee Report (n 20), 1 and 3

<sup>162</sup> 11 USC Section 1189(a)

<sup>163</sup> 11 USC Section 1129(a)(8)

<sup>164</sup> 11 USC Section 1191(b)

<sup>165</sup> 11 USC Section 1191(b)

<sup>166</sup> 11 USC Section 1129(a)(7)(A)(ii)

<sup>167</sup> 11 USC Section 1192

(Hereinafter referred to as the '**Bad Faith Test**').<sup>168</sup> Dismissal after confirmation but without a discharge, will generally restore the parties to their pre-bankruptcy status.<sup>169</sup>

The FET shall have to be applied when there is a cram down, as stipulated under 11 USC Section 1191(b). 11 USC Section 1191(c) provides a rule of construction stipulating the conditions which are required to be satisfied for application of the FET. Broadly, it lays down three sets of requirements for a cram down (i) stipulations for secured creditors under section 1191(c)(1), (ii) stipulations for unsecured creditors (in the form of the PDI) under section 1191(c)(2) and (iii) Remedies and requirements for feasibility under section 1191(c)(3).

### 3.3.1 Cram down requirements for secured claims under section 1191(c)(1)

The plan may be crammed down notwithstanding the dissent of a secured creditor class if it permits the secured creditors to retain their lien on the property; the lien securing the allowed claim held by secured holder.<sup>170</sup> Additionally, the plan must provide for secured creditors to receive on account of the allowed secured claims, payments, either present or deferred, of a principal face amount equal to the amount of the debt or collateral.<sup>171</sup> The secured creditors' claim should also be satisfied by realisation of its '*indubitable equivalent*'.<sup>172</sup> Indubitable equivalence is achieved by providing a lien on a similar collateral but cash payments less than secured claim amount would not satisfy this requirement.<sup>173</sup>

### 3.3.2 Cram down requirements for unsecured creditors in the form of PDI Test under Section 1191(c)(2)

The cram down confirmation imposes a PDI test with respect to unsecured creditors.<sup>174</sup> 11 USC Section 1191(c)(2) requires the plan to provide that PDI of the debtor to be received in the three-year period after the first payment under the plan is due, or in such longer period not to exceed 5 years, should be applied to make payments towards the plan.<sup>175</sup> Alternatively, the plan may provide that the value of the property to be distributed under the plan within the three year or longer period is not less than the PDI of the debtor.<sup>176</sup> The PDI has been defined under 11 USC Section 1191(d) as the income that is received by the debtor and not reasonably necessary to be expended, either for the maintenance of debtor or its dependent, or for a domestic support obligation that first becomes payable after the date of filing of the petition. It also excludes income necessary for the payment of expenditures necessary for continuation, preservation or operation of the business.<sup>177</sup> The courts are given the discretion to decide the length of

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<sup>168</sup> 11 USC Section 1112(b)(4)(N); *In re Thomas Young and Connie Young*, 8 to 11, Opinion No. 20-11844-t11, <[https://www.govinfo.gov/content/pkg/USCOURTS-nmb-1\\_20-bk-11844/pdf/USCOURTS-nmb-1\\_20-bk-11844-0.pdf](https://www.govinfo.gov/content/pkg/USCOURTS-nmb-1_20-bk-11844/pdf/USCOURTS-nmb-1_20-bk-11844-0.pdf)> Accessed July 12, 2022

<sup>169</sup> Paul W. Bonapfel, 'A Guide to the Small Business Reorganisation Act of 2019', (Revised May 2022, Originally published at 93 Amer. Bankr. L.J. 571 (2019)), ('**SBRA Guide**'), 197

<sup>170</sup> 11 USC Section 1129(b)(2)(A)(i)

<sup>171</sup> 11 USC Sections 1129(b)(2)(A)(ii) and Section 1191(c)(1)

<sup>172</sup> 11 USC Section 1129(2)(B)(2)(ii)

<sup>173</sup> *In re Murel Holding Corp*, 75 F 2d 941 (2<sup>nd</sup> Circuit, 1935); Legislative statements, Historical and Revision Notes, 11 USC Section 1129, <<https://uscode.house.gov/view.xhtml?path=/prelim@title11/chapter11&edition=prelim>> Accessed July 12, 2022

<sup>174</sup> 11 USC Section 1191(c)(2)

<sup>175</sup> 11 USC Section 1191(c)(2)(A)

<sup>176</sup> 11 USC Section 1191(c)(2)(B)

<sup>177</sup> 11 USC Section 1191(d)

the commitment period.<sup>178</sup> A 3-year term is the baseline requirement.<sup>179</sup> For SME Debtors, this has usually been considered to be appropriate.<sup>180</sup> The courts have suggest that a plan of 3 years is more reasonable than a five year term, in the absence of unusual circumstances, to balance the shorter life-span planning of small businesses and timely cost-effective benefits to debtors, against the benefits to creditors.<sup>181</sup> Essentially, there has to be a balance between the needs of unsecured creditors for higher payments and the inherent risks for SME Debtors for their business.<sup>182</sup>

### 3.3.3 Reasonable Likelihood and Default Remedies Tests under Section 1191(c)(3)

The SME Debtor should be able to make all payments under the plan,<sup>183</sup> or the court must be able to assess that there exists a reasonable likelihood that the SME Debtor will be able to make all such payments.<sup>184</sup> The '*reasonable likelihood*' (Hereinafter referred to as the '**Reasonable Likelihood Test**') requirement under Section 1191(c)(3)(A)(ii) strengthens the more relaxed feasibility test which already existed under Section 1129(a)(11). Section 1129(a)(11) merely requires that confirmation is not likely to be leading to the liquidation or need for further reorganisation of the SME Debtor.<sup>185</sup> In *re Pearl Resources*, the court has held that this '*requirement for confirmation requires showing that the debtor can realistically carry out its plan. Though a guarantee of success is not required, the bankruptcy court should be satisfied that the reorganised debtor can stand on its own two feet.*'<sup>186</sup> For assessing whether the Reasonable Likelihood Test has been satisfied, the court may examine the bankruptcy schedules, statement of financial affairs, monthly operating reports, financial projections and liquidation analysis.<sup>187</sup>

The plan should also provide appropriate remedies including liquidation of non-exempt assets, to protect the holders of claims or interests in the event the payments are not made (Hereinafter referred to as the "**Default Remedies Test**").<sup>188</sup> By adopting a literal interpretation of Section 1191(c)(3)(B), the court has held that the satisfaction of Default Remedies Test does not require anything beyond the preservation of a creditor's right to seek to the enforcement of the plan terms in the bankruptcy court and seek appropriate relief from the court.<sup>189</sup> The courts would have to assess whether the Default Remedies Test on a case to case basis. The court in *re Moore and Moore Trucking LLC*, permitted the plan which provided remedy in the form of authorising the creditors to foreclose its interests in the collateral that secures its claim, in the event of default.<sup>190</sup> In *re Hyde*, the court stated that a restructuring plan that allows the debtor and her non-filing spouse to grant a second mortgage on their home, in case of default,

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<sup>178</sup> SBRA Guide (n 169), 134

<sup>179</sup> *In Legal Services Bureau v. Orange County Bail Bonds Inc.* (Cal. Ct. App. Apr. 5, 2021, CC-21-1086-GTL), 12 and 13

<sup>180</sup> *In re Urgent Care Physicians, Ltd.*, 21-24000-beh (Bankr. E.D. Wis. Dec. 20, 2021), 17 and 18

<sup>181</sup> *In re Urgent Care Physicians, Ltd.*, 21-24000-beh (Bankr. E.D. Wisc. 2021), 18

<sup>182</sup> *Ibid*, 19

<sup>183</sup> 11 USC Section 1191(c)(3)(A)(i)

<sup>184</sup> 11 USC Section 1191(c)(3)(A)(ii)

<sup>185</sup> 11 USC Section 1129(1)(11)

<sup>186</sup> *In re Pearl Resources LLC*, 622, B.R. 236 (Bankr. S.D. Tex. 2020), 268

<sup>187</sup> *In re Lost Cajun Enters. LLC*, 634 B.R. 1063 (Bankr. D. Colo. 2021), 1072

<sup>188</sup> 11 USC Sections 1191(c)(3)

<sup>189</sup> *In re Urgent Care Physicians, Ltd.*, 21-24000-beh (Bankr. E.D. Wisc. 2021), 19 and 20

<sup>190</sup> *In re Moore & Moore Trucking LLC*, No. 20-10925 (Bankr. E.D. La. Jan 12, 2022), 24

to have satisfied the Default Remedies Test.<sup>191</sup> Having discussed the requirements for application of the FET, I will now look at the FET enables equity interests' retention for SME Debtors during their restructuring under the SBRA in the next sub-section.

### 3.4 Enabling Equity Retention for SME Debtors

To understand the extent to which the FET enables equity retention for SME Debtors, I look at the drawbacks which the APR suffers from, in enabling equity retention and analyse whether the FET mitigates these drawbacks. In case of a cram down under 11 USC Proceedings,<sup>192</sup> application of the APR<sup>193</sup> denies SME Debtors the opportunity to retain their equity interests in a situation where the unsecured creditors are not paid in full, subject to the New Value Exception.<sup>194</sup> This condition is not required to be satisfied under the FET in the SBRA. The unsecured creditors do not necessarily have to be paid in full. The new requirements are based on the PDI of the SME Debtor in the three-to-five-year period following confirmation.<sup>195</sup> After 2 years of SBRA's enactment, it was asserted by scholars that SBRA was '*monumental financially and psychologically*'<sup>196</sup> for SME Debtors; making '*equity holders, winners*'<sup>197</sup> in restructuring by removing the APR and thereby allowing the equity holders to retain their interests while coming up with a restructuring plan to make payments to the creditors within a period of 3 to 3 years.<sup>198</sup> That having been said there could be issues for SME Debtors under the FET which may hinder equity interests' retention during restructuring:

- (i) The pre-petition equity holders might not be incentivised to stay and work for the SME Debtor since they would have to work, not to earn profits from the business but to pay the creditors for a period of 3 to 5 years.<sup>199</sup> Psychological pressures may also be at play discouraging the SME Debtor since it has an extended period of debt and does not benefit from immediate discharge.<sup>200</sup>
- (ii) In the event of the inability of the SME Debtor to come up with PDI that satisfies FET, the plan may be rejected or the case may be converted into a chapter 7 bankruptcy case.<sup>201</sup> Therefore, the SME Debtor risks who is not in a condition to be able to satisfy the test given the business conditions, may risk having its assets liquidated.

In order to further expound on the analysis, I conduct quantitative analysis using hypothetical figures in Table 2 below to understand the extent to which the FET enables equity interests' retention for SME Debtors, in comparison to the BIT and the APR.

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<sup>191</sup> *In re Hyde* No. 20-11525 (Bankr. E.D. La. Jun. 6, 2022), 20

<sup>192</sup> 11 USC Section 1129(b)

<sup>193</sup> 11 USC Section 1129(b)(2)(B)

<sup>194</sup> 11 USC Section 1129(a)(7)(A)

<sup>195</sup> *Ibid*

<sup>196</sup> Brian Shaw, '2 years of Small Biz Bankruptcy Law: Winners and Losers' (April 4, 2022) <<https://www.law360.com/articles/1480550/2-years-of-small-biz-bankruptcy-law-winners-and-losers>> Accessed July 12, 2022 ('**Brian Shaw**')

<sup>197</sup> *Ibid*

<sup>198</sup> Brian Shaw (n 196)

<sup>199</sup> Ballerini (n 17), 22

<sup>200</sup> McCormack (n 58), [7.26]

<sup>201</sup> *In re Thomas Young*, Opinion No. 20-11844-t11 <[https://www.govinfo.gov/content/pkg/USCOURTS-nmb-1\\_20-bk-11844/pdf/USCOURTS-nmb-1\\_20-bk-11844-0.pdf](https://www.govinfo.gov/content/pkg/USCOURTS-nmb-1_20-bk-11844/pdf/USCOURTS-nmb-1_20-bk-11844-0.pdf)> Accessed July 12, 2022, 11 and 12

### 3.5 Hypothetical Illustration to understand application of BIT with FET (Table 2)

I use the same data as earlier in Table 1, to understand the manner in which BIT may be conjointly applied with FET, to enable equity retention.<sup>202</sup> It has been held a 3-year time period for making payments under the restructuring plan is usually considered to be appropriate for SME Debtors under the FET.<sup>203</sup> For practical convenience, that the payment is to be made according to a repayment plan within 3 years by the SME Debtor. Table 2 illustrates the distribution possibilities when BIT is applied in conjunction with FET.

**TABLE 2: DISTRIBUTIONAL POSSIBILITIES UNDER THE FET IN SBRA**

	<b>BIT</b> (Minimum Realisable Value set by BIT)	<b>APR</b> (When total value payable under the repayment plan is 180)	<b>FET based on PDI</b> (When total value payable under the repayment plan is 180)
<b>DISSENTING SECURED SENIOR CREDITORS</b>	100	110	<b>110<sup>204</sup> (100%)</b>
<b>DISSENTING SENIOR UNSECURED CREDITORS</b>	10	50	<b>10 (20%)</b> (the plan may provide based on the PDI any amount between 10 to 50)
<b>DISSENTING JUNIOR UNSECURED CREDITORS</b>	0	20 (Need to be paid 60 to be satisfied in full but only gets 20 due to limited reorganisation surplus)	<b>35 (58.34%)</b> (the plan may provide for payment based on PDI of any amount between 0 to 60)
<b>EQUITY HOLDERS</b>	0	0 (Need to be paid 25 to be satisfied in full but doesn't get any value due to limited reorganisation surplus)	<b>25 (100%)</b> (It is possible but not necessary in all cases, that 100% of the pre-petition equity be retained)

Applying both the BIT and FET, a restructuring plan may only be confirmed over the veto of a dissenting class if the following conditions are satisfied:

- (i) The plan distributes as Realisable Value to dissenting secured senior creditors in a manner that they (1) retain the liens securing such claims and (2) receive deferred cash payments totalling the value of their claim. However, if the value of collateral used to secure the claim is less than 110 in value, then the SME Debtor is only liable to pay that lower value to the secured creditor.

<sup>202</sup> Simple Guide to RPR (n 40), Example 7 on page 5

<sup>203</sup> *In re Urgent Care Physicians, Ltd.*, 21-24000-beh (Bankr. E.D. Wisc. 2021), 17 and 18

<sup>204</sup> For the sake of simplicity, it is assumed the cash payments as indubitable equivalents have been arranged under the plan for the lien created on the property used for securing the senior creditor class satisfying the test under 11 USC Section 1129(b)(2)(A). It is also assumed that the dissenting secured creditor is not under-secured in that its claim does not exceed the value of the property in which it has a lien.

- (ii) The plan distributes as Realisable Value to dissenting unsecured senior creditors any value between 10 to 50.
- (iii) The plan distributes as Realisable Value to dissenting unsecured junior creditors class any value between 0 to 60.
- (iv) The SME Debtor may retain 100% of its equity interest, as long as the stipulations under (i), (ii) and (iii), stand fulfilled.

From the quantitative analysis, it can be assessed that the FET enable equity interests' retention for SME Debtors by permitting them to retain more equity in comparison to the APR. It may be possible under the restructuring plan for equity holders to retain 100% of the pre-petition equity. However, this will not necessarily be the case in every scenario. In certain situations, equity holders may have to part with their equity interests if BIT is not satisfied while making repayments under the restructuring plan to the dissenting creditors. For instance, if the BIT value for dissenting unsecured senior creditor class would have been 40 instead of 10, then equity interests would have to sacrificed to the extent it is necessary to provide the BIT value of 40 to dissenting unsecured senior creditor class. However, the SME Debtors have flexibility under the FET to decide how the distribution is to made based on their business conditions, which may increase possibilities of the revival of their business, post restructuring.

To sum up the discussion under this chapter, following points can be synopsisized. Historical legal research shows that RPR has been used by scholars to describe a wide variety of Fairness Tests that may be used as alternatives to the APR. Amongst the prominent theories, is the form of RPR proposed by Baird. This form of RPR has also subsequently been expounded upon in the ABI Commission Report, which proposed the SME Equity Retention Plan and the New Value Exception as form of RPR, specifically for restructuring of SME Debtors. Instead of adopting these tests, the SBRA proposed the FET as the Fairness Test for restructuring of SME Debtors. Doctrinal research and quantitative analysis reveal that the FET enables equity retention for SME Debtors by permitting them to set the values based on which distribution will be provided to the unsecured dissenting creditor classes. It might be possible, but not necessarily be the case in every situation, that SME Debtors retain 100% of their pre-petition equity under the FET.

## **4 CHAPTER 4: COMPARING THE RPR IN EU-PRD WITH THE FET IN THE SBRA**

### **4.1 Introduction**

I compare the RPR under EU-PRD with the FET under the SBRA in this last chapter, to answer the primary research question, 'To what extent does RPR enable equity interests' retention for SME Debtors in comparison to the FET?'. Firstly, I shed light on the differences in RPR's conception under EU-PRD from the theorisations in US to understand if these differences shake the credibility of the RPR as a Fairness Test, in so far as its equity retention enabling ability is concerned. Secondly, I summarise the differences in application of RPR under Article 11(1)(c) of PRD and 11 USC Section 1191(c) of the FET under the SBRA. Thirdly, to understand the equity retention ability of FET and the RPR based on these differences, I conduct a quantitative analysis (in Table 3), to compare the distribution possibilities under the FET and the RPR. Lastly, using the findings in the quantitative analysis, I compare both the RPR and the FET based on 4 indicative factors, (i) early access incentivisation, (ii) balancing of the creditor and equity holders' interests, (iii) possibility of consensual plan confirmation (iv) impetus for equity retention on a macro-economic scale.

## 4.2 Different conceptions of the Relative Priority Rule

In chapter 2, I traced the genesis of RPR in the European context and in chapter 3, I highlighted the concept of RPR as theorised in US by legal scholars. In this sub-section, I compare these two forms of RPR building on the historical search conducted in chapters 2 and 3.<sup>205</sup>

The RPR in EU-PRD envisages a reshuffling by permitting that under certain conditions, value is given to shareholders without higher ranking classes receiving payment in full, or plans that make provision for payment to unsecured creditors before preferential or secured creditors receive a full distribution.<sup>206</sup> Both the ELI Business Rescue Report and the COIRE placed reliance on the so '*confusingly labelled*'<sup>207</sup> RPR theorised in the US context. In particular reference was placed on the concept of the RPR propagated by Baird.<sup>208</sup> However, Baird himself argued that his conception of the RPR was starkly different from the one incorporated under Article 11(1)(c) of EU-PRD. He averred that:

*'But it would be a serious mistake to equate 'relative priority' as I and others conceive it with the idea that is being put forward in the latest European Directive. Relative priority, properly understood, is altogether, different from a regime in which senior stakeholders are entitled only to be treated more favourably than those junior to them*

*[...] Relative priority is grounded in the idea of option value, rigorously defined.*<sup>209</sup>

He argued that under a regime of the RPR, junior stakeholders should receive value only if the debtor does unexpectedly well. It postpones the valuation from the moment of reorganisation to a future date, given the possibility that the debtor might increase in its value enough to pay the senior creditors in full.<sup>210</sup> Baird supported the form of RPR as theorised in the ABI Commission Report such as the SME Equity Retention Plan and the New Value Exception.<sup>211</sup> It can be assessed that the form of RPR proposed in US is different from the RPR incorporated in the EU-PRD. RPR under the EU-PRD however, allows retention of pre-petition equity interests, so long as a relatively better distribution (in terms of percentage) has been provided to more senior ranking creditor classes.<sup>212</sup> However, the forms of RPR proposed in US such as the SME Equity Retention Plan and the New Value Exception, do not allow retention of pre-petition equity interests. It instead provides an option value to equity holders to regain their equity interests in the SME Debtor by either contributing new value in money or money's worth or making contributions by providing their skills to the reorganised SME Debtor.<sup>213</sup> Be that as it may, the fact that RPR's in European context is different from the RPR propagated in US, does not impede its credibility or make it any less fair as a priority test, in so far as its equity retention enabling function is concerned. The RPR under the EU-PRD does not seem to be based on a misunderstanding of the RPR in US context, contrary to the assertions made by some scholars.<sup>214</sup> Rather, based on the analysis, it seems to be a completely different Fairness Test, which enables retention of pre-petition equity

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<sup>205</sup> Discussed under sections 2.2 and 3.2 of this thesis

<sup>206</sup> McCormack (n 58), 6.77

<sup>207</sup> De Weijs et. Al. Imminent Distortion of European Insolvency law (n 17)

<sup>208</sup> Refer to Section 2.2 of the thesis for a discussion on the same

<sup>209</sup> Douglas Baird's Letter (n 19)

<sup>210</sup> Ibid

<sup>211</sup> Ibid; SME Equity Retention Plan and New Value Exception have been discussed under section 3.2 of this thesis

<sup>212</sup> Discussed under section 2.3 of this thesis

<sup>213</sup> SME Equity Retention Plan and the New Value discussed under Section 3.2 of this thesis

<sup>214</sup> De Weijs et. al. Imminent Distortion of European Law (n 17), 11

interests.<sup>215</sup> Therefore, it may not be prudent to compare the RPR conceptions theorised in US with RPR under the EU-PRD. SBRA does not adopt such forms of RPR theorised in US and instead, provides for the FET under the SBRA.<sup>216</sup> The FET under the SBRA has been compared with the RPR under the EU-PRD in the next sub-section.

#### 4.3 Differences in the requirements for application: RPR and FET

The RPR in EU-PRD under Article 11(1)(c) only mandates that dissenting voting classes are treated as favourably as any other class of the same rank and more favourably than any junior class. A Relaxed RPR approach allows derogations from this rule if this is necessary to achieve the aims of restructuring and the plan does not unfairly prejudice the rights of interests of affected parties. Under SBRA, no priority tests (APR or RPR) are mandated. Instead, satisfaction of FET test under 11 USC Section 1191(c). Broadly, it lays down three sets of requirements for a cram down (i) stipulations for secured creditors under sub-section 1191(c)(1), (ii) stipulations for unsecured creditors (in the form of the PDI) under sub-section 1191(c)(2) and (iii) Remedies and requirements for feasibility under sub-section 1191(c)(3).<sup>217</sup>

Since EU-PRD as a directive aims to provide harmonisation, while providing flexibility to Member States to their own procedural laws, the Fairness Tests could not have been provided in a similar manner, as provided under SBRA. Member States differ vastly on the order of priorities.<sup>218</sup> Certain Member States, for instance, like France, Italy and Portugal prioritise secured creditors.<sup>219</sup> Therefore, it could not have been possible to have separate priority rules for secured and unsecured creditors under the EU-PRD.<sup>220</sup> On the other hand, the FET has separate rules for priority, for each class of secured and unsecured creditors.<sup>221</sup>

#### 4.4 Hypothetical Illustration to compare application FET and RPR (Table 3)

I analysed in chapters 1 and 2, the distribution possibilities under RPR in Table 1 and FET in Table 2. Now, using the same data, I compare both the FET and the RPR. I assume for practical convenience that the payment under the repayment plan has to be made within a 3-year time period, since under both the SBRA and the EU-PRD, a 3-year time period for making repayments under the restructuring plan is considered appropriate.<sup>222</sup>

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<sup>215</sup> Discussed under section 2.3 and 2.4 of this thesis

<sup>216</sup> Discussed under section 3.3 of this thesis

<sup>217</sup> Discussed under section 3.3 of this thesis

<sup>218</sup> Dahlgreen, J., Brown, S., Keay, A., et al, European Commission, Directorate-General for Justice and Consumers, 'Study on a new approach to business failure and insolvency: comparative legal analysis of the Member States relevant provisions and practices' (Publications Office, 2016, University of Leeds), 112

<sup>219</sup> Ibid, 114

<sup>220</sup> 11 USC Section 1191(c)

<sup>221</sup> 11 USC Section 1191(c)

<sup>222</sup> Recital 78 and Article 21(1), EU-PRD; *In re Urgent Care Physicians Ltd.*, 21-24000-beh (Bankr. E.D. Wis. Dec. 20, 2021), 18

**TABLE 3: COMPARING DISTRIBUTION POSSIBILITES UNDER RPR AND FET**

	<b>BIT</b> (Minimum Realisable Value set by BIT)	<b>APR</b> (When total value payable under the repayment plan is 180)	<b>RPR</b> (When total value payable under the repayment plan is 180)	<b>FET based on PDI</b> (When total value payable under the repayment plan is 180)
<b>DISSENTING SECURED SENIOR CREDITORS</b>	100	110	<b>100 (90.9%)</b> (Any value between 100 to 110 may be provided)	<b>110 (100%)</b> <sup>223</sup>
<b>DISSENTING SENIOR UNSECURED CREDITORS</b>	10	50	<b>40 (80%)</b> (Any value lesser than 90.9% of the total value of 50 may be provided)	<b>10 (20%)</b> (the plan may provide based on the PDI any amount between 10 to 50)
<b>DISSENTING JUNIOR UNSECURED CREDITORS</b>	0	20 (Need to be paid 60 to be satisfied in full)	<b>30 (50%)</b> (any value lesser than 80% may be provided)	<b>35 (58.34%)</b> (any amount between 0 to 60 may be provided unlike RPR where the % value has to be lesser than the amount provided to dissenting unsecured class)
<b>EQUITY HOLDERS</b>	0	0 (Need to be paid 25 to be satisfied in full)	<b>10 (40%)</b> (Any value lesser than the 50% of total value of 25 may be provided to junior creditors)	<b>25 (100%)</b> (It may be possible, but not necessary, to retain 100% of the pre-petition equity)

Data in Table 3 depicts three notable differences between the RPR and the FET:

- (i) The equity holders retain a higher proportion of their equity interests in FET than under the RPR since the equity holders can only be provided a distribution (in percentage) which is lesser than the distribution (in percentage) provided to the most junior ranking creditor class, (unless a Relaxed RPR approach is permitted). It may be possible under the FET for equity holders to retain 100% of the pre-petition equity. However, this will not necessarily be the case in every scenario. In certain situations, equity holders may have to part with their equity interests if BIT is not satisfied while making repayments under the restructuring plan to the dissenting creditors.

<sup>223</sup> For the sake of simplicity, it is assumed the cash payments as indubitable equivalents have been arranged under the plan for the lien created on the property used for securing the senior creditor class satisfying the test under 11 USC Section 1129(b)(2)(A). It is also assumed that the dissenting secured creditor is not under secured in that its claim does not exceed the value of the property in which it has a lien.

- (ii) The junior dissenting unsecured creditors have a higher possibility under the FET to be provided a higher distribution (in percentage) than under the RPR. This is simply because the creditors above the junior creditors would have to be provided a higher percentage distribution under the RPR while no such requirement exists under the FET. This is evident from Table 3, where a junior dissenting unsecured creditor may be paid any value between 0 to 60 but under RPR, the creditor can only be paid any value which is lesser than 40 i.e., 80% of his total value.
- (iii) The FET provides more flexibility in comparison to the RPR in permitting the SME Debtors to decide the distribution possibilities under the repayment plan. These distribution possibilities could be based on the pressing needs of business, and may increase the possibility of a successful restructuring of the SME Debtor. For instance, in certain situations, SME Debtors may find that providing a higher distribution (in percentage) to junior dissenting unsecured creditors than to the senior dissenting unsecured creditors, would increase its possibility of being able to revive its business.

I will apply the conclusions based on this analysis in the next sub-section to compare the FET and the RPR based on equity retention indicators.

#### 4.5 Equity Retention Indicators

Expounding on the analysis conducted so far in this thesis, I comparatively analyse equity retention abilities of the RPR and FET based on 4 indicators, (i) early access incentivisation, (ii) balancing of the creditor and equity holders' interests, (iii) possibility of consensual plan confirmation (iv) impetus for equity retention on a macro-economic scale.

##### 4.5.1 Incentivising Early Access

The first equity retention indicator is the ability of the RPR and FET to incentivise SME Debtors to access restructuring, at an early stage. Early access to restructuring would enable the SME Debtors to benefit from timely use of restructuring proceedings and the option of drawing on specific knowledge, expertise and goodwill of the equity holder, which should incentivise approval of the plan.<sup>224</sup> Under the FET, unlike the RPR, the leverage of reviving the business back on track would be the responsibility of the SME Debtor itself.<sup>225</sup> The FET shifts the burden upon equity holders to ensure that payments are made and business is revived. It increases the possibility of early access by equity holders to ensure that their reorganisation plan is successful since only the debtor can propose the plan under SBRA.<sup>226</sup> Additionally, as seen in Table 3 above, under the FET there is a higher possibility for equity holders to retain a higher proportion of their equity interests. The SME Debtors also have more flexibility to structure the distribution possibilities under the restructuring plan under the FET.<sup>227</sup> All these factors evidence that the FET provides more incentives to the SME to access the restructuring at an early stage. Resultantly, based on this indicator, the FET seems to be relatively more effective in enabling retention of equity interests for SME Debtors.

##### 4.5.2 Balancing creditors' and equity holders' interests

The second equity retention indicator is based on the principle that a successful restructuring cannot be achieved by exploiting creditors or promoting risk-taking behaviour of SME Debtors. There would inevitably in most situations be a conflict between the equity holders' interests and those of creditors

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<sup>224</sup> CODIRE (n 11), 46 and 47

<sup>225</sup> *NetJets Aviation, Inc. v. RS Air, LLC*, WL 1288608, (B.A.P. 9th Cir. 2022) 8-9; *National Loan Invs. v. Rickerson (In re Rickerson)*, 636 B.R. (Bankr. W.D. Pa. 2021), 416, 422

<sup>226</sup> 11 USC Section 1189 (a)

<sup>227</sup> Discussed under section 4.4 of the thesis

due to the Debt/Equity Bargain.<sup>228</sup> Ultimately a balance has to be struck between creditor protection and debtor relief.<sup>229</sup> To understand this equity retention indicator I discuss two factors which balance these rights (i) preventing creditors exploitation and averting SME Debtor's risk-taking behaviour and (ii) according protections for protection of the rights of the creditors

#### 4.5.2.1 *Preventing creditors exploitation and averting SME Debtor's risk-taking behaviour*

Scholars have argued that the RPR may lead to exploitation of creditors since an over-levered debtor may exploit the creditors by calculating the exact percentage of claim amount required to satisfy the RPR, and discharge the rest of the creditors.<sup>230</sup> De Weijs et. al., have argued that this may promote risk-taking mentality since the equity interest holders would not be deterred, knowing their ability to retain control of the debtor.<sup>231</sup> This exploitation of creditors and risk-taking behaviour by SME Debtors is also possible under the FET. Although there are precedents mandating good faith while proposing the PDI under the FET, even under the FET, there remains a possibility that SME Debtors may project a low income to evade payments to creditors.<sup>232</sup>

I assert that this reasoning might not be entirely justified when RPR and FET are applied for restructuring of SME Debtors. Firstly, as seen in the Working Definition of SME Debtors, they often lack resources necessary to continue business in the event equity is not retained.<sup>233</sup> At the stage of preventive restructuring, when continuation of the SME Debtor as a going concern is intended, a better alternative may be to retain equity with the creditors facing a relative reduction in their claim.<sup>234</sup> Further, risk-taking behaviour may justifiably be defined as behaviour leading to a business with no economically viable prospects of being restored, rather than accessing the preventive restructuring mechanism which actually promote risk-aversion than risk-taking behaviour.<sup>235</sup> That being said, both SBRA and EU-PRD acknowledge that a situation where no prospect of survival exists for a business and state that such businesses should be liquidated, instead of restructuring.<sup>236</sup>

#### 4.5.2.2 *According protections for creditors*

It has been asserted that PDI is successful in at least increasing chances of achieving consensus in cases of disagreements between the creditors and equity holders.<sup>237</sup> It promotes compromise since the creditors have lesser grounds to challenge the plan<sup>238</sup> and debtors would be mandated to satisfy PDI,

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<sup>228</sup> Discussed under section 1.3.1 of the thesis

<sup>229</sup> Recital 3, EU-PRD; *In re Wildwood Villages, LLC*, Case No. 3:20-bk-02569-RCT (Bankr. M.D. Fla. May. 4, 2021), 6

<sup>230</sup> De Weijs, *Imminent Distortion of EU Law* (n 17), [6.2]

<sup>231</sup> Seymour and Schwarz (n 17), 35

<sup>232</sup> *In re, Thomas Young and Connie Young*, Opinion No. 20-11844-t11, <[https://www.govinfo.gov/content/pkg/USCOURTS-nmb-1\\_20-bk-11844/pdf/USCOURTS-nmb-1\\_20-bk-11844-0.pdf](https://www.govinfo.gov/content/pkg/USCOURTS-nmb-1_20-bk-11844/pdf/USCOURTS-nmb-1_20-bk-11844-0.pdf)> Accessed July 12, 2022, 7 and 8

<sup>233</sup> Discussed under sections 1.4.2 and 1.4.3 of this thesis

<sup>234</sup> See Section 1.4.2 and 1.4.3 of this thesis for a discussion on the peculiar SME Debtors characteristics

<sup>235</sup> Recital 3 and 7, EU-PRD; Judiciary Committee Report (n 20), 1 and 2

<sup>236</sup> Recital 3 and 24, EU-PRD; *In re, Thomas Young and Connie Young*, Opinion No. 20-11844-t11, <[https://www.govinfo.gov/content/pkg/USCOURTS-nmb-1\\_20-bk-11844/pdf/USCOURTS-nmb-1\\_20-bk-11844-0.pdf](https://www.govinfo.gov/content/pkg/USCOURTS-nmb-1_20-bk-11844/pdf/USCOURTS-nmb-1_20-bk-11844-0.pdf)> Accessed July 12, 2022, 7 and 8

<sup>237</sup> Brian Shaw (n 196)

<sup>238</sup> Discussed under Section 3.3 of the thesis

which might curtail their discretion in the manner the SME Debtor's income is used. Based on the quantitative analysis under Table 3, it may be concluded that it also increases the possibility for providing higher returns to the dissenting unsecured junior creditors lower in ranking, in comparison to the RPR.<sup>239</sup> Additionally, the secured creditors rights are protected since they are guaranteed deferred payments under 11 USC Section 1129(b)(2)(A) totalling the value of their claim.<sup>240</sup> The plan should also provide appropriate remedies including liquidation of non-exempt assets, to protect the holders of claims or interests in the event the payments are not made.<sup>241</sup> By providing protections to creditors, the FET aims to strike a balance between creditor protection and debtor relief, in line with the overall purpose and function of the restructuring.<sup>242</sup>

While the EU-PRD does provide Member States with the option to refuse to confirm a restructuring plan not having a reasonable prospect of preventing insolvency of the SME Debtor or ensuring the viability of business,<sup>243</sup> it does not stipulate tests similar to the Reasonable Likelihood Test and the Default Remedies Test available for determination of the PDI under the FET. These tests assess whether the SME Debtor can realistically make payments under the repayment plan.<sup>244</sup> Additionally, the EU-PRD does not stipulate remedies such as liquidation of the assets of the SME Debtor for protection of the creditors. This may reduce creditor exploitation by SME Debtors and curtail the risk-taking behaviour of SME Debtors and shift the burden on SME Debtors to make sure that reorganisation plan is successful.

Considering both these factors discussed under 4.4.2.1 and 4.4.2.2, it may be concluded that both the RPR and the FET prevent creditor exploitation and avert risk-taking behaviour which may be taken by SME Debtors. However, the FET seems to relatively achieve a better balance between creditor rights protection and equity interests, in comparison to the RPR, while enabling equity retention for SME Debtors during restructuring. Achieving this balance is also fruitful in achieving a consensual plan, as discussed in the next sub-section.

#### 4.5.3 Consensual plan confirmation

Consensual plan confirmation, enables the SME Debtors to retain their equity interests by furthering the two equity retention indicators discussed above, (i) promoting a balance between the rights of the creditors and equity holders and (ii) incentivising early access to restructuring.<sup>245</sup> For a successful restructuring of the SME Debtor, the creditors, managers and shareholders may have to work together to accomplish a consensual restructuring in case of SME Debtors.<sup>246</sup> A Fairness Tests that promotes consensual confirmation of plans would enable the SME Debtors to retain their equity interests while balancing the rights of creditors. Since a consensual plan can be confirmed without the application of cram down rules, SME Debtors do not face the negative effects in terms of costs, delays and negative

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<sup>239</sup> Discussed under Section 4.3 of this thesis

<sup>240</sup> 11 USC Section 1111(b)(2)

<sup>241</sup> 11 USC Sections 1191(c)(3)

<sup>242</sup> *In re Wildwood Villages, LLC*, Case No. 3:20-bk-02569-RCT (Bankr. M.D. Fla. May. 4, 2021), 6

<sup>243</sup> Article 8(1)(h) and Article 10(3), EU-PRD

<sup>244</sup> Discussed under section 3.3.3 of this thesis

<sup>245</sup> Discussed under sections 4.5.1 and 4.5.2 of this thesis

<sup>246</sup> McCormack (n 58) [6.89]

publicity.<sup>247</sup> In fact, a negotiated restructuring plan may increase public confidence in the reorganised SME Debtor.<sup>248</sup>

The FET seems to provide more flexibility than the RPR for a consensual plan confirmation. Under the FET, the SME Debtor may retain equity interests even without provisioning for a relatively better treatment to the creditors (assuming that the Relaxed RPR Approach is not applicable). Even if all classes reject a restructuring plan, it can still be crammed down on creditors if the plan does not discriminate unfairly and the FET is satisfied.<sup>249</sup> So long as the creditors have been promised returns based on the PDI, SME Debtors do not have to sacrifice their equity interests to pay for the claim amount for the creditors at the time of commencement of the reorganisation.<sup>250</sup> Therefore, there may be lesser hold out problems, under the FET than RPR, simply because the creditors are not entitled to a higher percentage distribution and therefore, may not hold out from consensually voting for confirmation of a restructuring plan.<sup>251</sup> Therefore, the FET provides a mechanism which promotes the SME Debtors to access restructuring at an early stage and also, balances the rights of creditors and equity holders, thereby increasing the possibility of a consensual plan confirmation. Based on this indicator, the FET increases the possibility for equity retention by SME Debtors during their restructuring, in comparison to the RPR.

#### 4.5.4 Macro-economic perspective

SME Debtors equity retention's enabling ability under the RPR and the FET must be considered from a macro-economic perspective, considering that the SME Debtors dominate the business needs in both EU and US.<sup>252</sup> To incentivise early access, a Fairness Test should, while balancing creditor and debtor's interests, provide an impetus to reduce the overall expenses and time required for restructuring of an SME Debtor.<sup>253</sup> Consensual plan confirmation would also reduce the burden on courts thereby promoting equity retention from a macro-economic perspective by reducing the burden of cases on the judiciary.<sup>254</sup> Therefore, equity retention based on three indicators discussed above (i) Incentivising early access, (ii) balancing creditors and equity holder's rights and (iii) consensual plan confirmation, would also result in furthering equity retention enabling ability for SME Debtors on a macro-economic level.

In respect of the RPR under the EU-PRD, scholars have contended that from a macro-economic perspective that since RPR depresses creditor recoveries, debt investments may decrease in EU, thereby negatively impacting the SME Debtors.<sup>255</sup> It has been asserted this may adversely impact the bond market and investment by creating legal uncertainty.<sup>256</sup> However, I believe that this assertion is premised on the assumption that introduction of the RPR will necessarily decrease investor confidence in the preventive restructuring procedure which may not necessarily be true. Certain Member States are

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<sup>247</sup> ELI Business Rescue Report (n 17), 191 [261-262]

<sup>248</sup> Lynn M. LoPucki and William C. Whitford, 'Bargaining Over Equity's share in the Bankruptcy reorganisation of large, publicly held companies', 139 U. Pa. L. Rev. 125 (1990), 152-154

<sup>249</sup> 11 USC Section 1191

<sup>250</sup> 11 USC Section 1191(c)

<sup>251</sup> See Generally Bob Wessels Reply (n 17) (Wessels makes this argument while comparing RPR with the APR under the EU-PRD)

<sup>252</sup> Recital 17, EU-PRD and Judiciary Committee Report (n 20), 2; ELI Business Rescue Report (n 11), 367-368

<sup>253</sup> Discussed under section 1.4.2.4 of the thesis

<sup>254</sup> CODIRE (n 11), 334 to 338

<sup>255</sup> Seymour and Schwarz (n 17), 40

<sup>256</sup> De Weijs Letter (n 19), 5

yet to implement the EU-PRD and so far, only Austria has implemented RPR under its Restructuring Code based on EU-PRD.<sup>257</sup> RPR's application under the Austrian Restructuring Code has received support by scholars, who have symbolised this inclusion as 'remarkable'.<sup>258</sup> The amended Austrian Restructuring Code only entered into force on 17 July 2021 and based on governmental statistics for the first quarter of 2022, insolvencies have more than doubled to the previous year in Austria.<sup>259</sup> However, these figures of course cannot be considered in isolation to other factors, including investor confidence in the new Austrian Restructuring Code in general and the effects of COVID-19 Pandemic.

On the other hand, SBRA was enacted in the year 2020. The available statistics have so far indicated that FET under the SBRA has been fruitful in bringing the intended reforms for SME Debtors to a certain extent. Data analysis provided by ABI and Epiq,<sup>260</sup> suggests that small businesses have been incentivised to file SBRA proceedings. The filings under SBRA have increased by 21% in May 2022 compared to May 2021, although total bankruptcy filings have declined by 10%.<sup>261</sup> The US Trustee Program analysed a sub-set of 625 cases that were filed under SBRA through June 30, 2020 and provided the following percentages as of September 2020:

- (i) The percentage of confirmed plans under SBRA was six times higher than the percentage of confirmed plans under the Small Business Cases.
- (ii) More than 60% of the confirmed plans were consensual.<sup>262</sup>

However, many important figures, based on which FET's success may be evaluated would only be available in the year 2023, after the end of a three-year period from the starting date of insolvency. For instance, the percentage of reorganised subchapter V SME Debtors that successfully satisfy their plan obligations than seeking further insolvency relief would although be quite helpful, is not available.<sup>263</sup>

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<sup>257</sup> Section 36 of the Restructuring Code, Austria, (Restrukturierungsordnung), CELEX No. 32109L1023 <<https://www.ris.bka.gv.at/GeltendeFassung.wxe?Abfrage=Bundesnormen&Gesetzesnummer=20011622>> Accessed July 12, 2022; For details of the National Transposition measures by European Union member states refer to European Union, National transposition Measures communicated by Member States concerning Directive EU/ 2019/1023, Document No. 32019L1023 <<https://eur-lex.europa.eu/legal-content/EN/NIM/?uri=celex:32019L1023>> Accessed July 12, 2022

<sup>258</sup> Georg Wabl and Martin Trenker, 'Special Issue Preventive Restructuring 5. The Austrian Implementation of the PRD 2019: Game Changer or Missed Opportunity?', (HERO Herstructurering & Recovery Online, 8 July 2022) <<https://www.online-hero.nl/art/4358/special-issue-preventive-restructuring-5-the-austrian-implementation-of-the-prd-2019-game-changer-or-missed-opportunity>> Accessed 12 July 2022

<sup>259</sup> Statistics Austria, 'Bankruptcies sharply increased again in the first quarter of 2022; registrations decreased', ((Press release: 12.808-106/22) <<https://www.statistik.at/fileadmin/announcement/2022/05/20220510InsolvenzenQ12022EN.pdf>>; Also see press release 12.731-029/22, 'Bankruptcies in the fourth quarter of 2021 above pre-crisis level; continued slowdown in registrations' <<https://www.statistik.at/fileadmin/announcement/2022/05/20220209Insolvenzen2021Q4EN.pdf>> Both accessed on July 12, 2022

<sup>260</sup> Epiq Bankruptcy, 'The Future of Subchapter V: Navigating the Pandemic and Beyond' <<https://bankruptcy.epiqglobal.com/blog/the-future-of-subchapter-v-navigating-the-pandemic-and-beyond-0>> Accessed July 12, 2022

<sup>261</sup> Epiq Bankruptcy, 'May Total Commercial Chapter 11 Bankruptcy Filings Increased 34 percent over the same period last year' (3 June 2022) <<https://www.epiqglobal.com/en-us/resource-center/news/may-commercial-chapter-11-bankruptcies-increase>> Accessed July 12, 2022

<sup>262</sup> Clifford J White, 'Small Business Reorganisation Act: Implementation and Trends', American Bankruptcy Institute Journal, Vol. XL, No.1 January 2021, <<https://www.justice.gov/ust/page/file/1350736/download>> Accessed July 12, 2022

<sup>263</sup> Brian Shaw (n 196)

Therefore, it seems too early to assess based on statistical information and only time will tell, how successful the RPR and FET in providing impetus to the overall restructuring process to incentivise equity retention by SME Debtors. SME Debtors have however, shown confidence in both FET and the RPR, so far.

To sum it up, although the concept of RPR in European context is different from the one proposed in US, that by itself does not impede its credibility in so far as its equity interests' retention enabling function is concerned. The quantitative analysis reveals in comparison to the RPR, FET provides (i) a higher possibility of enabling equity interests' retention for SME Debtors and (ii) provides the SME more flexibility while deciding the distributional possibilities under the repayment plan based on the needs of their business. I conclude that FET, in comparison to RPR, increases the possibility for SME Debtors to retain their equity interests based on 4 equity retention indicators (i) incentivising early access, (ii) balancing creditors' and equity holders' rights, (iii) consensual plan confirmation and (iv) based on a macro-economic perspective.

## **5 CONCLUDING REMARKS AND SUGGESTIONS FOR EU MEMBER STATES**

SME Debtors dominate the business needs in both EU and US and yet are the most prone to failure, due to their peculiar characteristics. One of the ways in which the rehabilitation of SME Debtors can be furthered is by enabling Equity interests' retention in them during their restructuring. In this thesis, I have attempted to assess the extent to which the RPR as a Fairness Test under the EU-PRD enables equity interests' retention for SME Debtors, by comparing it with the FET under the SBRA. I contrast Article 11(1)(c) under EU-PRD which provides for RPR with 11 USC Section 1191(c), SBRA which provides for the PDI test based on the FET.

I started this research by arriving at a Working Definition for SME Debtors, which I used as a point of reference for conducting this comparison. Based on Working Definition of SME Debtors, SME Debtors, usually have (i) limited resources and lack of access to finance, (ii) are heavily interdependent with entrepreneurship, (iii) suffer from creditor passivity, (iv) lack incentives to access the restructure at an early stage and (v) have as their customers other SMEs which depend heavily on timely payments.

A historical legal search reveals that concept of RPR as developed under the EU-PRD is indeed starkly different from the concept theorised in US. However, I assert that the mere fact that the RPR under the EU-PRD is different from the RPR theorised in US, does not hinder its credibility as a Fairness Test in so far as its equity interest's retention enabling ability is concerned.

RPR under Article 11(1)(c) of the EU-PRD, provides flexibility to the SME Debtors to retain while only providing relatively better treatment to more senior creditors, to enable equity retention. SBRA, on the other hand, provides for PDI based on the FET. SBRA provides separate requirements for dissenting secured and unsecured creditors in a cram down situation. This could not have been possible under the EU-PRD since Member States have their own procedural laws on insolvency and they differ vastly, on the manner in which the order of priorities for payment are regulated.

A quantitative analysis using hypothetical data to compare the distributional possibilities under the FET and the RPR reveals 3 notable differences (as quantified based on data in Table 3):

- (i) There is a higher possibility of equity interests' retention (in percentage) under the FET, in comparison to the RPR. This is possible because under the RPR, equity interest holders cannot be provided a relatively higher distribution (in percentage) than the distribution (in percentage) provided to the junior most ranking creditor class, while no such requirement exists under the

FET. It may be possible under the FET for equity holders to even retain 100% of their equity interests in certain situations.

- (ii)** The possibility for junior ranking unsecured creditors to be provided more distribution (in percentage) under the FET than the under the RPR. Again, this stems from the RPR as a result of which a relatively higher distribution would necessarily have to be provided to more senior ranking creditors.
- (iii)** The FET provides more flexibility by permitting an SME Debtor to plan out the distribution possibilities under the repayment plan, based on pressing needs and concerns of their business. This may increase the possibility of a successful restructuring of the SME Debtor, while it makes payment based on the repayment plan, in comparison to the RPR under the EU-PRD.

The comparative analysis of the RPR with the FET based on 4 equity retention indicators, shows that:

- (i)** SME Debtors seem to be relatively more incentivised to access the restructuring process at an early stage, under the FET in comparison to the RPR, which increases the possibility of equity interests' retention by SME Debtors under the FET.
- (ii)** While both the RPR and FET prevent creditor exploitation and avert risk-taking behaviour which SME Debtors may indulge in, FET seems to relatively achieve a better balance between creditors rights protection and equity interests.
- (iii)** The FET increases the possibility of consensual confirmation in comparison to the RPR
- (iv)** From a macro-economic perspective, it seems too early to assess based on available statistical information, the success of these Fairness Tests in enabling equity interests' retention.

Based on these 4 indicators, it seems that the FET increases the possibility of enabling equity retention for SME Debtors during their restructuring, in comparison to the RPR.

Premised on this analysis, I assert that Member States who have not yet implemented EU-PRD in their national framework, may incorporate the RPR as a Fairness Test in a manner that it enables retention of equity retention for SME Debtors, by finding orientation under the FET in the SBRA. To allow the SME Debtors to gain from the equity interests' retention enabling ability of the FET, while implementing the RPR, a Relaxed RPR approach may be permitted. This Relaxed RPR approach can be applied using the existing provisions under the EU-PRD. Member States may permit SME Debtors under this Relaxed RPR approach to:

- (i)** Either have a straight discharge procedure or alternatively make payments based on repayment plans, or a combination of both, by relying on Recital 45 of the EU-PRD. If an SME Debtor chooses to make payments based on the repayment plan, Member States may provide for the following stipulations, by relying on Article 8(1)(h) and Article 10(3) of the EU-PRD:
  - (1)** a test similar to the Reasonable Likelihood Test to ensure that the SME Debtors will be able to make all the payments in a timely manner under the repayment plan, and
  - (2)** stipulation that SME Debtor is required to include protections within the plans, including liquidation of non-exempt assets and the satisfaction of a test similar to the Default Remedies Test to ensure that the rights of creditors are protected if payments under the repayment plan are not made.
- (ii)** Permit derogation from the RPR under this Relaxed RPR approach by relying on Article 11(2) of the EU-PRD, in the following situations:
  - (1)** when equity retention is necessary for enabling a successful restructuring of the SME Debtor, and

- (2) when for the successful restructuring of the SME Debtor and for the SME Debtor to be reasonably able to make all the payments based on the repayment plan, the unsecured junior creditor classes would necessarily have to be provided a better treatment (higher distribution in percentage) than the senior ranking unsecured creditor classes.

Mokal and Tirado, in my opinion aptly express how Member States should implement the RPR

*'The key now is for member states to particularise and implement the RPR in a way that would facilitate fair and efficient restructurings...Restructuring law is ready for a dose of relativity.'*<sup>264</sup>

In doing so, Member States may facilitate retention of equity interests for restructuring of SME Debtors, by finding orientation in the FET under the SBRA. It is hoped that the Member States will find some guidance, based on the suggestions stipulated above, to implement the RPR in a manner that it strengthens the equity interests' retention ability of the RPR. It however, remains to be seen whether for enabling equity interests' retention for SME Debtors the RPR may *'herald restructuring law's Einsteinian revolution'*.<sup>265</sup>

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<sup>264</sup> Mokal and Tirado (n 17), 235

<sup>265</sup> Ibid

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