Unfair and unstable: EU bankruptcy reform requires more scrutiny

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In 2019 the EU published its directive on bankruptcy reform, which national parliaments must now consider. This column argues the Relative Priority Rule that the reforms propose is unfair, would reduce financial stability, and may lead to a regulatory race to the bottom. The rule would aggravate risk-taking because returns would be captured by shareholders while losses would be borne by unsecured creditors.

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The EU Directive on its Preventive Restructuring Framework (European Parliament and Council 2019) has created a legislative battle. National legislators must choose between the Absolute Priority Rule (APR) principle used elsewhere or adopting a new EU Relative Priority Rule (RPR). Any shift to the RPR would weaken protection for unsecured lenders such as trade creditors and bondholders, while making debt restructuring easier for – perhaps deliberately – overburdened companies.

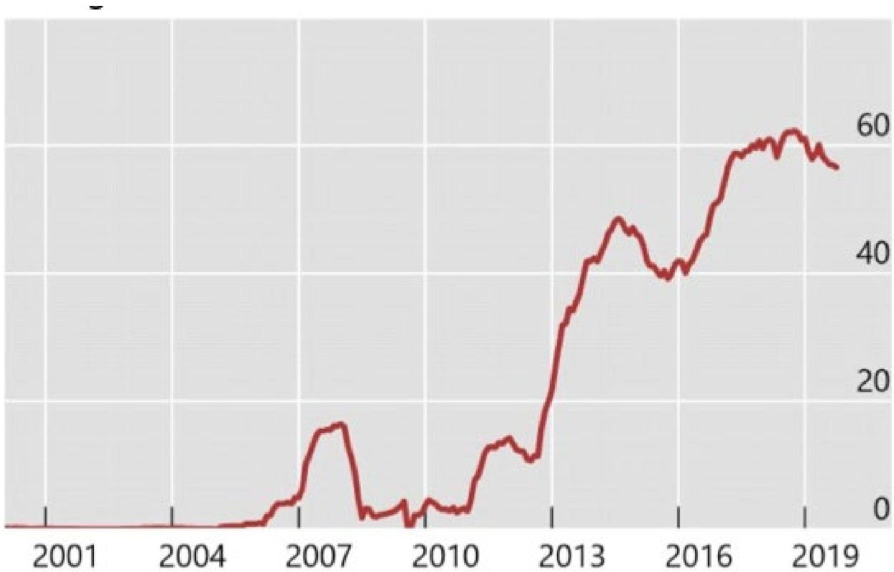
The shift to an EU RPR would offer few incentives to invest, undermine vulnerable lenders, and create a threat to financial stability at a time when credit standards are declining. It would also set back the vision of the European Capital Market Union that borrowers should transition away from an overreliance on bank credit towards more diverse sources of funding.

The APR is a traditional safeguard to prevent shareholders from retaining control in a reorganised company unless most creditors, as a group, consent. In some cases, strict adherence to APR may prevent competent shareholders from restructuring when there is excessive debt. On the other hand, debt renegotiation without APR exposes unsecured creditors to massive write-offs. Their bargaining position is vulnerable to collusion between secured creditors, such as banks, shareholders or private equity.

The ease with which shareholders could retain control over a reorganised company under EU RPR – even after largely wiping out unsecured debt – will not strengthen balance sheets. Instead it will encourage highly leveraged buyouts and equity withdrawals. Many industries have already seen a cycle of cynical equity extraction, by means of dividend recaps and share buybacks, driven by issuance of secured debt. This process leaves captured creditors (suppliers, bondholders tax authorities, pension funds and workers) exposed to the threat of default. The claim of an excessive debt burden is belied by such strategic restructuring.

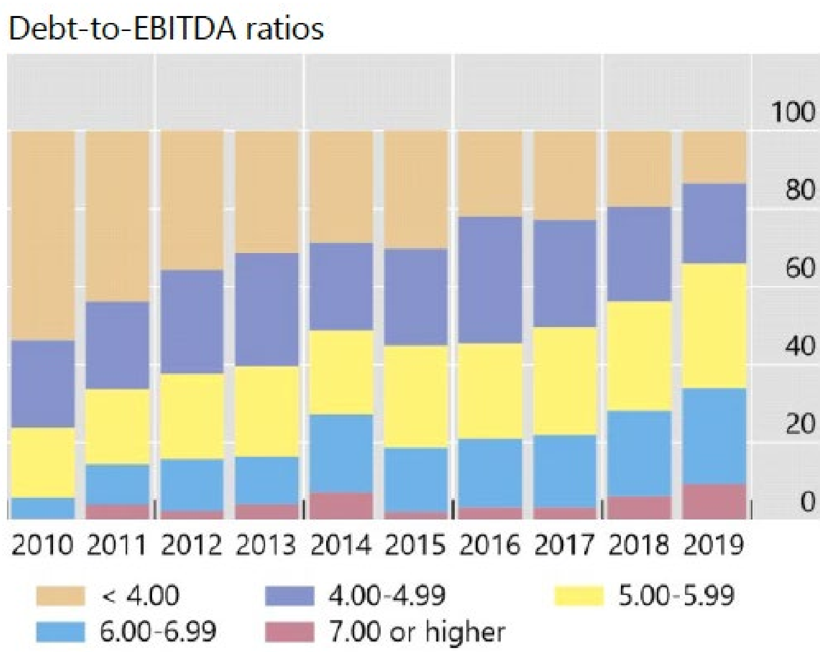
EU RPR raises concerns for financial stability too. Demand by savers for higher yield has produced strong incentives for banks to manufacture high-yield securities, especially given the declining demand for credit by healthy firms at a time of low investment, and a shift to less-tangible assets. European and global supervisors, such as the Financial Stability Board, have warned of the risks created by the rise in covenant-light unsecured loans by banks. These are subsequently repackaged as collateralised loan obligations (CLOs) and sold to bond funds. Figures 1–3, taken from a recent FSB report, show the rise in weakly protected unsecured loans, and their collateralisation (FSB 2019).

Figure 1 Global covenant-light share of issuance, 12-month rolling average, 2000-2019



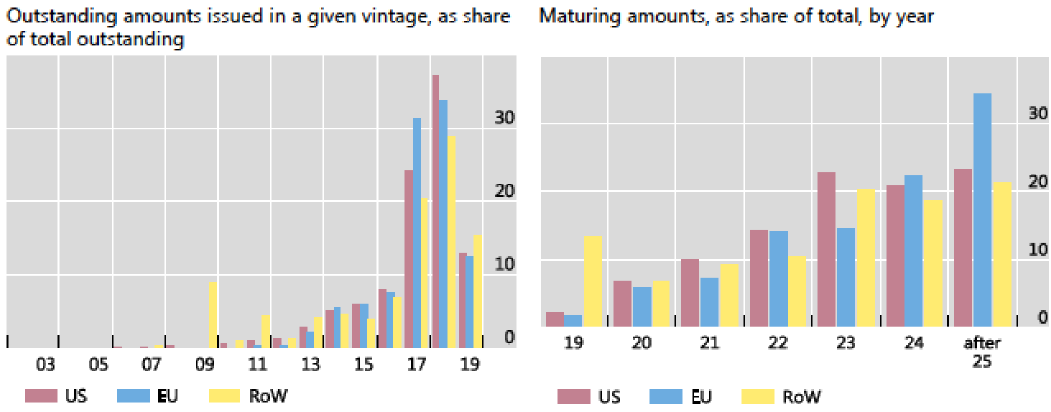
Source: FSB.

Figure 2 Debt-to-EBITDA ratios, 2010-2019



Source: FSB, based on data from JP Morgan.

Figure 3 Leveraged loans issued in a given vintage as percentage share of total outstanding, US, EU and rest of world



Source: FSB, based on Bloomberg and ECB calculations.

Further legal undermining of unsecured claims will lead to much larger bondholder if there are defaults in a recession. It will certainly lead to extreme illiquidity in the entire CLO segment, a worrying echo of the last credit crisis. Since bond funds are subject to open redemptions on demand, the chances of market panic are not to be underestimated.

The limited attention paid to this phenomenon by central banks – the first line of defence on financial stability – is surprising. In part, this reflects the more limited threat for banks. The shift may even reduce the nonperforming loan problem for many EU banks, but only by shunting losses elsewhere.

The legal perspective on the insolvency reform

The benchmark APR plays a role when the requisite majority of all voting classes do not accept a restructuring – 'a non-consensual plan' – and it becomes binding through a so-called 'cross-class cram-down' mechanism, applied by courts. The initial draft of the Directive required the mandatory inclusion of the APR as a condition for enforcing a non-consensual plan to protect the legal interests of dissenting classes.

Inspired by US Chapter 11, the APR ensures shareholders do not retain any interest in a reorganised company, unless creditors who agreed to financial concessions give their consent. But in a surprising last-minute change, the legislators introduced a vaguely formulated European priority rule as the preferred alternative to the tried and tested APR.

The EU RPR provides that dissenting creditors only need to be treated ‘more favourably’ than junior classes such as shareholders and subordinated creditors. The concept of relativity of treatment of different classes is extraordinarily imprecise, and the lack of clarity on how an EU RPR would assign value among stakeholders exacerbates this uncertainty. Shareholders are residual claimants, so their relative treatment cannot in any sensible way be benchmarked by a pay-out percentage.

The EU RPR would also facilitate strategic gifting, when creditors senior to dissenting claimants redirect a part of the distributed value, from their ‘own share’, to a class junior to the dissenting class. This priority-jumping activity de facto provides an opportunity to overcome objections, and expropriate unsecured creditors. This is a higher risk in jurisdictions with weak governance rules that furnish shareholders with controlling competences, such as the possibility of granting shareholders an exclusive right of proposing a restructuring plan under the Directives. Secured creditors that engage in gifting may transfer some value to the equity sponsor of the debtor (the plan-maker) to draft a plan that favours them, neglecting the interests of other creditors. Gifting is legally controversial in many priority regimes but, if jurisdictions opt for an RPR instead, it is much less likely that any creditor could successfully challenge a gift plan.

There are reasons to believe that the EU RPR has been advanced with limited attention to its consequences, and certainly with no coherent academic analysis. The European Law Institute (ELI)

Report made references to American legal scholars, claiming they supported the principle of relative priority. US legal scholars have differing views, but they respect non-bankruptcy rights and aim at facilitating negotiation under uncertain valuation for distressed firms. In contrast, the Directive allows an unprecedented and unjustifiable shift undermining the rights of unsecured creditors.[1]

A financial stability view

In an idealised Modigliani-Miller world, additional risks resulting from the application of the EU RPR would be priced. Unfortunately, recent evidence from macro and finance research shows that bond investors are often oblivious to rising risks at times of abundant funding and falling standards, as recalled in the recent speech at the ECB by Jeremy Stein, leading Harvard professor and a former Fed board member.

The reform would compound the problem for dispersed market participants, who historically relied on banks as gatekeeper of bond issuance, establishing covenants to protect them from excessive risk taking. Trade creditors, tax authorities and company pension funds are also in a weak position without APR.

Weak credit demand has left banks with fewer lending opportunities, while demand for highly leveraged loans by private equity has increased. The rapid expansion of unsecured CLOs by banks has caused alarm at the FSB, which two months ago issued a report highlighting financial stability risks associated with this development (FSB 2019).

An RPR regime at a time of modest growth aggravates risk taking. Positive returns would be captured by shareholders, while losses would be borne by the unsecured creditors.

Poorly designed bankruptcy reform clearly creates financial stability risks. Unsecured bonds supported only by weak covenants would face huge losses if there are defaults in a recession, and their liquidity would plummet once investors recognised the downside risk. Diffused illiquidity, driven by uncertain losses, would be a serious problem for bond mutual funds committed to redemptions on demand.

Mutual funds will not go bust if their share prices were to collapse, but they may be forced into liquidation or seek closed fund status, with massive damage to confidence on both liquidity and safety in the euro area. There is also the question of the extent to which central banks would be able to resist demands for liquidity support for these unregulated shadow banks. And so, unquestionably, a reckless RPR would undermine the EU’s Capital Market Union objectives to develop market alternatives to bank financing.

Whatever the merit of a softer bankruptcy regime, economic circumstances in the EU hardly justify such a major shift. In Eastern Europe during the 1990s, firms were burdened by excessive inherited debt, yet attracted new investment as they integrated into international markets. Current conditions are much less favourable. High firm leverage is a strategic choice by shareholders and private equity, not a burden inherited from the past. The main use of highly leveraged transactions at present is to fund large equity payouts, rather than as investment.

Conclusion

EU national parliaments will be adjusting national bankruptcy law within two years. A reckless shift to RPR as the preferred alternative to the classic benchmark rule will cause a rift between banks and private equity on one side, and defenders of bondholders, trade creditors, tax authorities, workers and pensioners on the other. The effort to harmonise EU legislation is at risk of being captured. This may lead to legal divergence, or even a regulatory race to the bottom.

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Endnotes

1 The RPR proposal by Prof Baird (Baird 2016) deviates from the APR only because it avoids collapsing all future possibilities to the present value. Based on his proposal, the expected investment value of each investor determines the amount of the premium that the junior investor should pay to acquire a control option. The junior investor would exercise her right only if the reorganised firm does well.

Prof Casey’s relative priority proposal (Casey 2011) creates incentives on the choice between sale or reorganisation while respecting non-bankruptcy rights. In his proposal (Option-Preservation Priority), creditors must buy out the contractually bargained for option rights of junior creditors if they wish to take control or sell the debtor’s assets. If the senior creditor considered that a sale was efficient, it would offer the junior creditor exactly the value of the call option. If a sale was judged inefficient, the senior creditor may either not make a buyout offer at all, or offer an amount which would be less than the junior creditor’s surplus from no sale. In that case, the junior creditor would reject the offer and the sale would not occur.