The Neutral Law? Essays in Honour of Johanna Niemi

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9 Roaming along the Stony Road: Absolute and Relative Priorities in Corporate Restructuring

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Abstract

This chapter critically examines the Finnish corporate restructuring framework under the Restructuring of Enterprises Act, highlighting its unchanged state since Johanna Niemi's 1995 doctoral thesis. A central concern is the protection afforded to shareholders of insolvent companies, while creditors bear the financial burdens through significant reductions to their claims. The chapter emphasises Niemi's influential perspective that insolvency law ultimately affects human lives, not just financial transactions. It also explores the moral and legal implications of the order of priority in insolvency proceedings, which the EU leaves to individual Member States. The chapter discusses the limitations imposed by the Finnish Supreme Court's ruling in KKO 2003:73, particularly regarding the application of the absolute priority rule (APR) in cross-class cram downs. It concludes by assessing the potential for future reform through ongoing legislative efforts, such as the debt-to-equity swap project, while acknowledging the enduring constraints of existing statutory law.

Creditors and Shareholders in Insolvency Proceedings

In her PhD (Niemi-Kiesiläinen 1995:362, footnote 10), Johanna Niemi states that 'reshaping the structure of the debtor company can only be done with the consent of the company itself'′. This holds true in corporate reorganization proceedings under the Finnish insolvency regime, governed by the Restructuring of Enterprises Act (8.2.1993/47 with amendments, hereinafter referred to as the ResEntAct). The current state of the relevant Finnish law is the same as it was thirty years ago, when Johanna Niemi defended her thesis.

The purpose of this chapter is to provide a critical approach to the fact that the shareholders of an insolvent company are protected from the measures of restructuring, while the creditors are left to bear the consequences of those measures, which typically involve significant cuts to their claims. As a long-time teacher, mentor and, finally, a colleague, Johanna Niemi has taught me to delve into the deeper structures of insolvency law; no matter whether the debtor is a small or medium-sized enterprise (SME) or a multi-national corporation, or whether a single creditor is an institutional credit provider or natural person, the problems of insolvency law ultimately concern human beings. The question is not only about the lack of money but also—even primarily—about the preconditions for a decent human life, i.e. the significance of money as a crucial means in the efforts aiming at achieving the potential of human beings and the communities built by them (including private companies and other forms of collaboration).[1]

[1] The connections between insolvency law and human rights are culminated in consumer bankruptcy, understood as not only the traditional liquidation proceedings but also the various means of debt arrangements for private individuals. See, e.g., Niemi-Kiesiläinen 1999: 473-503. Inspired by Johanna's teaching and research, and by the writings of Donald R. Korobkin, I tried, in my doctoral thesis, to put in place the human rights-dimension also to the theory of corporate insolvency law. See Hupli 2004: 57-69 (developing the idea which I call 'value relativism' as a contrast to the purely utilitarian goals of

When evaluating the alternative measures of an ideal regime of insolvency law, the general view is, however, insufficient. Certain fundamental details must also be considered, since the details are the ultimate results of the basic principles. The order of priorities is a manifest example of problems where moral values and the law unite. In the following sections of this chapter, the competing principles, governing the order of priority in insolvency proceedings, are evaluated in the context of Finnish statutory law and case law. This order of priority can be easily labelled as a merely technical detail, but there is, in fact, a lot at stake. First, EU insolvency law has left it to the Member States to choose the order of the competing principles, and second, the treatment of the owners and the subordinated debts in insolvency proceedings may even affect the competitiveness of a particular Member State.

Types of Conflicts in Collective Insolvency Proceedings

Insolvency proceedings are usually considered undertakings between the insolvent debtor and the creditors of debt, i.e. creditors of borrowed capital (or creditors of the compensation for damages). Indeed, the problems which often lead to insolvency proceedings mainly concern the debtor's ability to fulfill the obligations of their debt liabilities. In corporate insolvency law, this focus is a 'natural' result since company law is based on the fundamental idea that the claims of company owners can only be legally satisfied after the claims of the creditors have been met (or, at least, secured by the test of insolvency). In other words, traditional bankruptcy liquidation results from the debtor's failure to satisfy the claims of the creditors.

In liquidation bankruptcy, the shareholders of the debtor company typically lose their entire investments; even the creditors typically only receive a small share of the returns, which usually has little financial importance. Despite the fact that a traditional bankruptcy results in economic loss for all of the affected parties, i.e. both the owners and the creditors, bankruptcy, in its classic form, is based on two different conflicts: one between the debtor and its creditors, and another one among the creditors themselves. The conflict between the debtor and the creditors concerns the efforts of enforcing the creditors' claims, while the conflict among creditors is ultimately a question of equality between them.

The law of corporate restructuring, in turn, is designed to avoid the brutality of bankruptcy liquidation by providing the tools for seeking, planning and deciding on the measures of business restructuring, aimed at offering a better economic result as compared to the meaningless share of the insolvent debtor's assets. The law of corporate restructuring also introduces a 'third party' into the conflict: the shareholders of the debtor company. Since the purpose of business restructuring is not the dissolution of the debtor entity but to preserve it and revitalise its potential in some capacity, the regime of corporate restructuring forces the legislators to consider whether the owners of the debtor company should participate in the recovery of a troubled company. This question is ultimately a matter of legal policy. However, the general theory of the law of limited liability companies would require that the owners, even in the restructuring proceedings, bear the negative effects of the residual claim; the owners must lose their investment entirely unless all claims of the borrowed capital are fully satisfied.[2]

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economic 'efficiency') and 2004:70-89 (presenting and evaluating the 'Rawlsian' contractarian models, created especially by Donald R. Korobkin, to justify the regime of corporate restructuring).

2 The theory of residual claims (and claimants) is one of the cornerstones of any legal system based on market economy. The very content of the theory requires that the residual claimants of corporations are 'the parties who suffer increasing injury as the corporation does progressively worse and who likewise

The Order of Priority: Absolute or Relative?

The requirement of 'wiping out' the shareholders of an insolvent corporate debtor, unless debt creditors are fully satisfied, reflects the legal (and moral) maxime of *absolute priority rule* (hereafter also the 'APR'). In contrast, a competing principle, the *relative priority rule* ('RPR') has recently gained attention in the insolvency law of the European Union (see, e.g., Ballerini 2021 and Krohn 2021).

More specifically, Article 11(1)(c) of the EU Directive on restructuring and insolvency[3] indicates the RPR: a restructuring plan may be confirmed and become binding upon dissenting voting classes through a so-called cross-class cram down, provided, *inter alia,* that the plan ensures 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. The very idea of the RPR is expressed by the words 'at least as favourably' and 'more favourably', indicating that the Member States, in their national laws, are not strictly bound by the APR.[4] As a result, under Article 11(1)(c) of the Directive, junior classes *may* receive some form of compensation, such as payment or another interest of economic value, even though the more senior classes are not fully satisfied under the restructuring plan.

In the following, I evaluate the distinction between the APR and the RPR by using Finnish law as an example to illustrate the fundamental problems. According to the statutory Finnish law on corporate restructuring, neither the absolute nor the relative priority rule applies to the relations between the owners of the debtor company and the creditors of the borrowed debt. The investment of the owners remains intact, regardless of how dramatically the claims of the creditors must be decreased to restore the solvency of the company. As to the ranking between the classes of creditors under Finnish law, the requirement of APR is only applied in cases of cross-class cram down; the APR is not required when the restructuring plan is supported by all of the classes of creditors (let alone when the unanimous consent between the creditors is achieved). Despite that, the Supreme Court of Finland has held, in the ruling *KKO 2003:73,* that the APR should be applied as a general rule, regardless of the support the plan has gained among the creditors.

Statutory Law, Ratio Legis and the Supreme Court Ruling KKO 2003:73

Statutory Law and its Purpose

ResEntAct provides three alternative conditions for confirming a restructuring plan. According to Sections 50–51 and 54 ResEntAct, the plan may be confirmed on the basis of: 1) the unanimous consent of all creditors, 2) the acceptance of the majority of creditors in all classes of them and, as an ultimate opportunity, 3) cram down, i.e. acceptance by at least one class of creditors.

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enjoy increasing gains as the corporation does progressively better', see *Kim* 2021:43-44. In the research of insolvency law, it has been stated that '[T]he residual owner—typically defined as the investor who will reap the marginal dollar of the firm's gain or suffer the marginal dollar of its losses—is a frequently-invoked hero of economic theory' (*LoPucki* 2004:1343-1344).

3 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

4 Article 11(2) of the Directive provides the Member States with an option to adopt or retain the APR in domestic laws.

The absolute priority rule is laid down in Section 54, Paragraph 1(5) ResEntAct, which stipulates that a restructuring plan is approved via cram down provided that 'creditors with claims which have a lower priority than the group of creditors voting against approval, other than one composed of secured creditors, are not to receive payment'. The absolute priority is an *additional safeguard, which compensates for the lack of majority approval in cram down scenarios, where creditors may reject the plan or abstain from voting.* If absolute priority was a general requirement for plan confirmation, the section in question would be redundant. The provision clarifies that absolute priority does not apply when the majority of creditors approves the plan.

Here, parallels can be drawn to US Bankruptcy law, which has been a key influence for the Finnish ResEntAct. Herbert (1995:331) has depicted the US situation in the following words: 'so long as the debtor does not resort to cramdown, and so long as the plan meets the best interest of creditor's test, the debtor may propose almost anything'. Similarly, Finnish legal literature highlights that absolute priority serves as an additional safeguard for cram down plans, compensating for the absence of majority support (Hupli 2004: 325).

The Government Bill 182/1992 for the ResEntAct further illustrates the flexible approach to creditor equality in reorganisations by stating that the creditors of the same ranking must be treated 'similarly or at least in an equal manner' during debt adjustment (89). This underscores a more flexible principle of equality between creditors, compared to the rigid absolute priority rule.

The Finnish Supreme Court Ruling KKO 2003:73—Courts Disagreeing

The observations above show that the APR is not a general requirement for the confirmation of the restructuring plan; it is also shown that absolute priority must be applied only in cram down. Provided that the plan is supported by the majorities of all of creditor groups, the absolute priority rule *may* be applied, but is not mandatory, since other options are available. Nevertheless, the Finnish Supreme Court, in its ruling *KKO 2003:73,* has held the following:

> Since the debtor's obligation to pay the subordinated, convertible loan had been abolished in the restructuring plan, the creditor's right to convert the loan into shares of the debtor company also had to be abolished.

In the restructuring case which led to the Supreme Court ruling KKO 2003:73, the plan proposed by the administrator (i.e. the insolvency practitioner) included the full extinction of the receivable based on the subordinated convertible bond. This decision was grounded on the absolute priority rule, as creditors with higher ranking claims did not receive full payment. The subordinated creditor did not oppose the full reduction of its cash receivable, but claimed that the right to convert the cash into equity should remain in force. The District Court, dismissing the creditor's claim, confirmed the plan as proposed by the administrator. Thus, at the end of the restructuring proceedings in the District Court, the creditor of the subordinated loan had lost both the right to receive a cash payment and the right to convert it into shares in the debtor company.

On Appeal, the Court of Appeal of Helsinki reversed this decision, allowing the convertible bond to remain valid in respect of the right to convert. After the debtor had applied for and obtained a leave to appeal, the Supreme Court repealed the decision of the Court of Appeal and, thus, ordered the decision of the District Court to be followed.

The reasoning of the District Court, the Court of Appeal and the Supreme Court in *KKO 2003:73* does not clarify whether or not the debtor needed to resort to cram down in order to get the restructuring plan confirmed. The District Court merely stated that the convertible debt 'could not be satisfied on the basis of the restructuring plan since the debts with higher priority were not fully satisfied'. Similarly, the Supreme Court held that the obligation to pay the subordinated loan was to be abolished in the restructuring plan, because the obligation to pay the claims in higher ranks had been reduced. The Supreme Court even stated that: 1) on the basis of the fact that the obligation to pay the subordinated loan was abolished, there was no more credit that could have been converted into equity, and 2) this would have been an 'undisputed' result. But it was not undisputed; instead, the applicability of the absolute priority rule was the *very reason for the dispute.*

In contrast, the Court of Appeal reached a different conclusion and preserved the creditor's right of conversion. Its reasoning rested on two arguments, both derived from ResEntAct Section 44. First, the abolition of the right to convert violated the rule of *least intrusive means* in debt settlement. The abolition, in other words, interfered with the creditor's rights more than necessary to achieve the purpose of the restructuring plan, or to fulfill the requirements laid down in the ResEntAct concerning the mutual position of creditors (Section 44(3)). Secondly, according to the Court of Appeal, the abolition of the right to convert was not a permissible means of debt relief, listed exhaustively in the ResEntACt (Section 44(1–2)). However, the exhaustive list only concerns the means of debt relief which can be applied *by force*. Nothing prevents the creditors from accepting other measures of relief, such as debt-to-equity swap.

The reasoning, and the resolution of the Court of Appeal aligns with the wording and the purpose (*ratio legis*) of the ResEntAct. Unfortunately, the Supreme Court departed from this reasoning without explaining its rationale. Interestingly, the case *KKO 2003:73 did not involve* a cram down.

The Supreme Court ruling KKO 2003:73 raises several concerns. The first is that its reasoning and outcome is inconsistent with the ResEntAct, since the application of the absolute priority rule was divorced from the level of creditor support for the restructuring plan. The ruling is a curious one, since it contradicts both the letter and purpose of the ResEntAct. In practice, whenever the status of subordinated loans is negotiated in the restructuring proceedings, those who are aiming at wiping out those loans and their creditors, can easily refer to the preliminary ruling of the highest instance.

The second concern in the case is that it disregards the principle of *least intrusive means*, as the Supreme Court failed to address whether the abolition of conversion rights met the standard of minimal interference, a key tenet of debt adjustment under the ResEntAct. Finally, a third problem in the case is its impact on subordinated creditors and financing, since the ruling risks fostering passivity among subordinated creditors and, in the long term, weaken the supply of mezzanine financing in Finland. The argument that there was no more debt to be converted, since the duty to pay the subordinated loan by cash was abolished by the restructuring plan, is nothing short of 'a magic trick' to seemingly resolve the situation (without actually doing so). It cannot be an overwhelming intellectual performance to order that the converted sum of money would be the sum still unpaid at the moment when the restructuring plan came into force.

Concluding Remarks

Due to KKO 2003:73, it is important—at least in Finnish legal doctrine, but also more generally within the European Union—to identify the measures by which the APR remains limited only to the cross-class cram down, i.e. the measures to protect the will of the majority of creditors in restructuring proceedings.

To approach a solution, a couple of fundamental issues should be clarified.

Firstly, the concept of priority in corporate restructuring should *not be identified* with the order of priorities in bankruptcy liquidation. The discussion—including the judgment KKO 2003:73—on the absolute and relative priorities has completely ignored the fact that in restructuring proceedings, the creditors' right to receive payments is not realised from any static mass of assets, as in traditional bankruptcy. Instead, the payments depend on the debtor's reversible solvency, achieved through the implementation of the restructuring plan.

The second fundamental issue is EU insolvency law's lack of compulsory use of the absolute priority rule, even in cross-clam cram downs. Article 11(1)(c) of the EU Directive on Restructuring and Insolvency establishes relative priority as the default rule, with absolute priority offered only as an optional framework for Member States.

Finally, it seems unlikely that European harmonisation of insolvency laws would provide a solution to the problems caused by the ruling in KKO 2003:73. At the Finnish national level, there is a project of law drafting concerning the debt-to-equity-swap. This project might offer an opportunity to alleviate the present state of the law. No matter whether this opportunity materialises or not, judges, insolvency practitioners, as well as scholars, are bound by the statutory law which, for reasons explained above, requires the APR to be applied in cram down only.

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