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# Rethinking Corporate Bankruptcy Theory in the Twenty-First Century

Sarah Paterson\*

*Adopting a comparative UK/US approach, this article argues for the need to rethink corporate bankruptcy theory in the light of developments in the finance market. It argues that these developments have produced an effective mechanism, in large cases, for selecting between companies which will be worth more if they continue to trade and companies which ought to be allowed to fail, such that corporate bankruptcy law need no longer concern itself with steering creditor choice away from a sale of the business and assets and towards a restructuring. Moreover, it suggests that whilst the automatic stay remains a central tenet of corporate bankruptcy law where the market decides that the business and assets should be sold, in cases where the market sees more value if a company continues to trade, corporate bankruptcy law may operate very well without a stay as a resolution procedure for deadlocked negotiations. The article identifies that in many large restructuring cases the only liabilities which are implicated are financial liabilities, and queries the extent to which the distributional concerns of the progressive movement, and US federal bankruptcy law, apply where losses are shared amongst sophisticated financial institutions. It ends with an explanation of why the analysis is limited to large cases, an indication of areas for further research and a note of caution for the future.*

Keywords: corporate law; comparative law; law and economics; law and finance; legal theory

## 1. Introduction

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US bankruptcy scholars have traditionally described the role of corporate bankruptcy law in the following way.<sup>1</sup> Once a company is in financial distress, individual creditors have an incentive to rush to enforce their claims against the company's assets in order to be paid out before the assets are gone. If this happens, the company will be broken up piecemeal. This prevents two things from happening. First, it prevents the creditors from agreeing a new deal amongst them, so that the company can continue to trade (a restructuring). Secondly, where a restructuring is not in prospect, it prevents the business from being sold as a whole (or as a going concern), notwithstanding that this would be likely to attract a higher price than a piecemeal realisation of the individual assets.<sup>2</sup> Although individual creditors who win the race to the assets will be better off, overall creditors will be worse off (the common pool problem). Thus the purpose of all corporate bankruptcy law is to impose a stay (or a moratorium) to prevent creditors from taking individual enforcement action to 'grab' assets, so that the business can either be restructured or the business and assets sold.<sup>3</sup> All US bankruptcy scholars have generally agreed with corporate bankruptcy law's role in maximising value (the size of the pie), and the role of the stay

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<sup>1</sup> 'Bankruptcy' to an English lawyer relates only to individuals. In the US, on the other hand, 'bankruptcy' applies to both individuals and companies. For the purposes of the comparison in this article the term 'corporate bankruptcy' has been adopted.

<sup>2</sup> See M Harner, 'The Value of Soft Variables in Corporate Reorganizations' (2015) *University of Illinois Law Review* 509, 510

<sup>3</sup> See TH Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91(5) *The Yale Law Journal* 857; TH Jackson, 'Translating Assets and Liabilities to the Bankruptcy Forum' (1985) 14(1) *The Journal of Legal Studies* 73; TH Jackson *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986); TH Jackson, RE Scott, T Eisenberg and M Roe, 'On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain' (1989) 75(2) *Virginia Law Review* 155

in achieving this.<sup>4</sup> Controversy rather focuses on the extent to which, and the way in which, corporate bankruptcy law should concern itself with how value is distributed (how the pie is shared).<sup>5</sup>

Part of the distributional concern arises because creditors at the top of corporate bankruptcy law's order of distributional priority have little incentive to agree to a restructuring if (i) they will recover all or most of their claims on a sale of the business and assets; and (ii) a sale may be more timely, and cheaper to implement.<sup>6</sup> This leads to a concern that these creditors will not agree to a restructuring plan, so that businesses which could have been saved will be sold instead, jobs will be needlessly lost and other (more vulnerable) creditors, lower in corporate bankruptcy law's order of distributional priority, will suffer losses which could have been avoided.<sup>7</sup> This is particularly likely to affect trade creditors (who have supplied the company but not been paid, or who have paid for goods or services but have not received them), and tort creditors who never imagined that they would be creditors of the company in the first place.

As a result, US scholars of what might broadly be described as the 'progressive school' see a role for corporate bankruptcy law in steering

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<sup>4</sup> See, for example, JL Westbrook, 'The Control of Wealth in Bankruptcy' (2004) 82(4) *Texas Law Review* 798, 821 describing maximisation of value for distribution amongst beneficiaries as the 'consensus goal'

<sup>5</sup> See, for example, E Warren, 'Bankruptcy Policy' (1987) 54(3) *The University of Chicago Law Review* 775; DR Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91(4) *Columbia Law Review* 717

<sup>6</sup> See, for example, J Johnston, 'The Bankruptcy Bargain' (1991) 65(2) *American Bankruptcy Law Journal* 213, 246-247; E Warren, 'Making Policy with Imperfect Information: the Article 9 Full Priority Debates' (1990) 82(6) *Cornell Law Review* 1373, 1390

<sup>7</sup> See, for example, DG Baird, 'Bankruptcy's Uncontested Axioms' (1998) 108(3) *The Yale Law Journal* 573, 577 citing K Gross *Failure and Forgiveness: Rebalancing the Bankruptcy System* (1<sup>st</sup> edition, Yale University Press, 1991), 235-43 and Korobkin (n 5), 766-68

creditor choice away from a sale and a distribution of the proceeds, and towards a new bargain. Law and economics scholars, on the other hand, worry that this is to be put the proverbial cart before the horse. They view the role of bankruptcy law as facilitating the allocation of resource in the economy to highest and best use. If capital is withdrawn from businesses which are failing, and redeployed in businesses which are succeeding, the rest (in terms of jobs and prosperity) will follow. On the other hand, they worry that if corporate bankruptcy law pursues the protection of jobs as an independent objective, capital may continue to be deployed in less-efficient producers in the economy.<sup>8</sup> Moreover, they are concerned with the extent to which corporate bankruptcy law interferes with the rights of senior, secured creditors, and the consequences for the availability and the cost of credit for healthy companies.<sup>9</sup>

Notwithstanding these concerns, the theoretical framework of the progressive school has had a significant influence on US federal bankruptcy law.<sup>10</sup> Management is handed the ability to file a financially distressed company for protection pursuant to Chapter 11 of the US Bankruptcy

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<sup>8</sup> See TH Jackson and DA Skeel Jr, 'Bankruptcy and Economic Recovery' University of Pennsylvania Law School Institute for Law and Economics Research Paper No 13-27, 29-34 (available at SSRN: <http://ssrn.com/abstract=2306138>) (last accessed 29 May 2015)

<sup>9</sup> See DG Baird, 'Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren' (1987) 54(3) *University of Chicago Law Review* 815, 824-28; RK Rasmussen, 'The Ex Ante Effects of Bankruptcy Reform on Investment Incentives' (1994) 72 *Washington University Law Quarterly* 1159, 1162-65; DA Skeel Jr, *Debt's Dominion: a History of Bankruptcy Law in America* (Princeton University Press 2001), 224; G Triantis, 'The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers and Guillotines' (1996) 16(1) *International Review of Law and Economics*, 101

<sup>10</sup> See, for example, Skeel *Debt's Dominion* (n 9), 227

Code,<sup>11</sup> and Chapter 11 provides a strong, automatic stay on individual creditor action.<sup>12</sup> In other words, management is provided with an effective veto over creditor threats.<sup>13</sup> Moreover, once a Chapter 11 filing has been made, management is handed the almost exclusive right to propose the solution to the company's problems for the first 120 days after a filing, on the assumption that members of management will prefer a restructuring plan (which will save their jobs) over a sale (which may not).<sup>14</sup> Detailed machinery has developed over time which enables the bankruptcy judge to impose a restructuring plan on dissenting creditors, so that it can be implemented with less than unanimous consent.<sup>15</sup> Thus US federal bankruptcy law offers not only a strong stay against creditor action, but also a structure which incentivises restructuring rather than sale. Not surprisingly, law and economics scholars are highly critical of some of these policy choices, and a lively literature has followed.<sup>16</sup>

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<sup>11</sup> Section 301 of the US Bankruptcy Code

<sup>12</sup> Section 362 of the US Bankruptcy Code

<sup>13</sup> See H Miller and S Waisman, 'Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?' (2004) 78(2) *American Bankruptcy Law Journal* 153, 176-177; DA Skeel Jr, 'An Evolutionary Theory of Corporate Law and Corporate Bankruptcy' (1998) 51(5) *Vanderbilt Law Review* 1325, 1377-1380; H Miller, 'Chapter 11 in Transition – From Boom to Bust and into the Future' (2007) 81(4) *American Bankruptcy Law Journal* 375, 386-387

<sup>14</sup> Section 1121(a)-(d) of the US Bankruptcy Code, which can be extended for up to eighteen months (this limit on extensions was added in 2005). For a description of how this incentivises a restructuring see RD Thomas, 'Tipping the Scales in Chapter 11: How Distressed Debt Investors Decrease Debtor Leverage and the Efficacy of Business Reorganization' (2010) 27 *Emory Bankruptcy Developments Journal* 213, 225-226; Jackson and Skeel, 'Bankruptcy and Economic Recovery' (n 8), 25-26

<sup>15</sup> For a more detailed description of the technical provisions see R Olivares-Caminal, J Douglas, R Guynn, A Kornberg, S Paterson, D Singh and H Stonefrost *Debt Restructuring* (Oxford University Press 2011) 103-114

<sup>16</sup> See, for example, LM LoPucki 'The Debtor in Full Control – Systems Failure under Chapter 11 of the Bankruptcy Code?' (1983) 57 *American Bankruptcy Law Journal* 247, 249; M Bradley and M Rosenzweig, 'The Untenable Case for Chapter 11' (1992) 101(5) *The Yale Law Journal* 1043; L Bebchuk and H Chang, 'Bargaining and the Division of Value in Corporate Reorganization' (1992) 8(2) *Journal of Law, Economics and Organization* 179, 253; BE Adler, 'Financial and Political

We do not find the theoretical framework of the progressive school clearly reflected in English law. Instead, English law offers multiple procedures,<sup>17</sup> only sometimes offers a moratorium on creditor action,<sup>18</sup> and offers a weaker moratorium where one is available at all.<sup>19</sup> Over the years this has been a cause of concern for English policy makers, scholars and practitioners and there has been an occasional dalliance with reform.<sup>20</sup> However, the powerful deposit banks, which have traditionally provided the bulk of finance to corporate Britain, have raised serious objections to reform which reflect many of the concerns of law and economics scholars in the US. First, they warn of the risk of a decrease in the availability of finance, and an increase in the cost of credit, if corporate bankruptcy law interferes significantly with secured creditor rights. Secondly, they argue that by steering creditors away from a sale, and towards restructuring, companies which should have been allowed to fail will continue in business, draining

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Theories of American Corporate Bankruptcy' (1993) 45(2) Stanford Law Review 311; LM LoPucki, 'The Trouble with Chapter 11' (1993) Wisconsin Law Review 729; DA Skeel Jr, 'Rethinking the Line Between Corporate Law and Corporate Bankruptcy' (1994) 72(3) Texas Law Review 471, 535; A Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 107(6) The Yale Law Journal 1807; DA Skeel Jr, 'Creditors' Ball: The New New Corporate Governance in Chapter 11' (2003) 152(2) University of Pennsylvania Law Review 917, 920-21

<sup>17</sup> There are six procedures: compulsory winding up, creditors' voluntary winding up, receivership, administration, company voluntary arrangement and schemes of arrangement

<sup>18</sup> A moratorium is imposed in administration and compulsory liquidation. There is no automatic moratorium in a creditors' voluntary winding up, although it is possible to apply to court for a stay (section 112(1) Insolvency Act 1986). A moratorium is available in a company voluntary arrangement, but only for small companies satisfying 2 or more of the requirements in section 382 of the Companies Act 2006. There is no moratorium in a scheme of arrangement or receivership

<sup>19</sup> The stay in compulsory liquidation does not prohibit enforcement by a secured creditor (in re David Lloyd & Co (1877) 6 Ch. D 339, 343-46). The moratorium in an administration proceeding does but it does not prevent a party from terminating a contract for insolvency (Re Olympia & York [1993] BCC 154) whilst such *ipso facto* clauses are stayed in Chapter 11

<sup>20</sup> Most notably the reforms introduced by the Enterprise Act 2002, discussed below

resources away from other, more successful businesses.<sup>21</sup> Over the years these concerns have tended to trump concerns for creditors lower in corporate bankruptcy law's distributional order of priority, and powerful financial creditors have effectively been trusted to select between businesses which should be saved and businesses which should be allowed to fail. These arguments also appeal to English lawyers' broader respect for freedom of contract, and their pathological fear of interfering too early and too extensively in contractual rights, lest England become a less attractive place to do business.<sup>22</sup>

Recently, four significant adaptations in the finance markets have appeared to be driving the practice of restructuring in the UK and the US closer together, at least for large and larger mid-cap companies, and notwithstanding the different theoretical frameworks reflected in the law on the books. The first adaptation is the increasing globalisation and diversification of the type of creditor providing finance, particularly in the UK.<sup>23</sup> The second is the rise of financing arrangements in which a financial creditor has security over all, or substantially all, of the assets of the debtor,

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<sup>21</sup>See, for example, G McCormack, 'The Priority of Secured Credit: An Anglo-American Perspective' (2003) *The Journal of Business Law* 389, 390-392; I Fletcher, 'UK Corporate Rescue: Recent Developments – Changes to Administrative Receivership, Administration, and Company Voluntary Arrangements – the Insolvency Act 2000, The White Paper 2001, and the Enterprise Act 2002' (2004) 5(1) *European Business Organization Law Review* 119, 129-130; J Armour, A Hsu and A Walters, 'Corporate Insolvency in the United Kingdom: The Impact of the Enterprise Act 2002' (2008) 5(2) *European Company and Financial Law Review* 148, 161-162; R Bork *Rescuing Companies in England and Germany* (Oxford University Press 2012), 147-148

<sup>22</sup> See, for example, R Calnan, 'Ban the Ban: Prohibiting Restrictions on Assignment of Receivables' (2015) 30(3) *Journal of International Banking and Finance Law* 136, 137

<sup>23</sup> See J Armour, 'The Rise of the 'Pre-pack': Corporate Restructuring in the UK and Proposals for Reform' in RP Austin and FJG Aoun (eds), *Restructuring Companies in Troubled Times: Director and Creditor Perspectives* (Ross Parsons Centre of Commercial, Corporate and Taxation Law 2012) 43-78



particularly in the US.<sup>24</sup> The third is increasing debt-raising capacity, with the result that large and larger mid-cap companies have significantly higher ratios of debt to equity than we might hitherto have expected.<sup>25</sup> The last is the development of a specialist market for the purchase of the debt of financially distressed companies in both jurisdictions.<sup>26</sup> Moreover, as the service sector grows in both jurisdictions, many companies are defined by cash flows rather than hard assets, and by the team of employees which goes up and down in the lift every day, so that preserving cash flow becomes a priority, there are few hard assets to enforce against and the team of employees must be kept together.<sup>27</sup>

Notwithstanding predictions that these adaptations in the finance market, and the changing nature of the debtors themselves, would drive law in one regime closer to the law in the other regime,<sup>28</sup> arguably the two

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<sup>24</sup> Harner, 'The Value of Soft Variables' in Corporate Reorganizations' (n 2), 515-517

<sup>25</sup> BR Cheffins and J Armour *The Eclipse of Private Equity* (University of Cambridge, Centre for Business Research, 2007), 33

<sup>26</sup> For the development of the market in the US see CJ Fortgang and TM Mayer, 'Trading Claims and Taking Control of Corporations in Chapter 11' (1990) 12 *Cardozo Law Review* 1; CJ Fortgang and TM Mayer, 'Developments in Trading Claims: Participations and Disputed Claims' (1993) 15 *Cardozo Law Review* 733; MH Whitaker, 'Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure' (1993) 3 *Cornell Journal of Law & Public Policy* 303; S Gilson, 'Investing in Distressed Situations: A Market Survey' (1995) 51(6) *Financial Analysts Journal* 8; F Tung, 'Confirmation and Claims Trading' (1995) 90 *North Western University Law Review* 1684; PM Goldschmid, 'More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process' 2005 *Columbia Business Law Review* 191; M Harner, 'The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing' (2008) 77 *Fordham Law Review* 703; M Harner, 'Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives' (2008) 16 *American Bankruptcy Institute Law Rev* 69. For the development of the market in the UK see S. Paterson, 'Bargaining in Financial Restructuring – Market Norms, Legal Rights and Regulatory Standards' (2014) 14(2) *Journal of Corporate Law Studies* 333

<sup>27</sup> See DG Baird and RK Rasmussen, 'The End of Bankruptcy' (2002) 55(3) *Stanford Law Review* 751, 758, 762-765; Miller and Waisman (n 13), 192-193 and LM LoPucki, 'The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's "The End of Bankruptcy"' (2003) 56(3) *Stanford Law Review* 645, 651-659

<sup>28</sup> See, for example, J Armour, BR Cheffins and DA Skeel Jr, 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55(6) *Vanderbilt Law Review*, 1733, 1775-1776

regimes have been meeting somewhere in the middle.<sup>29</sup> As a result, there have been fewer assaults on US federal bankruptcy law by law and economics scholars.<sup>30</sup> English scholars, practitioners and policy makers wonder whether some reform of law on the books might be advisable to better reflect the practice of UK restructuring.<sup>31</sup> In contrast, the American Bankruptcy Institute Commission to Study Reform of Chapter 11 has been considering whether some reform of law on the books is necessary to bring about changes in the practice of US restructuring, and its recent report and recommendations appear to reaffirm a commitment to reforming Chapter 11, so that it continues to meet the two, traditional policy objectives of reducing the incentive for creditor action and steering creditors towards a restructuring.<sup>32</sup> It may be, therefore, that the two jurisdictions will draw apart again.

As a result of the adaptations in the markets, this article will suggest that a generally efficient market mechanism exists for choosing between good companies with the wrong capital structure (which ought to be restructured) and companies with more profound problems (so that the

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<sup>29</sup> See, for example, G McCormack, 'Control and Corporate Rescue – An Anglo-American Evaluation' (2007) 56(3) *International and Comparative Law Quarterly* 515, 516; Harner, 'The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing' (n 26), 757-758

<sup>30</sup> See, for example, MB Jacoby, 'What Should Judges do in Chapter 11?' (2015) *University of Illinois Law Review* 571, 580-581

<sup>31</sup> See, for example, the measured response to a recent Government consultation on the European Commission Recommendation on a New Approach to Business Failure and Insolvency C (2014) 1500 final from the City of London Law Society (available at [http://www.citysolicitors.org.uk/index.php?option=com\\_content&view=category&id=132&Itemid=469](http://www.citysolicitors.org.uk/index.php?option=com_content&view=category&id=132&Itemid=469)) (last accessed 29 May 2015)

<sup>32</sup> ABI Commission to Study Reform of Chapter 11 2012-2014 Final Report and Recommendations (available at <http://commission.abi.org/>) (last accessed 29 May 2015)

business and assets ought to be sold in insolvency proceedings). For large and larger mid-cap companies it will propose an analytic divide between the role of corporate bankruptcy law when debts are to be restructured, on the one hand, and when assets and liabilities are to be sold to a third party for the best price reasonably obtainable (an insolvency), on the other, with the market choosing between the two. Whilst corporate bankruptcy law continues to be primarily concerned with dis-incentivising individual creditor action in an insolvency situation, in a restructuring it primarily provides a deadlock resolution procedure. The article will suggest that there may yet be a case for reform of the law, but to address new concerns emerging in new markets, rather than to reinforce the law's response to old concerns from an old market. Finally, it will argue that the new concerns relate largely to the availability and cost of credit and, as a result, are likely to be the source of less controversy between law and economics scholars and progressive scholars, between policy makers, or between the US and the UK. In short, they largely raise empirical questions rather than philosophical ones.

The rest of the paper proceeds as follows. First, the development of modern insolvency and restructuring law in the US and the UK is briefly explored, showing how each jurisdiction set off along divergent paths but recent developments suggested convergence. The second part considers the significance of these market changes for bankruptcy theory and briefly considers certain new proposals and recommendations from the ABI

Commission which indicate a re-affirming of the traditionally different philosophical approach and a possibility for the two jurisdictions to draw back apart.<sup>33</sup> The final part of the article suggests a new theoretical framework for the role of corporate bankruptcy law when large and larger mid-cap companies face financial distress, and a few reflections for further research.

## 2 The Development of Corporate Bankruptcy Law in the US and the UK

### A Restructuring Law in the US: 1979 to 1990

US restructuring law had its start at the end of the nineteenth century with the restructuring of the railroads.<sup>34</sup> There was a strong public interest in restructuring the railroads, which were seen as providers of prosperity and modernity.<sup>35</sup> Moreover, a piecemeal realisation of railroad assets was unlikely to produce much of value for anyone; as Miller and Waisman put it, ‘There was a broad national consensus that the troubled railroad industry must be saved, the absence of which would leave “nothing but a streak of

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<sup>33</sup> Ibid

<sup>34</sup> See, for example, A Martin, ‘Railroads and the Equity Receivership: An Essay on Institutional Change’ (1974) 34(3) *The Journal of Economic History* 685; Korobkin (n 5); Skeel, ‘An Evolutionary Theory’ (n 13), 1353-1358; Skeel, *Debt’s Dominion* (n 9); DG Baird and R Rasmussen, ‘Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations’ (2001) 87(5) *Virginia Law Review* 921, 925-936; Miller and Waisman (n 13); DG Baird, ‘Present at the Creation: the SEC and the Origins of the Absolute Priority Rule’ (2010) 18(2) *American Bankruptcy Institute Law Review* 591

<sup>35</sup> Skeel *Debt’s Dominion* (n 9), 60-63

iron-rust on the prairie”<sup>36</sup> But the railroads had issued multiple series of bonds, and different bondholders had security over different assets. Many of these assets were 'hard' assets, capable of realisation for cash.<sup>37</sup> Thus the concern of railroad restructuring was to prevent individual enforcement and dismemberment of the company.<sup>38</sup>

Moreover, the holders of the bonds were widely dispersed geographically (many investors were based in England).<sup>39</sup> Thus a critical question was how to coordinate the restructuring effort, whilst preserving going concern value to maximise overall creditor return.<sup>40</sup> Scholars have shown how the likes of JP Morgan fulfilled this function in the era of the railroads, both raising capital in the primary markets and coordinating restructuring efforts when issuers faced financial distress.<sup>41</sup>

The ability of the Wall Street Banks to fulfil this coordination role was neutered by the New Deal reforms following the Great Depression,<sup>42</sup> and management was replaced by a trustee in Chapter X of the Chandler Act (intended to facilitate large restructurings).<sup>43</sup> This resulted in very few Chapter X cases and efforts to adapt Chapter XI (designed for a different

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<sup>36</sup> Miller and Waisman (n 13), 161, citing Cent. Trust Co of NY v Wabash 29 F. 618, 626 (E.D. Mo. 1886)

<sup>37</sup> Miller and Waisman (n 13), 164. For a good description of the practice of granting discrete sections of track or assets as collateral see Skeel, 'An Evolutionary Theory' (n 13), 1355-1356 and Skeel, *Debt's Dominion* (n 9), 62. See also Baird and Rasmussen, 'The End of Bankruptcy' (n 27), 779-780 and references therein

<sup>38</sup> See Westbrook (n 4), 810

<sup>39</sup> Baird and Rasmussen, 'Control Rights' (n 34), 927.

<sup>40</sup> Westbrook (n 4), 810

<sup>41</sup> Skeel *Debt's Dominion* (n 9), 63-69; Baird and Rasmussen, 'Control Rights' (n 34), 928

<sup>42</sup> Baird and Rasmussen, 'Control Rights' (n 34), 934-935; Skeel *Debt's Dominion* (n 9), 110-113; Skeel, 'An Evolutionary Theory' (n 13), 1368.

<sup>43</sup> Skeel *Debt's Dominion* (n 9), 119-127; Skeel 'An Evolutionary Theory' (n 13), 1368-1372; Skeel 'Creditor's Ball' (n 16), 920; Miller and Waisman (n 13), 169-70.

purpose) for large corporate restructurings. Thus, in the reforms of corporate bankruptcy law in 1978, management was allowed to remain in place in a Chapter 11 case, incentives were built into the Chapter 11 process making it an attractive option for management to use and a strong stay on creditor action was imposed on filing.<sup>44</sup> Moreover, management was handed significant power to control the course of the case,<sup>45</sup> in the expectation that directors would prefer a reorganisation (which would save their jobs) over enforcement and sale (which would not).

Finally, a robust architecture was to develop in Chapter 11 to impose a restructuring plan on dissenting shareholders and creditors. First, shareholders and creditors affected by the restructuring plan are divided into classes to vote upon it. A two-thirds majority of voting members of a class is required to accept the plan, and if every impaired class votes in favour of the plan then it may be confirmed by the court, subject to satisfaction of various other matters. If at least one impaired class votes in favour of the plan but others do not, the court may nonetheless confirm the plan over the objections of the dissenting classes (literally 'cram it down' on the dissenting classes) provided the plan meets the best interests test (creditors get at least as much as they would get on a liquidation); does not discriminate unfairly (generally, a class receives relatively equal value to similar classes); and

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<sup>44</sup> See, for example, Bradley and M Rosenzweig; Bebchuk and Chang; Adler and Schwartz (n 16) all cited in KM Ayotte and ER Morrison, 'Creditor Control and Conflict in Chapter 11' (2009) 1(2) *Journal of Legal Analysis* 511

<sup>45</sup> Miller & Waisman (n 13), 176-7; Skeel, 'An Evolutionary Theory' (n 13), 1377-1380; H Miller, 'Chapter 11 in Transition – From Boom to Bust and into the Future' (2007) 81 *American Bankruptcy Law Journal*, 386-387.

meets the requirements of the absolute priority rule (a junior class does not recover until a senior class has recovered in full, but a senior class does not recover more than it is owed).<sup>46</sup> Thus the legacy of the railroad era is clearly visible in Chapter 11: a positive policy of (i) reducing incentives for creditor action and (ii) promoting a restructuring over a sale of the business and assets. But, as we shall see, the UK set off down a very different track.

#### B Restructuring Law in the UK: 1979 to 1990

The structure of the finance market in the UK during this period was very different. It was dominated by powerful deposit-taking or ‘clearing’ banks which provided the vast bulk of finance in the economy.<sup>47</sup> These banks had different incentives from those of the widely dispersed creditors in the US. They had every incentive to monitor the companies they invested in, calling management to account at the earliest signs of distress.<sup>48</sup> Coordination problems could still arise where more than one bank provided credit to a company but, from the 1980s onwards, these were dealt with under ‘The London Approach’. This was a set of principles on how banks ought to behave when a company faced financial distress, originally seeded by the Bank of England, and subsequently enforced through the threat of reputational sanction in a small market of repeated interaction amongst a

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<sup>46</sup> See Olivares-Caminal *et al* (n 15), 103-113

<sup>47</sup> See Armour, Cheffins and Skeel (n 28), 1773.

<sup>48</sup> See, for example, J Armour and S Frisby, ‘Rethinking Receivership’ (2001) 21 *Oxford Journal of Legal Studies*, 83

defined number of players.<sup>49</sup> Thus law took almost no part in solving the coordination problems between banks, stepping in only once the stakeholders had decided that they were no longer willing to finance the business, to provide the necessary procedure to enable the business and assets, or assets, to be sold to a third party.<sup>50</sup>

In 1998 the then Secretary of State for Trade and Industry, Peter Mandelson, went on a trade mission to Silicon Valley and was educated in the central policy concern of Chapter 11: that a senior class may prefer to enforce and sell at a low point in the credit cycle, causing losses for other stakeholders which might not have occurred if the company had continued to operate.<sup>51</sup> English insolvency law's model of creditor control did not measure up well against this theoretical framework.<sup>52</sup> The banks had an almost unfettered power to select between debt restructuring and enforcement and sale, and the insolvency procedure in the shadow of which banks negotiated (receivership, renamed administrative receivership in the 1986 reforms following the Cork Report),<sup>53</sup> afforded them significant

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<sup>49</sup> J Flood, R Abbey, E Skordaki and P Aber, *The Professional Restructuring of Corporate Rescue: Company Voluntary Arrangements and the London Approach* (Certified Accountants Educational Trust 1995); J Armour and S Deakin, 'Norms in Private Insolvency: The "London Approach" to the Resolution of Financial Distress' (2001) 1(1) *Journal of Corporate Law Studies*, 42; Armour, Cheffins and Skeel (n 28), 1774.

<sup>50</sup> For a description of resort to formal insolvency only where efforts to renegotiate had failed see Armour, 'The Rise of the Pre-Pack' (n 23)

<sup>51</sup> 'Silicon Ballyhoo' *The Economist* 5 November 1998; McCormack (n 29), 524

<sup>52</sup> Jay Westbrook has called it 'a contractualist system based upon a dominant security interest' see Westbrook (n 4), 796.

<sup>53</sup> During this period a floating charge holder had the right to appoint a receiver over the secured assets; see Armour, 'The Rise of the Pre-Pack' (n 23); Armour, Cheffins and Skeel (n 28), 1739; Armour and Frisby (n 48), 86-91; S Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67(2) *Modern Law Review* 247, 253. The reforms introduced following the Cork Report (1982) Cmnd 8558 included a new collective procedure for rescuing the company as a going concern, administration, but this was motivated by concerns as to the position where there was no security



control rights. The concern emerged (based largely on theoretical analysis and perhaps without much empirical support)<sup>54</sup> that rather than persevering with a restructuring, the banks may be incentivised simply to put the business into receivership, sell the assets and realise the proceeds, imposing losses on trade creditors with unpaid liabilities which could have been avoided if the company had been restructured.<sup>55</sup> In effect, we began to worry that our insolvency system measured up poorly to its US cousin. Ultimately, this was to lead to the abolition of administrative receivership and its replacement with a more collective procedure, administration.<sup>56</sup> Moreover, a hierarchy of purposes for administration was inserted, with rescue of the company right at the top.<sup>57</sup>

But a number of challenges persisted. Although the reforms purported to incentivise management to seek rescue through administration, when a company was placed into administration, an insolvency practitioner replaced management except to the extent that he or she expressly left them to continue their functions (which the administrator rarely did).<sup>58</sup> The insolvency practitioner then controlled the decision to move from rescue of the company to the second purpose of administration, a sale of the business and assets, with a very wide margin of appreciation in his decision-making

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holder entitled or willing to appoint an administrative receiver rather than concerns with the process of administrative receivership itself, and the procedure was little used.

<sup>54</sup> On the lack of empirical evidence see Frisby, 'In Search of a Rescue Regime' (n 53), 253.

<sup>55</sup> See, for example, Insolvency Service, *A Review of Company Rescue and Business Reconstruction Mechanisms*, 14-15. For suggestions that this point was overdone see Armour and Frisby (n 48); Armour, Hsu and Walters (n 21), 157. See also A Walters, 'Statutory Erosion of Secured Creditors' Rights: Some Insights from the United Kingdom' (2015) *University of Illinois Law Review* 543

<sup>56</sup> Enterprise Act 2002.

<sup>57</sup> Insolvency Act 1986 Schedule B1 paragraph 3(1)(a).

<sup>58</sup> Insolvency Act 1986 Schedule B1 paragraph 64

power.<sup>59</sup> Crucially, the lenders continued to control the identity of the insolvency practitioner, who had little incentive to ignore their wishes if he or she were to hope to receive future work.<sup>60</sup> On a market level, although debt-for-equity swaps did happen, they were comparatively rare.<sup>61</sup> More often banks would agree to a series of non-core disposals (to pay down debt) and covenant holidays and revised amortisation schedules (to create space for the company to get back on its feet). Sometimes this would be successful but a company with a high ratio of debt to equity had the cards stacked against it in turning things around, compared with the far more dynamic reshaping of the balance sheet in the US. In short, nothing was to change. Administration became the insolvency procedure against which banks sought to renegotiate, restructuring generally still occurred out of court and administration was reserved for a sale of the business and assets, or assets, to a third party if the banks decided that they were no longer willing to support the business.

## C The Birth of the Distressed Debt Market and the Rise of Secured Credit: US

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<sup>59</sup> J Armour and R Mokal 'Reforming the Governance of Corporate Rescue: the Enterprise Act 2002' 2005 *Lloyds Maritime and Commercial Law Quarterly* 28, 49

<sup>60</sup> Insolvency Act 1986 Schedule B1 paragraphs 26 and 36; see, for example, Armour and Mokal (n 59) 36-37; R Stevens, 'Security After the Enterprise Act' in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (Oxford University Press 2006) 160; V Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press 2009) 435; Office of Fair Trading, 'The Market for Corporate Insolvency Practitioners: A Market Study' (2010), 32; Walters 'Statutory Erosion' (n 55), 565-568

<sup>61</sup> Armour and Frisby (n 48), 93.

Profound change was, however, to occur in the practice of restructuring on both sides of the Atlantic as a result of three developments in the financial markets. The first development was the emergence of a specialist market for buying the debt of financially distressed companies in the US in the 1980s and 90s, subsequently spreading to the UK.<sup>62</sup> The second was the reform of the Uniform Commercial Code in the US which made it significantly easier for creditors to perfect security over all or substantially all of the company's assets: a so-called 'blanket lien'.<sup>63</sup> These two developments effectively neutered the use of Chapter 11 as a threat by management to control creditor power. This is because lenders who have explicitly bought into the debt in order to control the restructuring increasingly have security over all of the company's assets put in place either before default, or immediately after default as a condition of continued support. This security interest enables them to control access to cash for financing the business, effectively enabling them to dictate the course of the case.<sup>64</sup> As secured creditors exert

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<sup>62</sup> See Harner, 'The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing' (n 26), 710 at fn 22; Miller, 'Chapter 11 in Transition' (n 45), 389 and Tung, 'Confirmation and Claims Trading' (n 26), 1685. For an account of the emergence of the market in the UK see Paterson (n 26)

<sup>63</sup> For a description see D Baird and RK Rasmussen 'Private Debt and the Missing Lever of Corporate Governance' (2006) 154(5) University of Pennsylvania Law Review 1209, 1228 and Harner, 'Soft Variables' (n 2), fn 22 and the text thereto

<sup>64</sup> See, for example, SC Gilson and MR Vetsuypens, 'Creditor Control in Financially Distressed Firms: Empirical Evidence' (1994) 72 Washington University Law Quarterly 1005; E Warren and JL Westbrook, 'Secured Party in Possession' (2003) 22 American Bankruptcy Institute Journal 12; Miller 'Chapter 11 in Transition' (n 45), 385; Skeel 'Creditor's Ball' (n 16); Baird and Rasmussen, 'The End of Bankruptcy' (n 27), 751; Baird and Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' (n 63); Ayotte and Morrison, 'Creditor Control and Conflict in Chapter 11' (n 44); G Nini, D Smith and A Sufi, 'Creditor Control Rights, Corporate Governance, and Firm Value' (2012) 25(6) The Review of Financial Studies 1713; B Adler, V Capkun and L Weiss, 'Value Destruction in the New Era of Chapter 11' (2013) 29(2) The Journal of Law, Economics, and Organization 461; CJ Tabb, 'Credit Bidding, Security and the Obsolescence of Chapter 11' (2013) University of Illinois Law Review 103, 104-5; Jackson and Skeel 'Bankruptcy and Economic Recovery' (n 8), 28-29

considerably greater control over the decision between restructuring, on the one hand, and a sale of the business and assets on the other, functionally Chapter 11 begins to look considerably more like restructuring and insolvency practice in the UK.

Moreover, increasingly companies which face financial distress have a far greater ratio of debt to equity than companies which faced financial distress in the early days of Chapter 11, and more complex capital structures.<sup>65</sup> These complex capital structures often involve ‘layers’ or ‘tranches’ of debt regulated by contractual priority agreements between the lenders, known as intercreditor agreements. Debt which ranks first in priority on an insolvency under these intercreditor arrangements is known as senior debt. ‘Junior’ debt ranks behind the senior debt and attracts higher pricing to reflect the higher risk. In other words, these agreements provide detailed priority and control provisions. Moreover, it is likely that the financial liabilities governed by these arrangements will be sufficient to absorb the losses on the balance sheet, so that there is no need to bring trade creditors into the restructuring plan.<sup>66</sup> This has a number of advantages. Trade creditors may be smaller, less sophisticated players who have a more emotional response to loss than the large financial players, making it difficult to reach an accommodation with them.<sup>67</sup> Furthermore, it reduces

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<sup>65</sup> ABI Commission Report and Recommendations (n 32), 12

<sup>66</sup> See BB Erens and TW Hoffman, ‘The Triumph of the Trade Creditor in Chapter 11 Reorganizations’ (2013) *Pratt’s Journal of Bankruptcy Law* 3, 17-30

<sup>67</sup> For a discussion of this issue in the context of the Company Voluntary Arrangement in the UK see Flood, Abbey, Skordaki and Aber, *The Professional Restructuring of Corporate Rescue* (n 49), 47;

the number of parties to the restructuring negotiations, cutting down the cost and time taken to reach a settlement. Perhaps most critically of all, it preserves the company's cash flows by indicating to trade creditors that they have no reason to cease supply or to withdraw their custom, and it preserves the team of employees by indicating that they have no reason to seek employment elsewhere. As highlighted at the outset, as many modern companies are little more than 'a good idea, a handful of people ... and a bunch of contracts',<sup>68</sup> preserving cash flows and people is likely to be a significant part of the restructuring implementation plan. Thus the restructuring negotiations become a horse trade amongst senior and junior creditors and the shareholders as to how the losses should be shared amongst them.

#### D The Birth of the Distressed Debt Market and the Rise of Secured Credit: UK

At the same time, changes in the UK debt market, coupled with the arrival of the distressed debt traders in the UK, were to draw UK restructuring and insolvency practice closer to the US. In the first place, banks started to move from the model of 'concentrated creditor governance' described above towards a model of arranging loans but subsequently distributing their own

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GAS Cook, NR Pandit and D Milman, 'Formal Rehabilitation Procedures and Insolvent Firms: Empirical Evidence on British Company Voluntary Arrangement Procedure' (2001) 17(4) *Small Business Economics* 255; V Finch, *Corporate Insolvency: Principles and Perspectives* (n 60), 496  
<sup>68</sup>J Micklethwait and A Wooldrige, *The Company – A Short History of a Revolutionary Idea* (Modern Library Chronicles 2003), 183

participation in them.<sup>69</sup> This was to severely weaken the model for achieving a restructuring in the UK, given that it challenged the ongoing effectiveness of the London Approach and reduced the incentive for any one bank, or small group of banks, to undertake monitoring.<sup>70</sup> Furthermore, increasingly other sorts of investors bought participations in loans. As these diverse stakeholders suffered increasing coordination issues, borrowers also started to access debt capital markets to a far greater extent.<sup>71</sup> Finally, although it has historically been straightforward to take a security interest over all of a company's assets in England and Wales, until the emergence of highly leveraged debt structures, most large company financings were unsecured. This was to change with the private equity boom, yet management had no credible levers to pull, given that administration was as likely as not to result in them losing their jobs.<sup>72</sup> As a result of all of these factors, corporates experiencing financial distress suffered many of the coordination problems in renegotiating with lenders as those in the US had found before them.

There was, therefore, a role for law to play in solving these coordination problems, but no single procedure had been properly designed to deal with them. Administration, as a standalone option, did not fit the bill for all the reasons already given. As a result, English lawyers developed two different techniques. The first, where unanimity could not be achieved in every class

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<sup>69</sup> Armour 'The Rise of the Pre-Pack' (n 23), Part 3.

<sup>70</sup> Paterson (n 26), 337-354

<sup>71</sup> *Trends in Lending* (Bank of England 2015), 8-9

<sup>72</sup> Cheffins and Armour, *Eclipse of Private Equity* (n 25), 33

but a majority in each supported the restructuring, was to use the scheme of arrangement procedure which had been on the company law statute books since the nineteenth century.<sup>73</sup> The second, where a class of financial creditor (or the equity) was unwilling to support the plan, or was to be offered nothing within it, was to ‘twin’ the scheme of arrangement with a pre-packaged administration.<sup>74</sup> In a pre-packaged administration, the administrator is introduced to management before appointment, observes the negotiation of a sale from the side lines, satisfies him or herself that the sale offers the best way forward and implements it immediately upon appointment. In a restructuring scenario, the pre-packaged administration is used to ‘sell’ the operating subsidiaries comprising the business to a new company owned by those stakeholders to whom equity has been allocated in the restructuring, in consideration for a release of their debt, leaving those who have been offered nothing stranded in an insolvent finance company with no assets.<sup>75</sup>

Thus the administration ‘sale’ is used for a purpose for which it was never envisaged and the disadvantages of a truly manager-displacing structure avoided (there is nothing to stop management emerging as the directors of the new company, often with significant equity in the new

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<sup>73</sup> Companies Act 2006 Part 26 sections 895-899. For a more detailed description, see Olivares-Caminal and others (n 15), 155-163

<sup>74</sup> This is necessary because, whilst it is possible to ‘cram down’ within a class in an English scheme of arrangement, it is not possible to ‘cram down’ on a dissenting class – see Olivares-Caminal and others (n 15), 155-163

<sup>75</sup> For a more detailed description, Olivares-Caminal and others (n 15), 163-170

business).<sup>76</sup> In short, English lawyers are able to adapt insolvency procedures to achieve a Chapter 11-style debt restructuring instead.

### 3 Implications of Market Changes for Bankruptcy Theory

#### A Implications of the Distressed Debt Market

Let us turn now to the implications of these new market dynamics for bankruptcy theory. The difference between the value of the company if it is sold and the proceeds distributed and the value if it is restructured and continues to trade is known as the restructuring surplus. As we have seen, it has traditionally been a principal objective of Chapter 11 to capture it by two mechanisms: by imposing a strong, automatic stay on filing (so that senior creditors are prevented from taking enforcement action), and by providing management with strong control rights (on the assumption that they will prefer a restructuring to a sale). As we have also seen, each of these mechanisms is under threat. But the question arises: does it matter?

Specialist distressed debt funds regularly raise money from investors on the promise of high returns, and are thus focused on maximising profit.<sup>77</sup>

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<sup>76</sup> And it is interesting to note here that a shift occurs from a 'manager-displacing' regime in the terms of Skeel's account in 'An Evolutionary Theory' (n 13) as Britain moves from a 'concentrated creditor' model of governance to a more dispersed creditor universe consistent with the analysis advanced by Armour, Cheffins and Skeel in 'Corporate Ownership Structure' (n 28). The critical point is that although what may appear to be the principal regime for restructuring in English insolvency law (administration) remains apparently manager-displacing, the way in which the procedures are used in action results in a system which is at least manager-implemented.

<sup>77</sup> See Goldschmid (n 26), 212; Fortgang and Mayer, 'Trading Claims' (n 26) 5-6; JHM Sprayregen and RJ Higgins, 'Chapter 11: Not Perfect but Better than the Alternative' (2005) 24 American



Other types of traditional investor (such as banks), who have lent money to the company when it was healthy, are likely to be interested in minimising their loss.<sup>78</sup> It is for this reason that banks may prefer an enforcement and sale over the rather uncertain prospects of a restructuring plan, whilst the distressed debt market is interested in upside. The distressed debt market now offers the traditional creditors an alternative: a negotiated sale of the debt at a certain price and a predictable loss, without the risks of an enforcement and sale process. Where the market identifies a restructuring surplus there will be a period of time during which those creditors who do not wish to stay with the company through the restructuring process trade out, and those who see opportunity in the restructuring process trade in. Negotiations for a restructured bargain can then get underway in earnest.

Distressed debt investors who trade in may have different investment strategies.<sup>79</sup> Some will buy debt at a deep discount to par or face value in the expectation that the price of the debt, or the equity it is swapped into, will trade up in the secondary market in anticipation of, or after, a successful restructuring, such that they will be able to sell this debt or equity at a profit. This is a comparatively short term investment horizon. Others seek to capture the difference between the sale price of the business today (reflected in the price at which debt is trading in the market) and the sale price after

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Bankruptcy Institute 60, 60; Harner 'The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing' (n 26), 710-711

<sup>78</sup> Harner 'The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing' (n 26), 750-751

<sup>79</sup> Gilson (n 26); Harner, 'The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing' (n 26), 716-717; Harner, 'Trends in Distressed Debt Investing' (n 26); Thomas, 'Tipping the Scales' (n 14)

things have settled down in two or three years. These investors seek to buy up debt which they regard as trading cheaply, having regard to their own assessment of the prospects for the business, and to make maximum profit (often far in excess of the face value of the debt) after deleveraging the balance sheet through a debt-for-equity swap, fixing certain operational issues in the business or simply waiting until the market has recovered, before selling or floating the company. In both cases, as Michelle Harner puts it, ‘Investors generally realize a gain on distressed debt investments when the debtor achieves, or the market anticipates, a successful turnaround’.<sup>80</sup>

If the distressed debt market will seek to exploit any potential restructuring surplus, there should be no need for the law either to provide a moratorium or to steer creditor choice towards a restructuring and away from a sale. Distressed debt investing provides a means for those who no longer wish to remain invested in a firm with a new risk profile to exit without the cost and risk of enforcement and sale. It restricts the sale of assets to third parties, and distribution of proceeds amongst creditors, to those situations where the market identifies no restructuring surplus, with the market selecting which companies are able to survive and which companies should be liquidated.

Yet when we turn to the US literature something of a puzzle emerges.

When a company files for Chapter 11 four possibilities are open to it. First,

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<sup>80</sup> Harner, ‘The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing’ (n 26), 715

the case may be converted into a Chapter 7 liquidation case.<sup>81</sup> Secondly, the company may propose a Chapter 11 plan of reorganization (in a large case typically a debt-for-equity swap) pursuant to section 1129 of the US Bankruptcy Code.<sup>82</sup> Thirdly, it may propose to sell its business and assets, or assets, pursuant to a Chapter 11 liquidating plan.<sup>83</sup> Finally, it may propose a rapid sale of the business and assets pursuant to section 363 of the US Bankruptcy Code.<sup>84</sup> The US literature reports an increase in these rapid section 363 sales of businesses and assets as a result of senior, secured, distressed debt investor control.<sup>85</sup> This suggests that the traditional concern that senior, secured creditors may prefer enforcement of security and sale over preservation of the restructuring surplus is alive and well. Yet it is an intuitively surprising conclusion that the distressed debt investor will be happy with the profit captured between the amount paid for the debt and the amount received on an enforcement of security and sale of the assets to a

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<sup>81</sup> See section 1112(b) of the US Bankruptcy Code. For a useful recent discussion, see CW Mooney Jr, 'The (Il)legitimacy of Bankruptcies for the Benefit of Secured Creditors' (2015) *University of Illinois Law Review* 735, 742-743

<sup>82</sup> Olivares-Caminal *et al* (n 15), 103-122

<sup>83</sup> Section 1123(b)(4) of Chapter 11 of the US Bankruptcy Code

<sup>84</sup> Olivares-Caminal *et al* (n 15), 122-127; see also SC Gilson, ES Hotchkiss and MG Osborn, 'Cashing Out: The Rise of M&A in Bankruptcy' (available at SSRN: <http://ssrn.com/abstract=2547168>) (last accessed 29 May 2015), 7-9

<sup>85</sup> See, for example, HR Miller, 'Chapter 11 Reorganization Cases and the Delaware Myth' (2002) 55(6) *Vanderbilt Law Review* 2002, 2016; Baird and Rasmussen, 'The End of Bankruptcy' (n 27), 787; Miller and Waisman (n 13), 194; HR Miller and SY Waisman, 'Is Chapter 11 Bankrupt?' (2005) 47 *Boston College Law Review* 129, 131; Sprayregen and Higgins (n 77), 60; RE Steinberg, 'The Seven Deadly Sins in section 363 Sales' (2005) 24(5) *American Bankruptcy Institute Journal* 22, 22; J Berge, 'An Efficiency Model of Section 363(b) Sales' (2006) 92(7) *Vanderbilt Law Review* 1639; LM LoPucki and JW Doherty, 'Bankruptcy Fire Sales' (2007) 106(1) *Michigan Law Review* 1, 43; 'Chapter 11 at the Crossroads – Does Reorganization Need Reform? – A Symposium on the Past, Present and Future of U.S. Corporate Restructuring' (2010) 18 *American Bankruptcy Institute Law Review* 365, 397-99; CJ Tabb, 'Credit Bidding, Security and the Obsolescence of Chapter 11' (2013) *University of Illinois Law Review* 103; MB Jacoby and EJ Janger, 'Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy' (2014) 123(4) *The Yale Law Journal* 869; CJ Tabb, 'The Bankruptcy Clause, the Fifth Amendment and the Limited Rights of Secured Creditors in Bankruptcy' (2015) *University of Illinois Law Review* 765; Gilson, Hotchkiss and Osborn (n 84)

third party, in circumstances where the market sees the potential for a restructuring surplus which will either be reflected in the trading price of the debt or the trading price of the equity allocated in the restructuring, or reflected in the ultimate sale price for the company once it has traded out of a difficult market with an appropriate capital structure.

Reading the US literature with this puzzle in mind, it is difficult to unpick the story because many authors refer interchangeably to a section 363 sale of the business to some of the financial creditors, and a section 363 sale of the business and assets to a third party, without distinguishing between the two and without identifying which assets and liabilities were transferred in the sale.<sup>86</sup> In large and larger mid-cap company restructurings section 363 may be used to sell the entire business to a new company owned by the financial creditors, in consideration for release of the transferring financial creditors' debt claims (known as credit bidding). After the sale, the transferring financial creditors own the equity in a new company owning the business, whilst other financial creditors may be left behind. Where the trade creditors are kept whole, this transaction is functionally a debt-for-equity swap amongst certain of the financial creditors. It is a different thing entirely from the situation in which a section 363 sale is used to transfer the

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<sup>86</sup> Bussell and Klee tantalisingly state, '... more recently, lenders or purchasers have preferred certain unsecured creditors by requiring that their debts be assumed and paid by the purchaser in derogation of the sub rosa plan doctrine. Practically, this reduces the purchase price, reorders the distributional priorities of the Bankruptcy Code, pretermits bargaining over a plan, and unfairly treats those creditors left behind' see D Bussell and K Klee, 'Recalibrating Consent in Bankruptcy' (2009) 83 *American Bankruptcy Law Journal* 663, 731. Moreover, there is some debate in the US literature as to whether the use of section 363 sales is as widespread as some scholars have suggested – see JL Westbrook, 'Secured Creditor Control and Bankruptcy Sales: An Empirical View' (2015) *University of Illinois Law Review* 831 and ABI Commission Report and Recommendations (n 32), 203-204 (describing the challenges with interpreting the limited empirical data on section 363 sales)

business to a third party, together with those assets and liabilities which the third party is prepared to assume, leaving other trade liabilities unpaid and providing cash proceeds which are only sufficient to compensate secured, financial creditors. In the UK, at least, most schemes of arrangement ‘twinned’ with pre-packaged administrations in large and larger mid-cap cases fall into the first category. In other words, they do not result in the sale of a financially distressed, but economically viable, business to a third party for cash, with losses for trade and other creditors which could have been avoided if a restructuring had been pursued instead. Functionally, they are debt for equity swaps amongst financial creditors.

We may still have concerns about a debt restructuring implemented via section 363 (rather than through a Chapter 11 plan in the US),<sup>87</sup> or via a pre-packaged administration sale in the UK.<sup>88</sup> We may be concerned that distressed debt investors (for who speed is of the essence) have taken legal procedures which were developed to facilitate a better realisation of the assets and adapted them to achieve a quick and dirty debt restructuring to the detriment of *other financial creditors*.<sup>89</sup> But different distributional concerns are implicated than those which arise when senior, secured

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<sup>87</sup> Reflected in the US doctrine that a section 363 sale may be an impermissible *sub rosa* plan of reorganisation when it simply seeks to avoid the protections provided for in section 1129 of the Bankruptcy Code – see Olivares-Caminal *et al* (n 15), 124-127

<sup>88</sup> See, for example, P Walton, ‘Pre-packaged Administrations: Trick or Treat?’ (2006) 19(8) *Insolvency Intelligence* 113 and V Finch, ‘Pre-packaged Administrations and the Construction of Propriety’ (2011) 11(1) *Journal of Corporate Law Studies* 1, 4-8

<sup>89</sup> See, for example, K Ayotte and DA Skeel, ‘An Efficiency-Based Explanation for Current Corporate Reorganization Practice’ (2006) 73 *University of Chicago Law Review* 425, 465-467 (discussing concerns where the ‘buyer’ is also the debtor’s lender); Jacoby and Janger, ‘Ice Cube Bonds’ (n 85)

creditors prefer enforcement and sale of the business and assets pursuant to section 363 to a third party, over a restructuring of a financially (but not economically) distressed company with the result that jobs will be lost and trade creditors will suffer heavy losses which could have been avoided.<sup>90</sup> We should not assume that what two US scholars have described as US corporate bankruptcy law's 'normative distributional commitments'<sup>91</sup> are the same whether we are examining distribution amongst sophisticated financial creditors or distribution between financial creditors and employees, trade and tort creditors.

#### B Other financial creditors

Even if distressed debt investors prefer to capture any restructuring surplus, we may still be concerned with our original policy objectives of imposing a moratorium and steering creditor choice if there are investors who do not choose to sell to the distressed debt investor, and who continue to prefer enforcement and sale. But it is suggested here that this will not normally be the case in large or larger mid-cap cases. First, let us consider a senior creditor who believes it is amply covered by the value of the assets in the business and who does not like the price quoted in the distressed debt market. In their article on restructuring in the UK in the early 1990s, Armour and Deakin note that it is 'rational for ... a creditor to refrain from

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<sup>90</sup> See, for example, Bussel and Klee (n 86), 663; Jacoby and Janger, 'Ice Cube Bonds' (n 85)

<sup>91</sup> M Jacoby and EJ Janger, 'Ice Cube Bonds' (n 85), 873

enforcing if it thinks that the returns to renegotiation will be higher than its likely return in insolvency'.<sup>92</sup> The senior secured creditor who is amply covered by the collateral in the business, but who considers the distressed debt market is mispricing its return, given the prospects for a restructuring, is ordinarily in this position. Certain types of creditor may have particular incentives to prefer a legal process. Collateralised debt obligations (CDOs) may be limited in their ability actively to vote on a restructuring but they are also likely to prefer to collect fees for as long as possible, and are unlikely to favour an enforcement sale.<sup>93</sup> Holders of credit default swap (CDS) protection may actively prefer an enforcement sale because it will be a clear trigger event in their documentation.<sup>94</sup> However, these holders are not incentivised to initiate an enforcement sale because doing so may lead to concerns that they are not entitled to claim, as a consequence of having brought about the trigger event.<sup>95</sup> And junior creditors and equity have no incentive to enforce because the priority rights afforded to senior creditors means this will almost certainly result in a loss of value.<sup>96</sup>

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<sup>92</sup> Armour and Deakin (n 49), 38.

<sup>93</sup> This is because CDOs may have reinvestment restrictions which prevent them from supporting the restructuring, see DJ Lucas, LS Goodman and FJ Fabozzi, *Collateralized Debt Obligations: Structure and Analysis* (John Wiley & Sons 2006) 17-23 and 386

<sup>94</sup> F Partnoy and DA Skeel Jr, 'The Promise and Perils of Credit Derivatives' (2007) 75 *University of Cincinnati Law Review* 1019, 1035

<sup>95</sup> See cases from the insurance field in which a claim is prevented because the insured has deliberately caused the insured event. See, for example, *Genesisuk.net Ltd v Allianz Insurance Ltd* [2014] EWHC 3676 (QB); *Bristol Alliance Ltd Partnership v Williams and another* [2013] EWCA Civ 1267

<sup>96</sup> Armour and Frisby (n 48), 87 citing R Picker, 'Security Interests, Misbehavior, and Common Pools' (1992) 59 *The University of Chicago Law Review* 645, 669-675 which argues that allocation of rights of priority to payment can solve collective action problems

Moreover, in comparatively recent times, a significant strand of scholarship has grown up in the US arguing for ‘privatisation of bankruptcy’; in other words, that contract law could provide an effective substitute for restructuring and insolvency law.<sup>97</sup> Whilst this remains controversial in the area of what we might call ‘full insolvency’ in which the interests of many different stakeholders are implicated, as we have already described, in the types of debt restructuring with which this paper is concerned sophisticated financing documents will be negotiated which will set out in detail how control rights are allocated and exercised in default.<sup>98</sup> Modern financing documents may go a long way towards providing the necessary stay on creditor action, through a combination of majority voting provisions and limited moratoria on junior creditor enforcement action for some period after negotiations start.<sup>99</sup> Thus, although there may not be an identity of interest amongst the creditor group and the truce may be a very uneasy one, in most cases there is either a contractual stay or a practical stay on action absent a legal one.<sup>100</sup>

## C The ABI Commission Report

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<sup>97</sup> R Rasmussen, ‘Debtor’s Choice: A Menu Approach to Corporate Bankruptcy’ (1992) 71(1) Texas Law Review 51; A Schwartz, ‘A Contract Theory Approach to Business Bankruptcy’ (n 16). For a good overview and more comprehensive references to the extensive literature see S. Block-Lieb, ‘The Logic and Limits of Contract Bankruptcy’ (2001) University of Illinois Law Review, 505 and fn 7 and 8

<sup>98</sup> Baird and Rasmussen, ‘Private Debt and the Missing Lever of Corporate Governance’ (n 63), 1247

<sup>99</sup> Baird and Rasmussen, ‘The End of Bankruptcy’ (n 27), 755

<sup>100</sup> See Baird and Rasmussen, ‘Private Debt and the Missing Lever of Corporate Governance’ (n 63), 1246



The ABI Commission report and recommendations recognise that the rise of the distressed debt market, and the rise of secured credit, have both undermined the mechanisms in Chapter 11 which are designed to steer the parties away from a sale and towards restructuring.<sup>101</sup> Crucially, though, the report does not appear to conclude that the distressed debt market operates in large and larger mid-cap cases to identify and capture the restructuring surplus, and reaffirms a commitment to the traditional policy objectives of Chapter 11 in imposing a stay and steering creditor choice.

First, the Commission recommends a 60-day moratorium on section 363 sales, reinforcing the role of the automatic stay in creating a breathing space for the debtor.<sup>102</sup> Perhaps more significantly, the ABI has seen the potential to develop a new mechanism to control creditor choice between restructuring on the one hand and insolvency on the other. The Commission recommendations suggest that where the business and assets are sold to a third party, a more complex valuation exercise will take place and, if that exercise suggests that there might have been value for other financial creditors if the company had continued to trade and been sold at a later date, senior creditors may be required to give up some of the consideration for the sale to junior creditors, even though any surplus which does in fact emerge will be captured by the purchaser.<sup>103</sup> This would seem to be a powerful new mechanism to steer creditors towards restructuring and away from a sale to a

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<sup>101</sup> ABI Commission Final Report and Recommendations (n 32)

<sup>102</sup> *Ibid* 83-87

<sup>103</sup> *Ibid* 207-224

third party for cash, even where the market concludes that that is the right outcome. If we remain sceptical that the distressed debt market is operating so that companies which are susceptible to a debt restructuring are being sold to third parties instead, then more empirical work may be needed to support this policy response.<sup>104</sup>

It is also notable that the ABI Commission proposes that section 363 ‘sales’ to financial creditors should follow additional requirements, broadly drawn from Chapter 11.<sup>105</sup> This would seem to be aimed at preventing financial creditors from using section 363 to achieve what is functionally a debt restructuring without complying with the requirements for confirmation of a Chapter 11 plan of reorganisation. Ultimately, it leads to the question of whether those requirements require some revision in light of new market mechanisms, and this is considered further below.

#### 4 Rethinking the Theory of Corporate Bankruptcy Law

Having dedicated a considerable portion of this article to considering what modern corporate bankruptcy law does not do in large and larger mid-cap cases, we must now try to set out a new theoretical framework against which it can be assessed.

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<sup>104</sup> And it is notable that the ABI Commission report (n 32) admits the lack of empirical data on section 363 sales and the difficulty of interpretation see, in particular, 203-204. See also Sprayregen and Higgins (n 77), 61 fn 26 (analysing sale cases cited by Miller and Waisman (n 27), showing why the sale outcome was preferred and reinforcing the point that not every company should be saved)

<sup>105</sup> ABI Commission report (n 32), 201-206

Notwithstanding the diverse range of creditors which a company may have, this article has argued that none of them is incentivised to implement a sale and enforcement where the distressed debt market has identified a restructuring surplus in a large or larger mid-cap case. It is suggested that the English market provides powerful evidence for this because, notwithstanding the fact that no moratorium is available in schemes of arrangement, there is no clarion call for a moratorium to be introduced.<sup>106</sup> The English approach of a smorgasbord of procedures which financial creditors can choose between appears to have operated well in the financial crisis, and the US approach of a single gateway which all financially distressed companies must squeeze through does not appear to be necessary in order to enable viable businesses to continue to trade. Thus the first thing we might do is impose an analytic divide between the role of corporate bankruptcy law when the market does not see a restructuring surplus (which we shall call an insolvency), and the role of corporate bankruptcy law when it does (which we shall call a restructuring). We might then consider whether different roles have developed for corporate bankruptcy law in large and larger mid-cap cases in the two situations.

Where a financially distressed company approaches its lenders in order to seek a new bargain, but the existing lenders are not willing to continue to support it and the distressed debt market does not consider that there is a restructuring surplus to be captured, corporate bankruptcy law's

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<sup>106</sup> See, for example, the measured response of the City of London Law Society to the recent European Commission recommendation on this issue (n 31)

role looks much the same as before. It is in everyone's interests that the money which is tied up in this failed business is extracted and redeployed elsewhere. Corporate bankruptcy law provides a stay, or moratorium, so that the business can be kept together and sold as a going concern wherever possible, in order to maximise the amount of capital which is redeployed. It also provides the priority rules according to which the proceeds are distributed and remains concerned that this redeployment of capital does not result in externalities, such as the cost of lost jobs, which ought properly to be taken into account in assessing whether the overall amount of capital which is redeployed is maximised. Similarly, corporate bankruptcy law is concerned not just with the external allocation of capital (ensuring that capital is allocated to companies best able to use it) but also internal allocation of capital (the investment of capital within a company). Thus it imposes duties on directors to ensure that capital is not invested in risky projects designed only to further shareholder interests, and it adjusts payments made in the vicinity of insolvency to reduce incentives to favour some stakeholders over others.<sup>107</sup> This rather ambitiously pithy summary of the role of corporate bankruptcy law in an insolvency situation would be as familiar to an insolvency scholar in 1986 as it is today. We would include any sale of the business and assets, or assets, and the transfer of only some of the liabilities to a third party on this side of the analytic divide. This

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<sup>107</sup> See, for example, LM Lopucki and WC Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 14 *University of Pennsylvania Law Review* 669

could include a Chapter 7 or Chapter 11 liquidating plan or a section 363 sale to a third party (in the US) or a sale to a third party in a creditors' voluntary or compulsory winding up, administration or pre-packaged administration (in the UK).

Corporate bankruptcy law has a different role, however where the market concludes that the company is worth more if it continues to trade. Ordinarily, a period of debt trading will have ensued, in which some financial creditors have left and new creditors have arrived, and it remains for a new bargain to be struck so that the company can emerge with an appropriate capital structure. However, negotiations over the new bargain are highly likely to arrive at a classically deadlocked position. Deadlock arises in restructuring negotiations where no party is prepared to compromise, but no party has the ability to compel the other to agree.<sup>108</sup> In an earlier piece the author described the 'hyper rationality' of distressed debt investors,<sup>109</sup> in other words their desire to capture every last crumb of their slice of the pie. At the same time, financial creditors and equity in the junior layers of the capital structure have little incentive to agree to a plan in which they receive no, or only a nominal, allocation.<sup>110</sup> Moreover, the fluid

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<sup>108</sup> See *Deadlocks in Multilateral Negotiations: Causes and Solutions* A Narlkier (ed) (Cambridge University Press 2010), 1-20

<sup>109</sup> Paterson (n 26), 337-342. See also Harner, 'The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing' (n 26) 754 and fn 331

<sup>110</sup> See, for example, CJ Fortnag and TM Mayer, 'Valuation in Bankruptcy' (1985) 32(6) *UCLA Law Review* 1061, 1106; GG Triantis, 'A Theory of the Regulation of Debtor-in-Possession Financing' (1993) 46 *Vanderbilt Law Review* 901, 906; LoPucki and Whitford, 'The Nature of the Bankrupt Firm' (n 27), 662; K O'Rourke, 'Valuation Uncertainty in Chapter 11 Reorganizations (Activism, Uncertainty and Abuse: Current Issues in Bankruptcy Law)' (2005) 25 *Columbia Business Law Review* 403; M Crystal and RJ Mokal, 'The Valuation of Companies: A Conceptual Framework: Part I' (2006) *International Corporate Rescue* 63, 66

nature of the creditor group, and the lack of a long-standing relationship between debtor and creditor, both contribute to making resolution more problematic.<sup>111</sup> Finally, as explained above, whilst other types of financial creditor are not incentivised proactively to enforce and sell, they may continue to prefer enforcement and sale to a restructuring plan.<sup>112</sup> Overall, compromise is difficult to achieve and negotiations can easily become protracted.

The state has an interest in unlocking this deadlock position because it wishes the maximum amount of capital to be redeployed in the economy as rapidly as possible. Thus it stands ready to provide the tools to force dissenting creditors, or hold outs, to accept a transaction so that the restructuring can be implemented. In this view, modern restructuring law provides a deadlock resolution procedure. In the US we would include a debt restructuring implemented via a ‘sale’ of the entire business to the financial creditors pursuant to section 363 of the US Bankruptcy Code or a Chapter 11 reorganization plan on this side of the analytic divide and in the UK we would include a debt restructuring pursuant to a scheme of arrangement, a scheme of arrangement ‘twinned’ with a pre-packaged administration sale or a standalone pre-packaged administration sale to some of the financial creditors.

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<sup>111</sup> See, for example, Thomas (n 14), 227-228 citing Miller, ‘Chapter 11 Reorganization Cases and the Delaware Myth’ (n 85); Tung (n 26), 1718; Paterson (n 26), 341

<sup>112</sup> See fn 88-92 and accompanying text

Difficult issues arise for restructuring law in breaking the deadlock. First, restructuring law must decide who it can bind to a restructuring plan. The 'cram down' provisions of Chapter 11 enable a plan to be imposed against the wishes of the shareholders,<sup>113</sup> whilst (as we have seen) this can only be achieved in English law by the rather cumbersome 'twinning' of a scheme of arrangement with a pre-packaged administration sale.<sup>114</sup> Undoubtedly matters would be more straightforward, and more transparent, if this could be tackled in a single procedure in English law, and English lawyers continue to mull over whether reform of the law in this direction would be broadly beneficial.<sup>115</sup>

Secondly, and more controversially, corporate bankruptcy law must decide the basis on which it will impose a restructuring plan on dissenters. Where the restructuring takes the form of a debt-for-equity swap amongst financial creditors (and potentially shareholders) this is a difficult question because the creditors and shareholders who receive equity in the debt-for-equity swap are changing the nature of their investment, but they are not crystallising a real economic loss. They will have the residual interest in the company and only once the company is floated or sold will it be clear how much of the debt they have recovered (and how much profit they have made). If there is a day of reckoning at all, it is a day of interim and not final judgement. This is the real question for policy makers in England and

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<sup>113</sup> Olivares-Caminal *et al* (n 15), 106-110; J Payne, 'Debt Restructuring in English Law: Lessons from the US and the Need for Reform' (2014) LQR 282, 300-301

<sup>114</sup> Olivares-Caminal *et al* (n 15), 163-166; Payne (n 113), 295-297

<sup>115</sup> Payne (n 113), 302-305; City of London Law Society (n 31)

the US: whether modern restructuring law and practice enables senior financial creditors to capture value which junior financial creditors and shareholders argue should have accrued to them – and, crucially, if it does whether we should be concerned about it.

In assessing the proposed new bargain the traditional approach in Europe has been to ask only whether those creditors who do not receive equity would have been better off if the insolvency route had been followed instead, and the business and assets sold.<sup>116</sup> This is usually established by a short bidding process which fixes the 'counterfactual' market price (the 'auction approach').<sup>117</sup> In other words, the European approach considers whether the bargain leaves some creditors worse off than the alternative, but it does not tackle whether some creditors receive too good a bargain at the cost of others.

Chapter 11 takes a different approach (the 'bargaining and litigation approach'). Concerned that the auction approach may produce an artificially low value when the market is distressed, and there is an absence of bidders and finance, it has left the parties to negotiate value using traditional valuation techniques such as discounted cash flow, comparable pricing and (recently) a private equity valuation, with the judge stepping in to make a

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<sup>116</sup> This also appears to be the approach advocated in the new European Commission Recommendation on a New Approach to Business Failure and Insolvency C (2014) 1500 final, Section III Part C paragraph 22(c)

<sup>117</sup> See Olivares-Caminal *et al* (n 15), 166; Payne (n 113), 297; Paterson (n 26), 341-348



decision if the parties cannot.<sup>118</sup> This gives rise to a different concern: that transaction costs are increased in negotiating with parties who have very little interest in the case, but nothing to lose by delay and debate.<sup>119</sup>

This has led some scholars to suggest a move away from attempting to crystallise value at all given, as we have seen, that economically the new equity holders are reshaping their bargain, but are not crystallising a loss. The alternative 'options model' builds on the seminal work of Black and Scholes.<sup>120</sup> It is still necessary to value the business at the time of the restructuring, and only those creditors with debt covered by the valuation receive equity. But all other stakeholders receive an option with a strike price equal to the full amount of the claims ranking senior to them.<sup>121</sup> Even if the creditors face liquidity constraints in exercising their options, they have a corporate security (the option) which has a value and which they are able to sell in the market.<sup>122</sup> The problem with the 'options approach', though, is that the firm should emerge with a capital structure which properly reflects its future prospects, and problems may arise if the capital structure with which the firm emerges is too complex.<sup>123</sup> Moreover, time

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<sup>118</sup> And this threat of judicial intervention is intended to encourage consensual resolution. See, for example, DG Baird and DS Bernstein, 'Absolute Priority, Valuation Uncertainty and the Reorganization Bargain' (2006) 115(8) *The Yale Law Journal* 1930; Bussell and Klee (n 86), 693-694

<sup>119</sup> For a more detailed description and analysis see Paterson (n 26)

<sup>120</sup> F Black and M Scholes 'The Pricing of Options and Corporate Liabilities' (1973) 81(3) *Journal of Political Economy* 637

<sup>121</sup> L Bebchuk, 'A New Approach to Corporate Reorganizations' (1988) 101(4) *Harvard Law Review* 775; P Aghion, O Hart and J Moore 'The Economics of Bankruptcy Reform' (1992) 8(3) *Journal of Law, Economics & Organization* 523; O Hart *Firms, Contracts and Financial Structure* (Oxford University Press 1995); L Bebchuk, 'Using Options to Divide Value in Corporate Bankruptcy' (2000) 44(4) *European Economic Review* 829

<sup>122</sup> Bebchuk 'Using Options to Divide Value' (n 121), 839

<sup>123</sup> See M Roe, 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 83 *Columbia Law Review* 529

and cost may still be wasted negotiating the terms of the options which, in the event, have very little value indeed.

The ABI Commission takes a different tack again. Very broadly, it adopts the idea of resetting the capital structure with equity holders and option holders but, instead of issuing the options, it uses options pricing methodology to calculate whether the options would have a value if they were issued and were then sold in the market. If the answer is that they would have a value, then the junior stakeholder receives an allocation of value in the restructuring in debt, cash, equity etc. If the answer is that they would have no value then the junior creditor receives nothing at all.<sup>124</sup> It remains to be seen what the market reaction will be to this somewhat complex model. It certainly seems to retain the contours of bargaining and litigation in agreeing the appropriate options methodology, the enterprise value of the company for the purposes of establishing the strike price and the volatility rate for the option.

The author has suggested elsewhere that restructuring law must adopt a middle ground between the ‘best price reasonably obtainable’ approach of insolvency law and the value destructive risks inherent in a subjective valuation approach.<sup>125</sup> Current proposals to deal with this issue in the US include using neutral experts to arbitrate on questions of value,<sup>126</sup>

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<sup>124</sup> ABI Commission Final Report and Recommendations (n 32), 207-224

<sup>125</sup> Paterson (n 26), 353-365

<sup>126</sup> ABI Commission Final Report and Recommendations (n 32), 180-183, building on an idea proposed by Judge James Peck - see ABI Commission to Study the Reform of Chapter 11 Field Hearing 21 February 2013 Las Vegas, Nevada Transcript of Proceedings (available at <http://commission.abi.org>)(last accessed 29 May 2015), discussed in Paterson (n 26), 354-355

and the author has made her own suggestions for UK law.<sup>127</sup> But there is also a pressing need for empirical work to decide whether we care about allocative fairness in the restructuring of financial liabilities in large and larger mid-cap companies, where we are not concerned with debts due to weak or vulnerable creditors, such as employees or small trade suppliers or customers, but with the claims of large, sophisticated financial institutions who make calculated investment decisions, who have the wherewithal to adjust the price at which they transact and who are free to decide whether to transact at all.

It is suggested here that whether the scholar, practitioner or policy maker relates to the progressive school or the law and economics movement, he or she only cares about the allocation of losses amongst these large, sophisticated financial creditors if it has an impact on (i) the total cost of credit (ii) the depth and strength of the finance market (meaning whether any constraints on the availability of finance will emerge) and (iii) the availability of equity financing, for healthy companies. These are complicated questions because the capital structures which the law supports must also match the risk and reward appetite of the providers of finance within a jurisdiction. Within the highly bank-dominated finance market of the UK in the last 50 years it may not have mattered whether or not senior creditor friendly insolvency and restructuring law held back the emergence

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<sup>127</sup> Paterson (n 26), 353-364.

of a strong junior credit market.<sup>128</sup> As we move away from relying solely on banks as the source of capital for corporate Britain it may still not matter if sufficient, all-senior capital structures (at a blended interest rate which is higher than that for senior debt in a senior/junior capital structure but lower than that for purely junior subordinated debt) is available.<sup>129</sup> But if insolvency and restructuring law does influence capital structure, and the structures which it supports are not attractive for all the financiers whom we may wish to attract to the jurisdiction, it may matter very much indeed. US scholars have argued that this is precisely why Chapter 11 seeks to leave the development of capital structures to the market.<sup>130</sup> But this is not quite right either. As the new Commission proposals reignite debate on the role of the law in steering creditor choice between restructuring and insolvency they may very well have an influence on the availability of senior credit and its cost. Without detailed empirical work we can never be confident that any insolvency or restructuring law is a benign influence in the market.

This analysis is only applicable to large and larger mid-cap companies where a restructuring is likely to take the form of an exchange of financial liabilities for equity. The position is murkier for small and

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<sup>128</sup> C Wells and N Devaney, 'Is the Future Secure for Second Lien Lenders in Europe?' (2007) *Journal of International Banking Law and Regulation* 443

<sup>129</sup> On the changing nature of the finance market see AFME Annual Review 2013 and 'Unlocking Funding for European Investment and Growth' commissioned by AFME from Oliver Wyman June 2013 (both available at <http://www.afme.eu/>) (last accessed 29 May, 2015). For concerns about sources of capital in Europe as bank finance continues to contract see AFME and Boston Consulting Group *Bridging the Growth Gap* February 2015 and European Commission Green Paper 'Building a Capital Markets Union' COM(2015) 63

<sup>130</sup> Westbrook (n 4), 826 '... Congress might have decided instead to have a system that encourages the market to decide on the appropriate combination of secured credit, unsecured credit and equity financing for each business. That would be a fair description of the present system in the United States'

medium sized companies, where it is possible that something of a hybrid between restructuring and insolvency may occur. It is unlikely that a debt-for-equity swap will be an attractive solution where there is no liquid market for the shares and it is also unlikely that there will be sufficient financial liabilities to absorb all the losses. Instead, the business and assets may be sold to a new company owned by incumbent management, supported by the incumbent financial creditors who roll over all or some of their debt on new terms to the new company (functionally a debt restructuring), but only some of the trade liabilities may be transferred to the new business and others left behind in the now insolvent corporate shell (as would occur in an insolvency sale). This is a messy (and controversial) scenario but amply illustrates why a different theoretical framework is needed for small and medium sized companies.<sup>131</sup> It is also accepted that special considerations may apply in mass tort cases.<sup>132</sup>

Two further notes of caution are added. First, the article has made the case for the efficiency of the distressed debt market in selecting between good companies with bad balance sheets, and bad companies, but has held its hand up to a lack of detailed empirical support and has pointed to a line of thought in the US literature in the other direction. Clearly more work is needed. At least three obvious areas of enquiry present themselves. The

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<sup>131</sup> It is notable that the ABI Commission report (n 32), 275-296 proposes a different framework for small and medium sized companies

<sup>132</sup> MJ Roe, 'Bankruptcy and Mass Tort' (1984) 84(4) *Columbia Law Review* 846; TS Smith, 'A Capital Markets Approach to Mass Tort Bankruptcy' (1994) 104(2) *The Yale Law Journal* 367; AN Resnick, 'Bankruptcy as a Vehicle for Resolving Enterprise Threatening Mass Tort Liability' (2000) 148(6) *University of Pennsylvania Law Review* 2045

first is considering whether there are particular sectors or types of business where a different dynamic is at play (such as real estate businesses). The second is whether there are structural differences between the UK and the US finance markets which go to the analysis. For example, in the UK the first purchase of distressed debt is still likely to be from a bank. It is possible that banks, constrained by capital requirements and the impact of recognising a significant loss on their balance sheet, drive a harder bargain than those trading debt in the US.<sup>133</sup> If this is right, it might be the case that there is a greater profit to be captured on an enforcement sale and distribution of proceeds in the US than in the UK. Or it may be that more of the section 363 ‘sales’ to financial creditors described in the US literature implicate trade creditors, even in large and larger mid-cap cases, than is the case in a scheme of arrangement ‘twinned’ with a pre-packaged administration in the UK. Finally concerns raised most prominently by Harvey Miller will benefit from examination, as cases which were restructured during the Financial Crisis trade out from it. Mr Miller has argued strenuously that the relatively short term horizon of the distressed debt investors, focused on a rapid exit from the investment within a comparatively short number of years of the restructuring, and the focus on the balance sheet which has been described here, may both have the result that necessary operational restructuring is not undertaken, such that the

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<sup>133</sup> For a good overview of capital adequacy requirements for banks see P Cresswell, WJL Blair, GA Walker, RB Mawrey and C Russo ‘Division A Regulation of Banking 5 Capital Adequacy’ in *Encyclopaedia of Banking Law* (LexisNexis 2014)

company does not emerge in good health and only fails again relatively quickly.<sup>134</sup>

Finally, a note of caution is sounded for the future. This article is written at a time of extraordinary liquidity, fuelled in no small part by government policy in the financial crisis. If this liquidity were to dry up, so that the distressed debt market could not fulfil the role prescribed for it here, then the law and practice of restructuring and insolvency may yet move back to something far more reminiscent of the early 1990s. Moreover, the capital markets are in constant, and rapid, change. Loan agreements typically contain a number of ratios designed to monitor the financial health of the company.<sup>135</sup> As bond issues with very few covenants, and so called ‘covenant lite’ loans, replace loan arrangements with a detailed suite of covenants used to monitor the financial health of the business, it may be that lenders have far less power to bring management to the table early.<sup>136</sup> This may mean that restructuring negotiations are launched in the face of an impending liquidity crisis, so that there is simply no time for those who do not see their future with the company to trade out and those who do to trade in. As ever, writing in a fast moving and unpredictable area, a crystal ball would be a friend.

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<sup>134</sup> For a good summary see Goldschmid (n 26), 265-267 citing H Miller, ‘Delaware Myth’ (n 85). See also Harner ‘The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing’ (n 26), 757 and fn 341. But note Hotchkiss and Gilchrist (n 84), 29-31 (considering survival rates after emergence from Chapter 11)

<sup>135</sup> For a good overview see A McKnight, *The Law of International Finance* (Oxford University Press 2008) 149

<sup>136</sup> See WJ Whelan, ‘Bond Indentures and Bond Characteristics’ in *Leveraged Financial Markets: A Comprehensive Guide to Loans, Bonds and Other High-Yield Instruments* William F Maxwell and MR Shenkman (eds) (McGraw-Hill 2010), 171

## 5 Conclusion

Traditionally US bankruptcy scholars have agreed that it is a central objective of all bankruptcy law to impose a stay on individual creditor action, so that the business and assets can be kept together and restructured if possible, or sold as a going concern if not. Some scholars have also worried that those near the top of corporate bankruptcy law's order of distributional priority will prefer a rapid sale and distribution of proceeds over a protracted restructuring renegotiation. US federal bankruptcy law provides a strong moratorium and strong management rights to address these concerns.

Powerful bank lenders in the English market have traditionally pointed to the danger that a strong moratorium and strong management rights will both reduce the availability, and increase the cost, of credit for healthy companies and will allow companies which ought to fail to continue to trade. These concerns reflect the concerns of law and economics scholars in the US (and the debate between the progressive school and the law and economics movement in that jurisdiction) and have been influential in the development of English corporate bankruptcy law.

Significant changes in the market in both jurisdictions have appeared to be bringing law in action closer together – indeed, US and UK restructuring practice has appeared to be meeting in the middle. But the ABI Commission has made recommendations which appear to reaffirm a



commitment to a philosophically different approach, and the two jurisdictions may yet grow apart again.

This article has suggested that the new market dynamics largely take care of the old policy concerns in large cases. It has argued for a strong, analytic divide between the role of corporate bankruptcy law in the insolvency of large and larger mid-cap companies (when the financial creditors are no longer willing to support it and new creditors cannot be found) and its role where the financial creditors are willing to support the business, but their debt arrangements must be restructured. It has suggested that a new set of concerns arise, which are broadly the same whatever view one takes of the need to protect jobs and more vulnerable trade creditors on the one hand, and the need to protect the state of the finance markets for healthy companies on the other. However, it is recognised that this analytic divide is limited to large and larger mid-cap over-leveraged companies, and the article has suggested the need to think about small and medium sized companies separately. It has also noted the need for further empirical research, and has sounded a note of caution for future adaptations in the finance market.

